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THE FRANCHISE RELATIONSHIP

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1 INTRODUCTION

Franchising is a business relationship by which a franchisor grants an independent operator the right to use its techniques to distribute products or services (often in association with a trade-mark of the franchisor) typically in return for a royalty fee based on a percentage of sales and perhaps other consideration. A franchisor would typically make certain proprietary know how and services available to its franchisees, which could include training, national advertising and other support services. Yet it is a more complex relationship than say, for example, a simple trade-mark license agreement or the grant by a licensor to a licensee of a right to manufacture, supply or distribute a product or service using the licensor's patents, trade-marks and/or proprietary know-how. While franchising often involves such a license, it also includes the right to use the franchisor's method of conducting business.

For those who practice franchise law, it is quite apparent that the term which categorizes their field of specialty, i.e., "franchise law", is truly a misnomer. Franchise lawyers should not only be intimately familiar with franchise legislation and case law, but they should also have some level of expertise in the associated fields of licensing and distribution as they are often called upon to consider these similar and overlapping areas of trade and methods of expansion.

With the wider proliferation of franchise legislation in Canada and the broad and serious legal consequences associated with the breach of such laws, entities that do not consider themselves to be franchising are encouraged to review the legal structure of their existing businesses with their legal counsel to ensure that they are not deemed to be franchisors under the franchise legislation (i.e., "accidental franchisors"). Businesses looking to expand should also consider various licensing, distribution and franchising approaches and means of expansion and their respective advantages and disadvantages before committing to one approach or another. Careful consideration of these distribution techniques is certainly warranted and recommended given the positive and negative consequences associated with each of them.

Before considering in greater detail the franchising option which is the principal focus of this paper, it is important for business owners to consider the various other means of expansion and distribution to determine the best means of expansion before committing to one approach or another. Business owners and their counsel are encouraged to consider whether franchising is actually the most appropriate method of expansion for the business in question. Based upon an analysis of a number of factors, including legal and business considerations, it is quite possible that a business's products or services could be distributed more effectively by means other than franchising.

By way of example, a manufacturer could grant distribution rights for its product to a distributor in the target market; or an owner of a patent or process could license others to produce and market the patented product for sale in a particular market or territory. There are various different means of structuring a distribution arrangement: sales agency, dealership, distributorship, and simple licensing, each of which has its own distinguishing characteristics and its own advantages and disadvantages.

Some businesses, however, will have no other alternative but to establish themselves as a franchise system and in such event, they will need to consider all of the associated ramifications of so doing. Once embarking on a franchise campaign, however, franchisors should consider the various means of expansion within the franchising model of doing business, that is, unit, multiple unit, territorial development, master franchising, area representation, affiliation and conversion, co-branding or multi-branding and joint venture franchising. Each such approach has its advantages and disadvantages, some of which we will explore below.

2 ALTERNATIVE ARRANGEMENTS

(a) Corporate Units

When businesses consider expansion, they often first consider doing so through the acquisition and opening up of additional offices or sites. Doing so certainly has its advantages:

- Businesses may be better positioned to react quickly to changing circumstances.

- Businesses can maintain full control over the business operations of their brands and have the ability to chart the course of their operations without any substantial interference from any third parties.

- Businesses can maintain all revenues generated without sharing any such profits.

- Businesses need not learn how to operate a franchising business and incur the related costs of expansion through franchising.

Expansion through corporate units however does have its disadvantages as well:

- Employees and management may be less motivated than third parties who have a vested interest in the operation of their respective businesses. Though employees can be incentivized through other means such as increased salaries, bonuses, stock options, employee stock plans, restricted stock grants and phantom stock option plans, these arrangements are not always sufficient to successfully motivate employees.

- The risk of loss is not shared with third parties and is wholly assumed by the corporation.

- To expand corporately through unit acquisition requires a significant investment of capital, which is often lacking especially for start-ups and mid-sized companies or is funded on terms and conditions that are disadvantageous to the business.

- The costs associated with growth in infrastructure can be prohibitive, and often thereby serve as a barrier for expansion, especially when the establishment of each business unit involves a large investment of capital (whether located domestically or internationally).

- Businesses incur increased risks relating to leases, offering of assets as security and other legal obligations that they may not have if they were to expand through franchising for example.

(b) <u>Distributorships and Dealerships</u>

A detailed discussion of distribution arrangements is beyond the scope of this paper. However, by structuring its relationship to allow for the mere distribution of its products or services, a licensor/distributor would avoid the extensive legal compliance that may be required if franchise legislation is in force in the target market as well as perhaps avoid the need to oversee as strictly the operation of the business in that market. Avoiding the application of franchise legislation is particularly recommended in those circumstances where there is no need for the licensor or distributor to exert significant control over the licensee or distributor or to provide significant assistance in the operation of the licensee's business operations. Other advantages to distribution arrangements include the following:

- Distribution arrangements are relatively speaking inexpensive as they do not require a large investment of capital or personnel.
- Distributorships are often capable of efficiently distributing products throughout far away and foreign markets with a minimum amount of delay.
- A distributor need not establish and implement complex methods, procedures and designs (often at significant expense) that are associated with franchising systems.

Careful consideration, however, should be given to whether or not the distribution or dealership arrangement is in fact a franchise from a franchise law point of view as it may inadvertently fall within the statutory definition of a franchise. Some of issues associated with becoming an "accidental franchisor" are delineated below. Another disadvantage is the supplier's possible loss of control over the sale of the products or services within the distributor's market and the foregoing of the profits that could be made by performing its own distribution.

(c) <u>Licensing</u>

Andrew J. Sherman provides a succinct summary of the distinction between trade-mark licensing and franchising:

> "Franchise rights can be characterized as "active rights" in contrast to the "passive rights" attendant to mere "licensing". The licensor's interest is normally limited to supervising

the proper use of the license and collecting royalties. The franchisor, however exerts significant active control over the franchisee's operations."[1]

In other words, for example, a company may simply wish or need to license certain of its trade-marks (or its patents, know-how or technology) to its licensees and not feel compelled to significantly control the operations of or provide significant assistance to its licensees. In such a case, a simple license may be preferable to implementing a much more intricate and expensive franchise system.

The advantages of using licensing as a means of expansion include the following:

- Some companies may wish to avoid becoming a franchisor and incurring the associated costs involved in establishing and maintaining a franchise system.

- In addition, some businesses do not have nor do they desire to establish the infrastructure (e.g., operations manuals, franchise training and support mechanisms) required to franchise their business operations. Such companies may also seek to avoid the application of franchise disclosure laws and the costs of complying with such legislation.

- A company may not require that its trade-marks be licensed or they may not have a method of operation to license to their licensees. As such, such a company would not need to consider anything but a simple licensing arrangement.

There are, however, certain disadvantages associated with licensing which include the following:

- A licensor would not have the right or ability to exert as much control over the business operations of its licensees.

- Given the lack of control that is typically associated with a simple license, a licensor is more likely to risk losing its proprietary know-how and systems to unrelated third parties.

(d) <u>Sales Agency or Representative Arrangements</u>

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1 Andrew J. Sherman, Franchising and Licensing: *Two Ways to Build Your Business*, 2nd Ed. (New York: Amacom, 1999), at 349.

Unlike in a typical dealership or distribution arrangement, sales agents or representatives do not take title to or possession of the goods in question but are simply intermediaries as between the manufacturer or supplier, for example, and the distributor, dealer, retailer or customer. While distributors and dealers often have the right to establish their own pricing for the product or service in question, sales agents and representatives do not. The disadvantage of engaging sales agents or representatives to distribute products or services is that such agents and representatives may not accurately represent the brand and that they may only be concerned with earning their commissions.

Manufacturers or suppliers who use sales agents or representatives need to confirm in their sales agency or representation agreements that only they are permitted to extend credit to the ultimate customers, and not the sales agents or representatives. Accordingly, such manufacturers or suppliers are often solely responsible for any risk of payment or collection issues relating to sale of product or services and the sales agents or representatives are often relieved of any liability whatsoever arising out of or relating to same.

When utilizing a sales agency or representative arrangement, query whether:

- Any disclosure document requirements arise in the context of a sales agency or representation arrangement. This would depend on whether a "franchise" is granted and whether the sales agent or representative is deemed a "franchisee" under the applicable franchise disclosure statute.

- Is the sales agent or representative to be accorded exclusive or a non-exclusive rights for and within a specific territory?

(e) <u>Strategic Alliances and Joint Ventures</u>

A strategic alliance or joint venture may be defined as a cooperative arrangement between two or more companies designed to achieve certain shared strategic objectives. A strategic alliance may be equity or non-equity based. Where it is equity-based, a strategic alliance may include a minority stock investment, joint venture and possibly even a majority investment. Non-equity based alliances on the other hand tend to be characterized by a contractual arrangement that specifies each of the party's responsibilities, the mode of operation of the venture and the considerations involved in expanding or terminating the alliance.

A strategic alliance or joint venture is an agreement between two equal or unequal partners. It may be established by the contribution of certain resources by two or more parties to a business or the establishment of another independent joint venture entity whereby each party would provide certain resources to the entity. It is often viewed as a less risky approach to expansion, representing shared risk but also shared control. From a capital investment point of view, a joint venture may reduce each individual venturer's need for capital as the capital requirements would be shared.

Though strategic alliances and joint ventures are often identical in their composition and implementation, there are on occasion some important distinctions between these two modes of conducting business. Though there certainly are hybrid structures that encompass elements of both, strategic alliances are often:

- Shorter term arrangements and are less formal and committal than joint ventures.
- Established and governed solely through contract as opposed to the formation of a separately formed legal entity that would operate a typical joint venture.

3 FRANCHISING

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(a) Advantages to Franchising

Franchisors choose franchising for several reasons, including the following:

- Rapid Market Penetration. Franchising enables franchisors to quickly expand their operations and to penetrate new and existing markets. Except in rare circumstances, it is quite difficult for many start-up companies to open up more than a handful of corporate-owned outlets per year given the constraints in finding the personnel and financing necessary to implement and to manage such an expansion. Yet, a franchisor may expand significantly quicker by adopting the franchising model and by licensing franchisees that are ready, willing and able to share in the burden of such expansion.

- Allocation of Risk. Franchising allows franchisors to spread the risk of growth and expansion among their franchisees, thereby minimizing the overall risk to the franchisor.

- Source of Capital. Where corporate expansion requires significant capital and the securitization of assets, franchising offers a means of expansion that utilizes the capital and the assets of third party franchisees. This is particularly attractive for emerging franchisors for whom capital is scarce and difficult to raise.

- Increased Drive and Commitment. Franchising often engenders a higher level of commitment from franchisees than a non-franchised business would derive from its employees. Employees in a traditional relationship with their employers often lack incentive, given their inability to share in the upside of the success of a business and the often present challenges of advancing up the "corporate ladder". Franchisees, however, may be viewed as being in business for themselves, but not by themselves. Most franchise systems nurture the entrepreneurial spirit, thereby fuelling a franchisee's desire to increase sales and to benefit personally and thereby, the system. Moreover, employees of existing franchisees may have an incentive to perform if they see the potential of owning a franchise themselves. Many employees of prominent franchise systems have subsequently become successful franchisees.

- Consistency. Franchising offers customers consistency in the standards of taste, quality control and in the delivery of goods and services, thereby engendering enhanced customer confidence and loyalty. A patron of a chain of franchised restaurants, for example, will expect to eat the same hamburger or experience the same level of service in Toronto as in New York, London or Moscow.

- Higher Success Rates. New non-franchised businesses are more likely to fail than franchised businesses due to the often unproven and speculative nature of their concepts. Becoming profitable, furthermore, may take longer for non-franchised businesses as they often require additional time to establish their brand in the marketplace.

- Rebates and Commissions. Franchisors may receive the benefit of their enhanced bargaining power with third party suppliers as they generate rebates and other commissions earned on the purchase of product from such suppliers on behalf of, or on account of, their franchisees, which may or may not be shared with franchisees.

Franchising offers franchisees certain benefits as well:

- Brand Recognition. Franchisees are not required to build and develop a business from scratch. With a successful franchise system they are associated with a proven brand and system immediately upon the commencement of their franchised business. Failures of franchised businesses are less likely to occur when franchisees buy into a successful and reputable franchise system.[2]

- Independence. While a typical franchisor highly regulates and controls the franchised business, a franchisee nevertheless obtains some independence in the operation of its franchise. Provided that it strictly follows the operating procedures required of it under the operations manuals and its franchise agreement, a franchisee is otherwise on its own in terms of the day-to-day operation of the franchise.

- Support and Training. Despite having a level of independence, a franchisee also benefits from the system's operating standards and the franchisor's training, support and quality

2 This assertion is based on anecdotal evidence (as there are no substantive studies that could verify this at this time).

control. From the initial training, ongoing training, use of the operations manuals, head office support, advertising expertise, to quality control methods, franchisees may often avail themselves of the expertise of their franchisors and as a result not need to spend months or even years to develop the systems, and to gain the requisite experience, to prosper and succeed.

- Motivation and Incentives. Franchising often provides employees of the franchisor and their franchisees with an opportunity to become franchisees themselves. The prospect and allure of owning a franchise gives employees the possibility of upward mobility and success and an incentive to perform on behalf of the franchisees. Such internal recruitment opportunities from the ranks of the franchise system itself, furthermore, provide the franchisor with a captive market of potential franchisees, without incurring the trouble or expense often associated with sourcing industrious employees for a non-franchised business.

- Economies of Scale. In some systems, franchisors may pass along the benefit of certain rebates and commissions to their franchisees. Even when franchisees are not entitled to share in the rebates provided to a franchisor, they benefit from the convenience of a franchisor arranging for supply and delivery of products or services from suppliers on the franchisees' behalf.

(b) Disadvantages to Franchising

Notwithstanding the above-noted advantages to franchising, it is important to recognize that the very strengths of franchising are often tied or related to its very disadvantages. Prospective franchisors and franchisees should consider these disadvantages when determining whether franchising is the most appropriate business model to adopt for their respective businesses.

Some disadvantages for a franchisor include the following:

- Loss of Control and Possible Diminution of Goodwill. Because franchisors license third parties to use their system and trade-marks, they risk losing control over the quality of the goods and services to be offered by such third parties. Franchisors also expose their trade-marks and goodwill to the possibility of being eroded as a result of the actions of their franchisees. The more parties who utilize the trade-mark and who distribute the goods and/or services associated with the trade-mark, the greater the risk to the franchisor that its reputation will be undermined or that they may become vicariously liable for the actions of their franchisees. The brand recognition associated with a franchise system is essential to protect, as it goes to the core of the success and viability of the system. Ironically, however, it is the very nature of franchising itself that potentially leads to brand erosion in the marketplace, as the franchise system is susceptible to being adversely affected by the actions of some poorly performing franchisees.

- <u>Administrative and Legal Costs of Compliance</u>. Managing and controlling a corporation's employees and/or corporate outlets is relatively easier than controlling "independent" franchisees. Rebellious or insubordinate employees, for example, are much more easily terminated or otherwise disciplined than franchisees that do not abide by franchisor's operating standards. Franchisors will inevitably incur increased administrative and legal costs in their constant vigil to enforce the franchisees' compliance with their franchise agreements and with system standards. Franchisors are often also required to employ additional personnel at significant cost to train and support franchisees, to monitor their ongoing sales and other activities and to generally ensure compliance.

- <u>Locating and Maintaining Qualified Franchisees</u>. It is often difficult for emerging franchisors and some well established franchisors to locate, maintain and to manage qualified franchisees. Locating acceptable franchisees is far more difficult than finding compatible and proficient employees, as franchisees also need to possess certain financial resources in addition to having the requisite characteristics necessary for being a successful franchisee. Once again, franchisors must incur costs to locate and maintain franchisees that meet their minimum financial requirements and other pre-qualifying criteria.

- Disclosure and Other Regulatory Obligations. The disclosure obligations in the Provinces of Ontario, Alberta and Prince Edward Island (and throughout the U.S. and in other jurisdictions world-wide) impose a significant regulatory burden on franchisors seeking to expand in those provinces, states and countries. Prospective franchisors must take into account the related financial cost of compliance with such disclosure (i.e., in the provinces of Ontario, Alberta and Prince Edward Island and in various US states), registration (as in certain U.S. states) and other regulatory requirements before expanding through franchising. Franchisors should also understand and take into account the consequences of their failure to fulfil such regulatory requirements, and in particular, the potential exposure for franchisors and their respective directors and agents.

- Disclosure of Sensitive Financial Information. An associated problem with providing disclosure is that a franchisor will need to reveal its financial statements to prospective franchisees as part of the disclosure obligations under franchise disclosure legislation. Many franchisors consider such information confidential in nature, and they are consequently very often reluctant and unaccustomed to sharing their private financial information with third parties.[3]

- Difficulties in Effecting Change. Franchisors may find it more difficult to roll out a system wide change given the resistance that some or many franchisees may have in implementing such changes.

For a franchisee, franchising also has associated with it certain disadvantages, including the following:

- No Ownership Interest. Franchisees do not gain an ownership interest in the franchise system or the trade-marks. They are simply licensed to use the system and the trade-marks for a specific, limited period of time. Upon expiration or termination of the franchise agreement, therefore, the franchisee will receive no compensation for any

3 Some franchisors circumvent the need to disclose such financial information by incorporating a new franchise company that acts as the franchisor entity.

goodwill that may have accrued to the franchise during the term of the franchisee's agreement with the franchisor.

- Loss of Independence. Franchisees are required to strictly follow the guidelines established by their franchisors from time to time or they risk termination or other severe penalties. Franchisees may be forced to forego their sense of creativity, distinctiveness and entrepreneurial spirit and to instead, abide by a stringent system of rules and operating standards as dictated by their franchisors. Franchisees, therefore, have little latitude and independence in the way that they operate their franchises.

- Lower Rates of Return. One typical feature of franchising is that a franchisee will be required to make regular and ongoing payments of royalties, advertising contributions and other payments to a franchisor. All such payments are made to compensate a franchisor for the franchisee's use of and benefit from a franchisor's trade-marks and system. The payments made to a franchisor will however inevitably reduce a franchisee's profit margin, as the payments are made from the gross (pre-tax) sales generated by a franchisee, which ultimately affects its "bottom line".

4 METHODS OF EXPANSION THROUGH FRANCHISING

Franchisors, like owners of other business formats fear that if they fail to take advantage of an opportunity today, competitors will and the opportunity may not be there tomorrow. As well, the first to occupy a market niche has a significant advantage through brand awareness and developed customer preference and whatever brand loyalty that goes with it.

Franchising itself developed in part to respond to the need for rapid expansion of a business concept by using the franchisee's access to labour and capital to develop new markets. For most franchise systems location is important. Slow growth may allow the best locations to be taken up by competitors. The best franchisees may also be taken. As they seek opportunities, franchisors must examine and assess the following possible range of expansion methods.

(a) Unit, Multiple Unit, and Master Franchising

(i) Single Unit

The most basic way for a franchisor to grow its franchise system is to find additional franchisees to own and operate new franchise units and grow the system one unit at a time. Identifying, qualifying and training franchisees takes significant time, effort and expenditure on the part of franchisors. To speed up the process, many franchisors try to grow their franchise system through various forms of multi-unit development.

From a legal perspective, expansion one franchise at a time is relatively simple since it involves franchise agreements where there are only two parties, with only one franchisee and one additional franchised unit being added to the franchise system per agreement. For multi-unit expansion, there are a host of variations which involve additional complex issues to be addressed in the contractual relationship between the franchisor and the franchisee. Multiple site acquisition or franchise system acquisition is one approach to multi-unit development, but is not covered in this paper. This paper examines three multi-unit expansion options: territorial development arrangements (where a new or existing franchisee obtains rights to develop multiple units in a specific area); master franchising (where the franchisee is granted rights to sub-franchise); and joint venture franchising (where the franchisor invests with a third party to create an entity which becomes the franchisee).[4] These approaches to multi-unit development are examined in more detail below, including the advantages and disadvantages of each.

(ii) Multiple Unit or Territorial Development Agreements

Territorial development agreements are contracts in which a franchisor grants to a franchisee the right to develop and operate multiple franchise units within a given territory, generally pursuant to separate franchise agreements for each unit. The franchisee agrees to a development schedule requiring at least a specified number of units

4 The terms 'joint venture franchising', 'territorial development arrangement" and 'master franchising' are not precisely defined terms and there are many variations of each. "Multi-unit franchising" is used to refer to all of the multi-unit franchising concepts including master franchising, territorial development agreements and joint venture franchising.

be developed by specified deadlines. The franchisee is typically not allowed to sub-franchise, but must develop all of the units independently. Generally multiple unit agreements require the franchisee to pay an upfront fee for the right to develop the territory. This fee is often treated as a deposit towards the development of franchises to be established in the future and are viewed as consideration for the protection of certain territorial rights granted to the franchisee. The franchisee will also pay a continuing royalty or license fee often calculated as a percentage of sales. The franchisee often pays additional development fees to the franchisor with each franchise unit established. The smaller the upfront fee, the larger the per unit development fee is.

(iii) Master Franchising

The term master franchising describes arrangements where a franchisor enters into an agreement with a master franchisee, frequently for a given territory and often providing for development or quota requirements, but also authorizing the master franchisee to grant sub-franchises to third parties. This section considers three variations on master franchising, although different variations or combinations are also possible.

(1) Indirect Sub-Franchising

One approach to master franchising involves a second tier of franchise relationships between the franchisor and the unit franchisees. Under this arrangement, the master franchisor grants to the master franchisee the right to develop and operate its own units, but also to grant sub-franchises to third party franchisees. The master franchisee thus assumes the role of franchisor to its sub-franchisees and these sub-franchisees have only an indirect relationship with the master franchisor.

(2) Direct Sub-Franchising

Another variation again permits the master franchisee to recruit additional sub-franchisees. The sub-franchisee would enter into a unit franchise agreement to which both the franchisor and the master franchisee would be parties. The sub franchisee would pay royalties to the master franchisee, but receive support and supervision from both the franchisor and master franchisee, but primarily from the master franchisee.[5] The franchisor would have direct privity of contract with the sub-franchisee.

(3) Area Representatives

Another approach sometimes (erroneously) described as master franchising involves a more limited role for the master franchisee. Under this arrangement, the master franchisee is essentially an area representative or selling agent for the franchisor. The unit franchise agreement is between the franchisor and the ultimate franchisee and the area representative receives some form of commission for facilitating the transaction. Under this scenario, the area representative may retain obligations to provide training, service or support to franchisees or alternatively may have no further contact with the unit franchisee once the franchise agreement is executed by the franchisor and the franchisee. While sometimes considered master franchising this arrangement is more accurately referred to as an area representative or brokerage arrangement rather than master franchising since there is no sublicense of a trade-mark and no grant of a franchise by the area representative. There may be occasions where the area representative continues to interact with the franchisee from time to time (to provide supplemental training or support for example) but this alone may not be sufficient to constitute a sub-franchise.

These different arrangements can be seen as a continuum within the concept of master franchising. All three involve the franchisor contracting out degrees of responsibility for expanding the franchise system. The differences between the arrangements reflect varying degrees of control being granted to the "master

5 V.S. Roh & W.P. Andrew, "Sub Franchising: A Multi-unit Alternative to Traditional Restaurant Franchising" Cornell, Hotel and Restaurant Administration Quarterly (December 1997) 39 at 40.; H.B. Lowell, "Multiple Unit Franchising: The Key to Rapid System Growth" (Washington: Brownstein, Zeidman and Schomer, 1991 area representation at 40.

franchisee". At one extreme, the master franchisee essentially becomes a franchisor itself of the franchise system, with all of the corresponding rights and obligations of a franchisor (subject of course to the terms and conditions of the master franchise agreement). At the other extreme, an area representative or broker is basically no more than a commissioned representative. It is important to note however that franchisors may choose from a wide and diverse range of possible permutations of these arrangements and that there is no "one size fits all" definitive structure.

(iv) Dual Distribution - Franchising and Corporate Expansion

A business may also adopt a dual distribution approach whereby they expand through a combination of franchising as well as through the establishment of corporate locations. As with other approaches of conducting business, dual distribution carries with it certain advantages and disadvantages. With a dual distribution system, franchisees of the system may perceive that a conflict of interest exists, even where such a perception is not warranted, if they believe that the franchisor is favouring its corporate units over its franchised ones. On the other hand, dual distribution systems allow franchisors to test new products, services or markets within a controlled corporate location, all while continuing to franchise its system.

(b) <u>Advantages and Disadvantages to Unit, Multiple Unit and Master Franchising</u>

- **<u>Applicable to all Multi-unit Franchising</u>**

There are both advantages and drawbacks for franchisors that are applicable to using either territorial development agreements or master franchising to expand their franchise system (and also are applicable to joint venture development which itself could be either territorial development or master franchising).

- **Cash Flow and Cost Effectiveness**

Multi-unit franchising facilitates rapid expansion of a franchised business without the capital outlays by the franchisor that are associated with the development of corporate units or unit-by-unit growth.[6] Granting territorial development rights will normally yield a fee to the franchisor which may exceed the costs of locating, qualifying and training the franchisee receiving the territory. The franchisor's ongoing cash flow may improve due to accelerated development of franchise units and associated royalty revenues.[7] In theory, the cost of capital to franchisors ought to be lower through stock offerings than franchising.[8] At the level of an individual franchisor, however, the franchise expansion through territorial development or master franchising may indeed be the most cost effective means to access capital required for expansion and growth[9].

- **Maintaining Control**

The ability for a franchisor to quickly grow its business without capital investment allows the franchisor to expand quickly without taking on debt or relinquishing control through stock offerings.[10]

- **Administrative Efficiencies**

A further advantage to franchisors of using multi-unit franchising is that it limits the number of franchisees with whom the franchisor has to deal. A more limited number of franchisees at least in theory translates into lower costs to the franchisor for identifying,

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6 G. Taylor, *Franchising in Canada*, 3rd Ed. (Toronto: CCH Canadian Ltd., 1995) at paragraph 110.

7 H.B. Lowell, "Multiple Unit Franchising: The Key to Rapid System Growth" (Washington: Brownstein, Zeidman and Schomer, 1991) at 8.

8 See P.H. Rubin, "The Theory of the Firm and the Structure of the Franchise Contract" (1978) 21 Journal of Law and Economics 223.

9 See Kaufmann & Dant, "Multi-Unit Franchising: Growth and Management Issues" (1996) Journal of Business Venturing 343 at 345. These authors argue after bank loans are exhausted, many entrepreneurs' only access to capital markets is through venture capitalists. When the subjective value of loss of control to the entrepreneur from bringing venture capitalists in is factored into the cost of capital the authors argue that franchising may in fact be the lower cost method to acquire capital..

10 P.M. Birkeland, *Franchising Dreams: The Lure of Entrepreneurship in America* (Chicago: The University of Chicago Press, 2002) at 4, citing A.R. Oxenfeldt & A.O. Kelly, "Will successful franchise systems ultimately become wholly owned chains?" (1968) 44:4 Journal of Retailing 69.

training and supporting franchisees than under other methods of expansion.[11] In addition, a smaller number of franchisees may make it easier to co-ordinate the development of markets,[12] helps exploit existing synergies with productive and successful franchisees and rewards franchisees for their successes to date.

- **Quality of Franchisees**

Multi-unit franchising may enable franchisors to attract more sophisticated investors than would be possible selling single franchise units.[13] More sophisticated franchisees may require less in the way of support from their franchisor and may bring valuable business experience and ideas to the franchise system as a whole[14] as well as capital and local credibility.[15] Multi-unit franchisees are particularly attractive where the area or territory in question is quite different than the franchisor's existing markets and the franchisees have language skills, particular market knowledge and connections in that area not readily available to the franchisor (for example, franchise systems expanding into the province of Quebec). Furthermore, franchisors who can point to the presence of several multi-unit franchisees are more likely to attract a higher number and calibre of prospective franchisees to their franchise systems given that multi-unit ownership is one indicia of a successful system.

- **<u>Advantages Particular to Master Franchising</u>**

- **System Control**

One advantage to using master franchise agreements is the ability to retain direct control over the franchise system and the use of trade-marks associated with it.[16] A franchisor

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11 A. S. Konigsberg, "Development Agreements and Master Franchise Agreements" in P. Denault & LeColton Ed., Franchising-Le Franchisage, 1992 Meredith Lectures (Cowansville, Quebec: Editions Y. Blais, 1993) at 35.

12 Lowell, *supra* note 7 at 8.

13 Konigsberg, *supra* note 11 at 35.

14 Lowell, *supra* note 7 at 8.

15 V.S. Roh and W.P. Andrew, "Sub-Franchising: A Multi-Unit Alternative to Traditional Restaurant Franchising,", Cornell, Hotel and Restaurant Administration Quarterly (December, 1997) 39 at 42

16 Konigsberg, *supra* note 11 at 35.

has greater ability to control the pace of development in order to avoid the risk of over-extending its resources.[17] This element of control also reduces the risk of liability associated with third parties soliciting and selling franchises to new franchisees.[18]

- **Increased Speed of Expansion**

Another advantage to master franchising is greater speed of system growth. The presence of one or many master franchisees opening units directly but also identifying other prospects and granting franchises allows a franchisor to achieve quicker development of the franchise system than would be possible through other more limited expansion vehicles.[19] In describing the rapid growth possible through master franchising, Roh and Andrew cite *Venture* magazine figures attesting that 31 of the 100 fastest growing franchises of the early 1980's adopted some form of sub-franchising arrangement.[20]

- **Other Advantages**

Master franchising also transfers some of the risks associated with expansion from the franchisor to the master franchisee.[21] As well, master franchisees are better positioned to provide greater supervision and quicker servicing of their unit franchisees as master franchisees operate locally[22], provided they fulfill these functions.

- **<u>Drawbacks Common To Multi-unit Franchising</u>**

As with any method of franchising or conducting business, there are however disadvantages to multi-unit franchising as well.

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17 Lowell, *supra* note 7 at 7-8.

18 *Ibid* at 8.

19 *Ibid* at 23.

20 Roh & Andrew, *supra* note 15 at 42.

21 Lowell, *supra* note 7 at 57.

22 *Ibid* at 42.

- **Balance of Bargaining Power**

One drawback of multi-unit franchising is that these arrangements attract more powerful franchisees. The multi-unit franchisees these arrangements create will be more powerful relative to the franchisor than would individual unit franchise holders collectively holding the same number of units.[23] Such a shift in the balance of power is not in and of itself detrimental to a franchisor and its system, but this could cause a franchisor difficulty in circumstances where such franchisees are uncooperative and confrontational in their approach to their franchisors.

- **Inhibited Growth**

Where a franchisor experiences difficulties with some of its multi-unit developers, multi-unit franchising may cause a franchisor to delay its original growth plans in certain key territories. If relations with a multi-unit franchisee deteriorate due to a poorly performing franchisee, franchise development in the entire territory could be compromised or delayed. This is particularly the case if the franchisee defaults, litigation results or the franchisor experiences a delay in finding a replacement developer.[24] Finally, the franchisor may be faced with a situation where a territory has been granted but the multi-unit developer's pace of development is not satisfactory.

- **Limits on Flexibility**

The grant of an exclusive territory or extensive rights in a territory to one multi-unit franchisee may limit a franchisor's flexibility to respond to changing market conditions. If a specific market turns out to be capable of absorbing more units than anticipated, a multi-unit franchise agreement could effectively prevent a franchisor from accelerating the pace of development from that set out in a particular development schedule[25] unless the franchisee agrees and is capable of accelerating development or agrees to withdraw from a certain segment of its territory.

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23 *Ibid* at 8.

24 *Ibid* at 9.

25 *Ibid* at 9.

- **Less Incentive in Aggregate**

Multi-unit franchising results in agency costs associated with separation of ownership and operation of franchised units. One explanation put forward for the success of franchising is that franchising gives the franchisee an economic incentive to be efficient.[26] Franchising removes the incentive that employees have to misrepresent their skills (adverse selection) and their effort (moral hazard), because compensation is determined on the basis of results at the unit franchise level. Multi-unit franchise arrangements of necessity require franchisees to hire employees of their own to manage units. As Kaufmann and Dant explain, "[t]he franchisee's employee managers present the same adverse selection problems to the franchisee that the franchise arrangement was designed to solve for the franchisor."[27] The entrepreneurial incentives inherent to franchising are thereby diluted with multi-unit franchising.

- **Loss of Focus**

Further, a poorly performing multi-unit franchisee may be burdened further by its obligation to develop several units, thereby inhibiting its ability to focus on making its initial or primary units successful.

- **Smaller Pool of Potential Multi-Unit Prospects**

Finally, it is far more difficult to locate franchisees with the financial resources and sophistication necessary to fund, manage and operate multi-unit growth than it is to find single unit franchisees.

- **<u>Drawbacks Particular to Master Franchising</u>**

- **Sharing of Revenue Stream**

A major drawback of master franchising is that it produces lower revenues for the franchisor than other methods of franchise expansion in that the franchise fees and

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26 Rubin, *supra* note 8 at 226.

27 Kaufmann & Dant, *supra* note 9 at 347.

ongoing royalties are shared with the master franchisee.[28] Although master franchising may, if implemented properly, consume less upfront administrative and financial resources, it promises less in the way of long-term revenue stream. In fact, given the three-way split in revenue as among sub-franchisees, master franchisees and their franchisors, it is sometimes difficult for any of these parties to generate sufficient revenues.

- **Potentially Counterproductive Incentives**

Master franchising can create counterproductive economic incentives for master franchisees. As discussed above, one of the major theories explaining the success of franchising as an organizational form is that firms use franchising to create efficiency incentives for franchisees.[29] However, in master franchising, fees received by the master franchisee for recruiting new unit franchisees provide an incentive in favour of short-term gains through franchise sales, often however, to the detriment of long-term goals with respect to franchise performance.[30] A major complaint about master franchisees by sub-franchisees is that master franchisees: "have time to sell the franchises but not to service franchises".[31]

- **Additional Loss of Control**

A further drawback of master franchising is the loss of control it entails for the franchisor. Placing a master franchisee between the franchisor and the sub-franchisee makes it difficult for the franchisor to control the actions of sub-franchisees.[32] Where there is no direct legal relationship between a franchisor and its sub-franchisees, a franchisor has added challenges in order to maintain the required control over, and to prevent misuse of,

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28 Lowell, *supra* note 7 at 24; Roh & Andrew, *supra* note 15 at 44.

29 See Rubin, *supra* note 8.

30 Lowell, *supra* note 7 at 59.

31 Roh & Andrew, *supra* note 15 at 45, quoting S. Hofmeister, "Let them Eat Cake" *Venture* 9:8 (August 1997) 50.

32 Lowell, *supra* note 7 at 24-25.

its intellectual or other property by franchisees.[33] Master franchisees may not be as motivated as a franchisor to police quality at the unit franchise level, leading to erosion of the goodwill associated with the franchisor's trade-marks. Roh & Andrew offer the example of Burger King being forced to abandon a sub-franchising program because its sub-franchisees could not maintain proper standards of quality.[34] Overly aggressive development by master franchisees can also lead to sub-franchisee claims that new units developed are encroaching on their natural territory (whether or not exclusive rights are granted) and cannibalizing sales. On the other hand, it is entirely possible that a master franchisee may be more concerned about system quality and enhancing brand value than its franchisor. Though this may be the case, the possibilities of a loss of control is increased with the number of parties involved.

- **Complexity, Liability**

Other drawbacks of master franchise arrangements include: the legal complexity these structures entail (both at the level of the agreements required to implement these structures,[35] and at the level of compliance with the statutory requirements inherent in developing and operating a franchise business such as disclosure requirements and trade-mark control[36]) and the increased risk to franchisors of vicarious liability inherent in allowing third parties to make representations in the course of recruiting unit franchisees.[37]

In appropriate circumstances, multi-unit franchising can offer many benefits to franchisors seeking to expand their franchise system. The determination of whether to proceed with this

33 Roh & Andrew, *supra* note 15 at 24.

34 *Ibid* at 25 citing Hofmeister, *supra* note 31.

35 Lowell, *supra* note 7 at 25, 42

36 Compliance with the *Trade-marks Act (Canada)* is complicated in master franchise arrangements by the requirement that only the owner of a trade-mark may license its use by a third party. For a discussion of how this obligation is met in the context of various master franchising structures, see Frank Zaid et al., Canadian Franchise Guide, looseleaf (Toronto: Thompson Carswell, 1992) [hereinafter Canadian Franchise Guide] at 3-412. Master franchises are also covered under Ontario's *Arthur Wishart Act (Franchise Disclosure), 2000* S.O. 2000, C. 3 (the "Ontario Act"). Master franchising arrangements thus require the preparation of a separate disclosure statement in jurisdictions with franchise disclosure legislation.

37 Lowell, *supra* note 7 at 42, 58.

strategic approach to expansion, and whether to select territorial development or master franchising, requires detailed analysis. A franchisor must weigh the extent to which the advantages described above are expected to be realized in the contemplated franchise expansion, against the extent to which the possible disadvantages may be experienced. In assessing whether to pursue multi-unit development, franchisors need to further bear in mind that the advantages and drawbacks of multi-unit franchising will be derived and exacerbated when a franchisor leaves greater control in the hands of a master franchisee.

(c) Affiliation and Conversion

Another specialized approach to expansion is affiliation and conversion franchising. In particular, a franchisor may deem it convenient and expeditious to convert and assimilate an existing independently-owned business or businesses to its franchise system and thereby expand its businesses in that manner. Such business or businesses may be affiliated or unaffiliated with another franchised or non-franchised system and/or the affiliation may occur as a result of the merger of two pre-existing affiliated or unaffiliated franchised or corporate-owned systems. The advantages of conversion franchising are obvious as a franchisor may expand quickly by incorporating a number of existing outlets, each possessing some minimal level of experience in the relevant industry, thereby reducing the amount of training and initial support necessary to convert such businesses into the franchised system.

On the other hand, a franchisor that pursues conversion franchising may face franchisees that are less amenable to being trained in accordance with the franchisor's system, given that they may already have (or perhaps incorrectly view themselves as having) extensive experience in the business in question and may be inflexible or disinterested in adapting to new or revised systems and procedures or to the new franchise system. A franchisor may also need to confront the difficult issue of territorial encroachment as exclusive territories may overlap with those owned by franchisees of the system to be merged.

Furthermore, it is quite possible that in converting another franchise system, a franchisor may be forced to accept and incorporate into its existing franchise system a number of poorly performing units. Finally, franchisors contemplating the conversion and assimilation strategy should be cognizant of the differences between assimilating complementary, competing and unrelated businesses as they each carry with them special issues and considerations. It is obviously far easier merging businesses and systems that are similar to each other in substance and in approach than those that are not.

(d) Co-Branding or Multi-Branding

Co-branding or multi-branding is an option for mature franchise systems seeking new and creative ways of generating sales and attracting customers in a highly competitive marketplace. Unlike site-sharing whereby two independent franchise systems share adjacent locations with each other, true multi or co-branding occurs when one owner offers two or more brands at the same location. In Canada, the most famous multi-brand franchise system is that franchised by YUM! Brands, Inc., which offers the KFC™, Taco Bell™ and Pizza Hut™ (among other popular brands).

YUM! Brands, Inc. is an example of a franchisor entity that controls and owns each of the co-branded franchised concepts in its co-branded portfolio. Co-branded arrangements are also formed by and between independent, arms length franchised entities. Tim Hortons™ and Cold Stone Creamery™, for example, recently co-branded nearly 50 restaurant locations in the U.S. and Canada.[38]

Franchisors may choose a co-branding franchising strategy for the following reasons:

- Franchisees may leverage their existing facilities and infrastructure to offer a variety of complementary products and/or services to their customers at one

38 See Business Week July 10, 2009 edition "Tim Hortons and Cold Stone: Co-Branding Strategies" available online at http://www.businessweek.com/smallbiz/content/jul2009/sb20090710_574574.htm.

convenient location. Tim Hortons™ and Cold Stone Creamery™ is a good example of a co-branded relationship which leverages "complementary dayparts [breakfast, lunch, and dinner in restaurant parlance] and seasonality to provide a quality experience for customers, a profitable scenario for franchisees, and to take advantage of prime real estate with little additional capital needed", according to Dan Beem, Cold Stone's president.[39]

- By offering an expanded range of products or services, customers are offered a wider range of products or services at one convenient location. By doing so, a franchisor may thereby increase the customer traffic at the location and ultimately improve the revenues generated from existing locations.

- Co-branding offers the possibility of lower initial and operating costs to franchisors and franchisees as the cost of locating, securing, constructing and operating the facilities may be reduced due to the synergies of having two franchise concepts operating under one roof.

- Brand recognition of the co-branded concepts may be heightened when the concepts are combined and offered as one.

- Franchisors may obtain access to attractive sites which they would not have otherwise.

Franchisors should however consider the following possible disadvantages associated with co-branding[40]:

- The logistical difficulties associated with training franchisees to offer two brands and with ensuring the continued compatibility of the two co-branded concepts.

39 Ibid.

40 For a more exhaustive list of advantages and disadvantages, see Multiplicity: The Challenges of Co-Branding, Andrew Seldon and R. Scott Topp, ABA 26th Annual Forum on Franchising, 2003.

- The franchisor of one of the two co-branded concepts may damage its brand through association with negative attributes subsequently associated with the other franchised concept.

- The legal documentation requires special attention to address the complexities associated with the interrelationship between the co-branded concepts.

- The respective owners of each of the co-branded concepts may lose certain proprietary know-how to each other and the confidentiality of such information may be jeopardized.

- Relationships can change. For instance Tim Hortons and Wendy's started sharing locations while independent and targeting different day parts, Wendy's later acquired Tim Hortons, Tim Hortons moved more into the lunch day part, competing more directly with Wendy's. Subsequently the Tim Hortons and Wendy's systems again became independently owned.

- Conflicts may arise as between the owners of the two co-branded concepts and the concepts may not be ultimately compatible with each other.

Some issues to consider when contemplating a co-branding campaign include the following:

- Are the brands compatible with each other or are they so different or so similar that one of the brands may cause brand confusion in the marketplace? Is it possible that one of the brands may cannibalize the sales of the others and thereby render any co-branding or multi-branding initiative ineffective?

- Are the brands owned by the identical franchisor or by two or more independent and arms- length franchisors? If the latter, codifying the co-branding agreement will inevitably be a more complex venture as details regarding the contractual and operational requirements will need to be negotiated, coordinated and codified into one internally consistent agreement. Alternatively, co-branding or multi-branding franchisors may wish to consider using separate agreements, but in such event, the franchisors will need to consider their interrelationship with each other such as, for example, the impact of a transfer or termination of one or more of the franchise agreements, if doing so is in fact so permitted, upon the remaining agreements. Other provisions which require special attention include provisions which address, coordinate and resolve:

- The length of the term and renewal terms of each of the franchise agreements.
- The reporting requirements so that the franchisees can easily fulfil their reporting requirements.
- Point-of-purchase equipment and other equipment specifications and requirements. Should one point-of-sale register be used for both or all of the concepts or should separate registers be used instead?
- The use and display of the brands' trade-marks and logos on uniforms, menus, signs and promotional literature.
- The physical placement of each of the brands within the facility.
- The special training and support that is required in a co-branding or multi-branding system.
- Any restricted territory issues which may arise from one or more of the systems.
- The unique marketing and advertising issues related to a co-branded or multi-branded system.
- The management and field supervision of the co-branded or multi-branded system to address the unique issues arising therefrom.
- Business issues between operators in a co-operative manner.

Finally, when using separate franchise agreements for each of the separate brands, co-branding or multi-branding franchisors may find an umbrella agreement useful which would coordinate the operation of the two or more franchise agreements and brands and address any possible inconsistencies as among the different systems and agreements.

(e) **Joint Venture Franchising**

In joint venture franchising, the franchisor takes on a partnership role or an equity position in the franchisee entity. The franchisor will license to the venture its proprietary franchise system and knowledge and, at times, will contribute capital to the franchisee entity. The other joint venture partner will typically act as the master franchisee of the franchise system in a foreign territory.

The joint venture entity then typically enters into either a territorial development agreement or master franchise agreement with the franchisor which agreement will govern the development of the franchise system in the designated market. Each franchise developed is governed by a separate unit franchise agreement either with the franchisor (in a territorial development arrangement) or with the joint venture entity (in a master franchise arrangement). This type of relationship requires two distinct contracts. The franchisor and franchisee will enter into the franchisor's typical territorial development agreement or master franchise agreement.

In respect of the joint venture entity there will be also an agreement to govern the relationship of the two parties that have an equity interest in the franchisee. Depending on how this is structured it may be a shareholder agreement, partnership agreement or co-ownership agreement, in each case to govern the relationship between the franchisor and its joint venture partner. Aside from the franchisor's need to maintain control of the franchise system these would be fairly typical agreements.

A joint venture franchise arrangement permits a franchisor greater control or influence over the franchise entity and higher participation in the anticipated return from development than is available through direct franchising. Further, if there are difficulties at the unit franchisee level, the franchisor will have an opportunity to identify them earlier and will likely have greater contractual rights to step in and assume full control.

From the franchisee's perspective, since the franchisor is retaining participation rights in profits the franchisee would typically pay a lower upfront franchise fee to become involved.

Many international franchise transactions have been structured as joint ventures, rather than true franchises, for a number of reasons. Under the law of certain countries, the joint venture is the only structure under law open to foreign investors. McDonald's foray into Russia was structured as a joint venture notwithstanding that it was promoted as a "franchise". A joint venture arrangement may also permit easier access and availability for government subsidies and favourable tax status, which may not be available to other structures. On the other hand, joint venture franchising requires a greater commitment by the franchisor in terms of the amount and extent of capital and personnel involved.

(f) <u>Other Variations of Franchising</u>

The number of possible structures and formats for franchises is virtually limitless. Other variations of franchises include:

- area franchises where a franchisor identifies a good operator and grants it the right to operate multiple sites with existing sites being transferred to the operator rather than being developed.

- grants to franchisees who were formerly employees. Often a franchisor of a business format franchise will identify a talented employee at a corporate location who is felt to have strong potential as a franchisee. Often these individuals do not have the finances to make the investment that a typical franchisee would make (whether for inventory, working capital or store fixturing). The franchisor will develop a special program for such individuals. These arrangements typically involve this person becoming the location operator, being required to purchase certain or all products from the franchisor, and involve some specified allocation of profit or revenue between the franchisor and franchisee.

The advantage of each of these approaches is that it involves a party who has already been identified as having the skill set to operate the business. With grants to employees a common disadvantage is that they do not have the funds to make the investment of a typical franchisee, resulting in the franchisor having greater capital tied up in the expansion.

5 WHAT IS A FRANCHISE? EXAMINING THE LEGAL DEFINITION

Certain business relationships are clearly franchises (such as McDonald's and Tim Hortons). Many other business relationships have been structured without consideration of the impact of being a "franchise" under franchise legislation. To this point the bulk of the franchise related litigation since the introduction of the Ontario Act has focussed on issues such as what constitutes proper disclosure and issues relating to alleged breach, including the statutory duty of good faith and fair dealing, and not on whether a particular business relationship constitutes a "franchise" under the Ontario Act.

American franchise case law has been developing for several decades and may indicate where the rapidly evolving Ontario and Alberta case law is headed on the question of what constitutes a franchise. In an effort to protect franchisees, some U.S. courts have gone to great lengths to find a franchise relationship between parties where such a relationship might not have been expected. Whether Canadian judges will follow their American counterparts remains to be seen, but given the broad wording under the Ontario Act it is very likely that there are businesses in Ontario which are unknowingly offering "franchises" without complying with the statutory requirements.

Unlike their U.S. counterparts, the Canadian judiciary (because of the facts presented to it to date) has not been particularly active in striving to find a franchise relationship in circumstances where the parties themselves may not have realized there was one. Most Canadian cases in which a franchise was found to exist between two parties were based on strong facts that were clearly indicative of a franchisor/franchisee relationship. Such cases are not overly helpful in interpreting the nuances of the Ontario Act[41]. The Ontario Act's broadly worded language, and

41 For example, a series of decisions involving the 3 for 1 Pizza and Wings franchise system and entities found by the courts to be affiliated, including Scott v 3 for 1 Pizza and Wings (Canada) Inc. et al [2003] O.J. No. 3879, Bekah et al v. Three for One Pizza et al 67 O.R. (3d) 305, MAA Diners v. 3 for 1 Pizza and Wings (Canada) Inc. et al [2003], O.J. No. 430, 1368741 Ontario Inc v. Triple Pizza [2003] O.J. No. 2922 (confirmed on appeal [2004] O.J. No. 3562), Ahmed v. 3 for 1 Pizza and Wings (Canada) et al [2004] O.J. No. 144.

the lack of interpretive case law, leaves potential for a franchise to be found in unexpected circumstances - and businesses, and their advisors, should be aware of the risk of a business unexpectedly being found to be a “franchise”. The obligations that may be imposed under the Ontario Act for failure to comply with the Ontario Act, and in particular to meet the disclosure requirements, could be damaging to a business that does not recognize its existing business arrangement is that of franchisor/franchisee. Without the benefit of clarifying judicial decisions, advisors must advise their clients what constitutes a “franchise” in Ontario to avoid a situation where a client unknowingly offers “franchises” without providing disclosure documents and otherwise failing to comply with the Ontario Act.

(a) <u>Franchise Defined</u>

To appreciate how easily a business can be considered under the Ontario Act to be a franchise, we will first overview how “franchise” is defined in the legislation.

Section 1(1) of the Ontario Act defines a franchise as:

A right to engage in a business where the franchisee is required by contract or otherwise to make a payment or continuing payments, whether direct or indirect, or a commitment to make such payment or payments, to the franchisor, or the franchisor's associate, in the course of operating the business or as a condition of acquiring the franchise or commencing operations and,

(b) in which,

(i) the franchisor grants the franchisee the right to sell, offer for sale, or distribute goods or services that are substantially associated with the franchisor's, or the franchisor's associate's, trade-mark, service mark, trade name, logo or advertising or other commercial symbol, and

(ii) the franchisor or the franchisor's associate exercises significant control over or offers significant assistance in, the franchisee's method of operation, including building design and furnishings, locations, business organization, marketing techniques or training, or

(c) in which,

(i) the franchisor, or the franchisor's associate, grants the franchisee the representational or distribution rights, whether or not a trade-mark, service mark, trade name, logo or advertising or other commercial symbol is involved, to sell, offer for sale or distribute goods or services supplied by the franchisor or a supplier designated by the franchisor, and

(ii) the franchisor, or the franchisor's associate, or a third person designated by the franchisor, provides location assistance, including securing retail outlets or accounts for the goods or services to be sold, offered for sale or distributed or securing locations or sites for vending machines, display racks or other product sales displays used by the franchisee.

The definition provides for two types of franchises. Those described in subparagraph (a) are sometimes referred to as "business format" franchises while those described in sub-paragraph (b) are sometimes referred to as "business opportunity" franchises.

To simplify, if a party to a contract meets only three requirements - the fee requirement or required payment (the required payment of money), the trade-mark requirement (substantial association with the franchisor's trade-mark), and the control requirement (by providing for some form of control over or assistance in the manner of operation of the business) - then a franchisor/ franchisee relationship will exist under the business format portion of the definition. For a business opportunity franchise to exist the three requirements are the required payment, a grant of representational or distribution rights for goods and services of the franchisor or its associate (representational or distribution rights), and location assistance. Trade-mark rights are not a required element of business opportunity franchises.

From a jurisdictional perspective one must also be careful. Where a franchise exists outside of Ontario the Ontario Act may still apply. Ss. 2(1) of the Ontario Act states that the Act applies to a business which is "*to be* operated partly or wholly in Ontario". Even if a franchise will not initially operate in this province - the phrase used is "to be operated" - granting of a master franchise or an exclusive territory that includes Ontario would trigger the application of the Ontario Act.

(i) Required Payment

The Ontario Act wording is broader than the wording commonly found in American franchise legislation relating to the requirement to make some form of payment to a potential franchisor. Most American franchise laws require that a "franchise fee" be paid. The Ontario Act's definition of franchise involves the franchisee being required "to make a payment or continuing payments". There is no definition of "franchise fee" under the Ontario Act and the scope of this phrase has yet to be defined, so any kind of payment may qualify. The fee requirement will be met whether such payments are made: (1) directly or indirectly; (2) to the franchisor or its associate; and (3) either as part of the process to acquire the franchise or during its operation. Alberta, and most U.S. jurisdictions, specifically exempt the payment for inventory in reasonable quantities at a bona fide wholesale price from constituting a required payment. Since the Ontario Act has no such exemption it is unclear whether such product purchases will be considered to constitute a "required payment".

Alberta previously required payment of a "franchise fee" in order for there to be a franchise but now, in addition to referencing a franchise fee, also applies the lower standard of any "continuing financial obligation" combined with significant continuing operational controls[42]. By expanding the definition the Alberta Act will apply to many product distribution relationships. If a franchisor has imposed a business or marketing plan and there is "substantial association" with the franchisor's trade-marks, under ss. 1(1)(d)(iii)(B) of the Alberta Act, when there has been payment of a franchise fee as defined, in order to be a franchise there is no additional requirement that there be significant assistance or control.

A payment that does not relate directly to entering into the franchise agreement can satisfy the required payment criteria. In Ontario any kind of required payment or series of payments, (which does not have to be called a "franchise fee"), or required continuing payments, will be

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42 Alberta *Franchises* Act, R.S.A. 2000, c. F-23, ss.1(1)(d)(iii)(A).

enough. Merely having a franchisee commit to make a payment or payments will also be sufficient. A contract with no upfront payment consideration that contains an obligation to make one or more future payments would satisfy the payment requirement even if the future payment required is not paid.

With no existing Ontario cases interpreting the payment requirement and the broad wording of the Ontario Act, it must be considered that the required payment could be met under a wide variety of circumstances. Completely discretionary product purchases should not meet the test of being a "required payment" since they are not "required". If discretionary inventory purchases are considered to be a "required payment" most distribution arrangements would come within the definition of franchise. The result is not clear where a distributor is obligated to purchase or maintain a reasonable inventory of product. If these goods are purchased at a reasonable bona fide wholesale price would that still be found to be a required payment for purposes of determining whether the relationship is a franchise? It may well be, as it meets the technical wording of the statute.

The language in the Ontario Act outlining the "required payment" is similar to the language used in the United States in the Federal Trade Commission franchise rule prior to the 2007 amendments. The portion of the former Federal Trade Commission rule relating to required payments read as follows:

> "franchisee is required as a condition of obtaining or commencing the franchise operation to make a payment or a commitment to pay to the franchisor, or to a person affiliated with the franchisor"

The Interpretative Guides to the prior Federal Trade Commission rule (the "Guides") outlined that payments made by a person at bona fide wholesale prices for reasonable amounts of merchandise to be used for resale, would not be considered to be a required payment. The recently amended FTC franchise rule (effective July 1, 2007 and mandatory July 1, 2008) expressly incorporates the prior interpretative exemption by stating "A required payment does not include payments for the purchase of reasonable amounts of inventory at bona fide wholesale prices for resale or lease."[43] The FTC Guides outlined that hidden franchise fees were what they intended to catch within the phrase "required payment". The Guides referred to a number of items that could be considered to be a required payment. Some are obvious, such as initial franchise fees and continuing royalties on product sales. The FTC Guides also identified less obvious payments that could constitute a required payment such as rent, advertising assistance, required purchases equipment, supplies (including those purchased from third parties where the franchisor or its affiliate receives a payment as a result), payment for training, security deposits, escrow deposits, and equipment rental payments.

Some guidance as to what will be considered to be a required payment can be taken from U.S. cases. While the U.S. statutes typically require payment of a franchise fee, as described above the U.S. franchise fee is more narrowly defined than the Ontario Act provisions outlining what amounts to a required payment. U.S. cases or FTC opinions have held the following fact situations amounted to a franchise fee: charges for the cost of finding retail locations for a manufacturer's product racks and for advertising costs;[44] required purchases of trade-marked motor oil, tires, and batteries from the manufacturer or approved suppliers;[45] payments for employee training, online computer services, and required advertising, promotion and sales materials;[46] and a working capital deposit (even though it was refundable when the relationship ended subject to permitted deductions) since the amount was potentially at risk when paid.[47]

With no Ontario case law interpreting the payment requirement to provide guidance, and the expansive wording of the Ontario Act addressing the nature of "required" payments, it must be analyzed from the perspective that the payment requirement may be met under a wide variety of fact situations.

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43 16 CFR section 436.1(s) extract from definition of required payment

44 *Lobdell* v. *Sugar 'N Spice*, 33 Wn. App. 881, 890 (Wash. Ct. App. 1983), Bus. Franchise Guide (CCH), 7947

45 *Blanton* v. *Mobil Oil Corp.*, 721 F. 2d 1207 (9th Cir. 1983)

46 *Tractor & Farm Supply* v. *Ford New Holland*, 898 F. Supp. 1198, 1204 (W.D. Ky 1995)

47 *FTC Informal Staff Advisory Opinion* 00-2 (January 24, 2000)

(b) Business Format Franchises or Product Franchises

(i) Substantial Association with a Trade-Mark

While business relationships can easily qualify as franchises from the perspective of the payment requirement, the test of substantial association with a trade-mark may be even more easily met.

In the definition of "franchise" a required element in the "business format" or "product distribution" portion of the definition found in part (a) of the definition is the granting by a franchisor of rights relating to sale or distribution of goods or services "that are substantially associated with" the franchisor's intellectual property.

The trade-mark requirement will be satisfied if the grant involves a "right to sell, offer for sale or distribute" goods or services that are "substantially associated with the franchisor's, or the franchisor's associate's, trade-mark, service mark, trade name, logo or advertising or other commercial symbol". The intellectual property does not need to be licensed to the "franchisee" or even owned by the franchisor.[48] There need only be "substantial association" between the goods and services offered and the intellectual property of the franchisor or the franchisor's associate. What constitutes "substantial association" is still subject to interpretation, as it has not yet been judicially considered. Perhaps offering goods or services with any trade-mark on the labelling or packaging will satisfy this requirement.

The Trade-Marks Act, R.S.C. 1985, c.T.-13 requires that a trade-mark be "used" in commerce to be enforceable against potential infringers. "Substantial association" as used in the Ontario Act appears to be a broader concept, based on American decisions that have considered similar phrases. In *Wright-Moore Corp. v. Ricoh Corp.*[49] an Indiana photocopier distributor who was not permitted to use the manufacturer's trade-mark as part of its operating name, but was allowed to hold itself out as an authorized distributor, was found to be operating in "substantial association" with the manufacturer's trade-mark and a franchise relationship was found to exist.

48 Ahmed v. 3 for 1 Pizza and Wings (Canada) Inc., [2004] O.J. No. 144

49 908 F. 2d 128 (7th Cir. 1990)

In Ahmed v. 3 for 1 Pizza and Wings (Canada) Inc.[50] (where no disclosure was provided) a subfranchisor (1571817 Ontario Inc.) did not own the trade-marks but was licensed to use them by 3 for 1, the trade-mark owner, which was an unrelated party. 1571817 argued that because it did not own the trade-marks used by the alleged franchisee, and the owner of the trade-marks was unrelated, that the relationship was not a franchise. The court considered the purpose of the Ontario Act in providing protection to prospective investors through disclosure of material facts, and that the definition of "franchisor" includes a "subfranchisor." The court decided that in a subfranchise relationship the reference to "substantial association with the franchisor's trade-mark" meant in substantial association with the subfranchisor's interest in trade-marks licensed to it, and determined that the relationship was a franchise.

In a California appellate court decision, a "substantial association" was found to exist where the association was extremely limited. In *Kim v. Servosnax, Inc.,*[51] a cafeteria was operated in an office building under contract between the owner of the building and Servosnax. Kim was licensed by Servosnax to operate the cafeteria. The court found that the plaintiff, Kim, was operating in substantial association with the trade-marks of the defendant Servosnax, even though Kim was specifically prohibited from using the marks and the Servosnax marks were not used or displayed in any way at the premises. The court still found a substantial association because Servosnax had communicated its trade-marks to the building owner, who was found to be a "customer" in connection with establishing and maintaining the business and based on that a substantial association with Servosnax's mark was found.

Logic would lead one to think that a retailer such as a supermarket operator should not be a franchisee of each of the suppliers of branded products that it sells, but certainly the trade-mark requirement would be met. If mere product purchases even though voluntary were found to constitute the required payment, since most wholesalers do not sell on consignment, at least theoretically, one retailer could be a franchisee of hundreds of different franchisors. Section 5(7)(e) of the Ontario Act, however, exempts "fractional franchises" from the disclosure

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50 Supra note 48

51 10 Cal. App. 4th 1346 (Cal. Ct. App. 1982)

requirements under the Ontario Act. If the goods and services are to be sold within an existing business of the "franchisee" and at the time are anticipated to be less than the prescribed percentage of total sales (20%), then no disclosure is required under the Ontario Act.

Section 2(3)(5) of the Ontario Act states that the Act does not apply to "an arrangement arising from an agreement between a licensor and a single licensee to license a specific trade-mark, service mark, trade name, logo or advertising or other commercial symbol where such license is the only one of its general nature and type to be granted by the licensor with respect to that trade-mark, service mark, trade name, logo or advertising or other commercial symbol". The parameters of this exemption have yet to be considered by the Ontario courts. In the U.S., a Federal Trade Commission staff advisory opinion states that their comparable exemption for a single license implies that the license must be the one, and only one, granted for the entire United States and that there must not be any way to grant an additional license to anyone.[52] Restrictive parameters such as this may also be applied in Canada, so advisors should be cautious when relying on the applicability of the single-license exemption from the Ontario Act.

(ii) Significant Control or Significant Assistance

In addition to there being a required payment and substantial association with the franchisor's trade-mark rights, there is a third element under the business format definition of "franchise". The franchisor or its associate must exercise "significant control over or offer significant assistance in, the franchisee's method of operation, including building design and furnishings, locations, business organization, marketing techniques or training", as provided in ss. 1(1)(a)(ii) of the Ontario Act. To date there are no Ontario cases considering the phrase "significant control" or "significant assistance" in the context of the definition of "franchise".

It must be kept in mind that "significant assistance" only needs to be "offered" or available, not actually provided to satisfy the "assistance" component. Whether the offered assistance is "significant" is a question to be assessed by the courts in applying this section of the Ontario Act.

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52 FTC Informal Staff Advisory Opinion 00-3, March 20, 2000, Bus. Franchise Guide (CCH) para. 6507 states that unless the license that the licensor wishes to rely on as an exemption to the disclosure requirement is effective in the entire United States, and is exclusive of and superior to all other licenses, the exemption is not available, even if the licensor does not plan to grant other licenses.

Considering whether a contracting party "exercises significant control" is a different analysis. Arguably the determination is made at the time the contract is signed so the relationship is just beginning. There is no historical pattern to consider, only the language of the contract. The analysis will be made taking the entire agreement between the parties into account. The provisions of the Ontario Act refer not to having the potential ability to control. The Ontario Act provides that the ability to control must not only exist but be exercised, either by the potential franchisor or its associate, to meet that portion of the definition of "franchise" under the Act. Given that the assessment of whether there is a franchise is made when the relationship begins there cannot have been any actual "exercise" of significant control. The language of the statute must, however, be given meaning. It must be possible to exercise significant control, so arguably what is meant by the Ontario Act is that the alleged franchisor has contractual rights that amount to significant control.

Again, the American decisions may provide guidance as to how the Ontario Act will be interpreted by Ontario judges. One interpretation of what constitutes "significant control" or "significant assistance" is that significant control or assistance exists where the "franchisee" is more reliant on guidance or control from the "franchisor" than it is on its own abilities. An FTC advisory opinion was provided on the question whether the relationship between Meridien Hotels, Inc. and the Parker-Meridien Hotel in New York, NY was a franchise.[53] Whether the opinion was correct is open to question. Meridien Hotels, Inc. provided the "franchisee" with marketing and sales assistance (including participation in its system advertising plan), along with reservation assistance. The contract between the parties also made other elements of control available to the "franchisor", only some of which were exercised. The FTC found that there was not a significant degree of control and assistance since the management of the "franchisee" was very experienced and did not use any expertise of Meridien in the day-to-day operations of the hotel itself. By this opinion the question whether there is significant control or assistance was determined not by what was available, but rather by what the franchisee actually needed. The test was not objective but rather based on the needs of the specific party. FTC advisory opinions have stated that the entire operation of a franchisee's business must be assessed in determining

53 Informal Staff Advisory Opinion 95-8, August 29, 1995, Bus. Franchise Guide (CCH) para. 6473

whether there is significant control or assistance - as opposed to whether significant control or assistance has been provided for only a small portion of the franchisee's overall business.[54]

The comparable provisions of the Alberta Franchises Act differ from those of the Ontario Act and are more like the wording found in the franchise legislation of many American states. The concept of significant control or assistance is not part of the definition in the Alberta Act. Instead, the definition of franchise requires that goods or services be sold, offered or distributed "under a marketing or business plan prescribed in substantial part by the franchisor or its associate".[55] When the definition of "marketing plan" is considered, the Alberta provision may be broader than the one in Ontario.

Having a plan "prescribed" by the franchisor involves a certain element of control by the franchisor. Since the marketing or business plan must be "prescribed" in "substantial part" by the franchisor this means that the franchisor must direct this aspect of the franchisee's business, at least in "substantial part". Agreements evolve over time. It is possible that increased control or assistance may be exercised by the "franchisor" over time, either by becoming more active or by revising its agreement at the time of renewal or by an amendment. What was once not a "franchise" could evolve into one by changed terms and thus require disclosure. If there is a change in practice but not a change in the actual terms could a relationship become a franchise and require disclosure on crossing some threshold of exercise of control? [56]

(c) <u>Business Opportunity Franchises</u>

For a business opportunity franchise, in addition to payment being required, two additional factors must be present for there to be a franchise.

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54 Informal Staff Advisory Opinion 95-2, February 14, 1995, Bus. Franchise Guide (CCH) para. 6206, and Informal Staff Advisory Opinion 97-7, August 18, 1997, Bus. Franchise Guide (CCH) para 6487

55 *Supra* note 42 at ss.1(1)(d)(i)

56 Dillon, *Annotated Alberta Franchises Act*, Canada Law Book, September 2002, 1-6

(i) Representational or Distribution Rights

There must be a grant of the representational or distribution rights "to sell, offer for sale or distribute goods or services supplied by the franchisor" or its designated supplier. Usage of a trade-mark is not required.

(ii) Location Assistance

In addition to a grant of representational or distribution rights, if the "franchisor" provides "location assistance, including securing retail outlets or accounts for the goods or services to be sold, offered for sale or distributed or securing locations or sites for vending machines, display racks or other product sales displays used by the franchisee" the arrangement will be a franchise (assuming there is a required payment).

Once again the language is inclusive, not exhaustive. It could be argued that location assistance must include either securing retail outlets or accounts, or securing locations or sites. It is more likely, however, to be interpreted that location assistance includes "securing retail outlets or accounts" or "securing locations or sites" but that there could be location assistance of a different nature. To date there are no Ontario cases considering what amounts to location assistance. In the U.S. an FTC staff advisory opinion on a comparable provision indicates that a "franchisor" would not need to actually secure locations to provide "location assistance". Location assistance was found to include providing investors with a list of persons able to provide location services, or instructing investors on how to find their own profitable locations.[57] Other possible examples that might constitute providing location assistance are assisting a franchisee to select a location for its outlet, advising on the fixturing of a retail location, or advising on lease negotiations. It should also be kept in mind that offering or providing such assistance subsequent to the agreement being signed might result in a relationship that was not originally a franchise later becoming a franchise.

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57 *FTC Informal Staff Advisory Opinion* 95-10

(d) When Does a Relationship Become a Franchise?

The Ontario Act defines "franchise agreement" quite expansively, and includes any agreement relating to a franchise between a franchisor or its associate and a franchisee. In 1368741 Ontario Inc. v. Triple Pizza (Holdings) Inc.,[58] the prospective franchisee had signed several documents, paid a deposit and executed documents related to a vendor take back loan, but the actual closing had not taken place. The defendants (Triple Pizza and its affiliate 3 for 1) had not provided any disclosure documents and took the position that, since the closing had not taken place, the plaintiff was not a franchisee and was not entitled to the remedies under the Ontario Act. The court ruled that even though the closing had not taken place the documents signed were a "franchise agreement". Based on that the plaintiff was a franchisee under the Ontario Act and was entitled to rescission rights.

As referenced above conceptually a relationship that was not originally a franchise could later become one. For instance if a required payment is present along with substantial association with a trade-mark, this could happen where the franchisor subsequently introduces substantial operational controls.

(e) Structuring Relationships so they are not Franchises

Structuring business relationships to avoid application of the Ontario Act is difficult. As outlined above for business format franchises the "substantial association" with franchisor intellectual property, and the significant control or assistance tests might easily be met, potentially including a wide range of business structures as franchises.

It may not meet the goals of most business people to structure an agreement so that there is no "required payment". Any mandatory purchases of goods or services by the "franchisee" might need to be avoided. The complete relationship would need to be assessed to avoid the "franchisee" being required to make payment for something (even if relatively minor in nature but over the $5,000 threshold), and through that requirement resulting in the relationship coming within the definition and being a "franchise".

58 Supra, note 41, see also MAA Diners Inc. v. 3 for 1 and Bekah et al v. Three for One Pizza, supra note 41

An alternative is to arrange things so that payments are not made by the potential franchisee to the potential franchisor but instead flow in the other direction, through a commission structure. (This is the business structure used in the insurance field.) A manufacturer could contract with a party to act as its agent to solicit orders for goods, but withhold from the agent authority to enter into contracts. The manufacturer would enter into the contract with the purchaser, receive payment directly and pay a commission to the agent who solicited the order. The manufacturer would need to avoid having a variable commission structure where a lower commission might be considered to amount to the agent being required to indirectly make payment for something.

The question whether an insurance agent is, or can be, a franchisee, has been raised several times in the U.S. In several decisions, the U.S. courts have held that the relationship between the agent and the insurance company was not a franchise. The key to each decision was that the agent did not have the right or authority to "sell" the insurance products of the insurance company. As the agent did not have the right to bind the insurance company, the U.S. courts determined that there could not have been an "offering" of the insurance products by the company to the agent. While the agents are not actually selling the insurance it could be argued that they are "offering for sale" or "distributing" a good or service and an Ontario court might find that there was a franchise relationship. The FTC, in its interpretive guides, has historically stated that "agency relationships in which the independent agents, compensated by commission, sell goods or services (*e.g.* insurance salespersons) are excluded" [from the coverage of the FTC Rule], since there is no "required payment". Instead the money is flowing from the insurance company to the agent. Particular facts may lead to a different result, since virtually any form of required payment could satisfy the terms of the definition.

Alternate approaches to avoid application of the Ontario Act involve relying on one or more of the following exclusions in Section 2(3) of the Act:

> "(3) This Act does not apply to the following continuing commercial relationships or arrangements:
>
> 1. Employer-employee relationship.

2. Partnership.

3. Membership in a co-operative association, as prescribed.

4. An arrangement arising from an agreement to use a trade-mark, service mark, trade name, logo or advertising or other commercial symbol designating a person who offers on a general basis, for consideration, a service for the evaluation, testing or certification of goods, commodities or services.

5. An arrangement arising from an agreement between a licensor and a single licensee to license a specific trade-mark, service mark, trade name, logo or advertising or other commercial symbol where such license is the only one of its general nature and type to be granted by the licensor with respect to that trade-mark, service mark, trade name, logo or advertising or other commercial symbol.

6. An arrangement arising out of a lease, licence or similar agreement whereby the franchisee leases space in the premises of another retailer and is not required or advised to buy the goods or services it sells from the retailer or an affiliate of the retailer.

7. A relationship or arrangement arising out of an oral agreement where there is no writing which evidences any material term or aspect of the relationship or arrangement.

8. A service contract or franchise-like arrangement with the Crown or an agent of the Crown."

Some of these exclusions have already been discussed. The exclusion for an oral agreement appears to be of little use. A franchisor would be expected to want clear agreement terms and to not be interested in an oral agreement. The application of this exclusion is severely limited by the decision of the Ontario Courts in Khachikian v. Williams[59] where there was only an oral agreement. The plaintiff had delivered a cheque for $10,000 to the defendant which had a notation that it was in payment of a "license fee". The court held that although the agreement between the parties was otherwise oral, the notation on the cheque was evidence of a "material term or aspect of the relationship or arrangement" between the parties for purposes of section 2(3). The court held there was a franchise agreement, that no disclosure was provided and the franchisee was entitled to rescind.

There are also disclosure exemptions in Section 5(7) of the Ontario Act which exempt the franchisor from disclosure obligations even though the relationship is still a franchise (which will not be discussed in detail). Other provisions of the Ontario Act would still apply. The fractional franchise exemption in 5(7)(e) is perhaps of most use in trying to avoid disclosure requirements under the Ontario Act. It eliminates disclosure requirements in circumstances where retailers sell branded goods provided by multiple suppliers (provided the 20% threshold is not exceeded).

(f) Unexpected Franchises

Clearly it is impossible to prepare an exhaustive list of circumstances where franchises might unexpectedly exist. By considering the elements of the definition of franchise in the context of fact situations one can appreciate how there may be a franchise relationship where one is not expected.

The most likely source of unanticipated franchises is product distributorships. Many of the elements of the definition of franchise will be present. Any kind of required payment will satisfy the first requirement under the definition in the Ontario Act. As referenced above, the Ontario Act lacks an exemption for purchases of inventory for a bona fide wholesale cost. What if the courts consider "required" to more broadly mean required from a practical standpoint? A distributor may not legally be required to purchase but realistically will not have a choice if the business arrangement is to be successful. If inventory purchases that are not mandatory constitute a "required payment" it should be extremely simple to find a payment, or commitment

59 Ontario S.C H, [2003] O.J. No. 5876 (The defendant was self represented and found to be lacking in credibility)

to pay, in almost any product distribution system, since the goods are typically supplied exclusively by the supplier to the distributor/franchisee. Even if discretionary product purchases are not considered to be a "required payment", as mentioned above there are many other payments that could be required by the relationship which would meet that element of the definition of franchise. Typically distributorships involve distribution of goods or services that are associated with a trade-mark of the "franchisor" which may well meet the second element of the definition. The final requirement, then, is for the franchisor to exercise significant control or offer significant assistance. How this term will be interpreted has not yet been determined. Many agreements contain provisions to the effect that assistance is available on request and that may meet the requirement since significant assistance only needs to be offered, not actually provided.

Some of the distributorships that satisfy the definition are readily identifiable. Automobile dealers, for example, certainly appear to qualify. The trade-mark is included in the name of the dealer in almost every instance and typically there will be some required payment (minimum inventory of vehicles or parts or purchase of promotional materials). Finally, the manufacturer typically retains the right to assist with the selection of or approve the location of an individual dealership. When the Ontario Act was first proclaimed those entitled to exemption from the requirement for financial statement disclosure were required to apply for it and be approved by regulation. Many automobile manufacturers applied for and obtained exemption from the requirement to provide financial statements to franchisees, confirming their assessment that their dealer relationships were subject to the Ontario Act.

Several American cases have held computer software re-seller arrangements to be franchises[60]. The FTC ruled that a service business offering technology integration (configuring computer technology to fit specific customers' needs) was a franchise because the "franchisor" licensed others to use its marketing expertise, advertising and marks in their marketing activities.

Considering business opportunity franchises, companies that place vending machines in cafeterias, schools, and other public places and sell, lease or license the contracts to others are

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60 See, for example, *Current Technology Concepts, Inc. v. IRIE Enterprises, Inc.* 530 N.W. 2d 539 (Minn. S. Ct. 1995), Bus. Franchise Guide (CCH), 10,673

likely franchisors. Private-label automated teller machines, as another example, are usually in locations where one party holds an exclusive contract for the provision of bank machines to such location, and then sub-contracts to an investor the right to purchase, maintain and operate the machine. Payment of some nature is made to the party controlling the location. All the elements of a “franchise” would seem to be present.

As a final example, consider a space sharing arrangement for lawyers operating under a common name which is the “brand” of the practice as a whole. No doubt minimum payments will be required (for rent) and there is substantial association with a trade-mark. The franchise analysis comes down to whether there is significant control or assistance (such as where some form of business or operational advice is provided to the practitioners in the group by one another). Even if there is some form of agreement between the parties disclaiming any control over each other's professional practice, to maintain uniformity in the provision of service each practice may be operated in accordance with some uniform standards or there may be some kind of standardized training required.

(g) Careful Review Required

Since the Ontario Act’s wording is broad, franchises may exist in many relationships not usually thought of as franchises. Practitioners must consider all aspects of a client's business before dismissing the need to comply with the requirements of the Ontario Act.

In considering whether a business relationship is a franchise, it is important to remember that substance is the key factor, not form. Despite planning to avoid the application of the Ontario Act to a business arrangement, it is easy to inadvertently be subject to the Act's requirements.

Advisors to entities that distribute products or services or license business opportunities to dealers, distributors or sales agents need to carefully review the definition of “franchise” in the Ontario Act in light of all the facts in assessing whether a particular relationship is a franchise. Unless a relationship is clearly not a franchise, clients may be well advised to consider a given arrangement to be a franchise and provide the required advance disclosure, since significant obligations may be imposed on a franchisor if disclosure is required but not provided as a franchisee will have the right to rescind or a right of action for damages relating to failure to disclose.

6 CONCLUSION

The franchising relationship is one of several alternative approaches to distribution that permit rapid expansion of a business using someone else's capital. It is not, however, without risk. Territorial development agreements and master franchise agreements establish and govern complex contractual relationships and require detailed advance analysis of the potential alternatives and of the consequences if the relationship does not work. The variations for franchising and otherwise expanding businesses are limited only by the imagination. All variations should be assessed from the standpoint of whether or not they are a "franchise" and as a result, in jurisdictions with franchise legislation, require delivery of a disclosure document by the franchisor before the parties may pay any monies or enter into the agreement.