Franchising Q&A: Canada

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Canada-specific information concerning the key legal and commercial issues to be considered when setting up a franchise.

This Q&A provides country-specific commentary on *Franchising: Cross-border overview*, and forms part of *Cross-border commercial transactions*.

General

1. Is franchising common? What statistics are available to show the importance of franchising in the national economy? What types of products/businesses are susceptible to franchising? What comments can be made about the expansion of domestic franchisors overseas?

The Canadian Franchise Association (CFA) regularly tracks the economic outlook for the franchise sector in Canada, including on its website at *www.cfa.ca/tools_resources/franchise-research-facts/*. The CFA currently provides the following statistics:

- There are approximately 1,380 franchised brands operating in Canada.
- There are over 75,000 franchised units operating across Canada.
- Franchised businesses generate approximately CAD96 billion each year in Canada.
- Over 1.85 million Canadians are employed directly or indirectly by franchised businesses.

In its publication, *CFA's 2018 Accomplishments Report*, the CFA forecasted continued growth across most industries in Canada in which the franchise business model is employed. In particular, between 2017-2018, forecasted growth will be:

- 3.8% in food.
- 3.8% in accommodation services.
- 2.8% growth in retail.
- 2.8% growth in commercial and residential services.

The franchise sector covers many industries and markets in the Canadian economy, including:

- Quick service restaurants.
- Food and beverage.
- Hotel and hospitality.
- Automotive retailing.
- Consumer products and services.
- Telecommunications.
- Education.
- Health services.
- Beauty and cosmetics.

Overseas expansion

2. Does national law permit a foreign franchisor to enter into a franchise agreement without establishing a wholly-owned subsidiary or a branch office in the foreign country?

Yes, foreign franchisors frequently grant franchises directly to Canadian residents without establishing a Canadian subsidiary or branch office. Some foreign franchisors choose to establish a Canadian subsidiary for a number of legal or business reasons, including to simplify compliance with pre-sale franchise disclosure legislation in force in the Statutory Provinces (*see Regulation of franchising*).

Canadian franchise disclosure legislation generally focuses on the disclosure to prospective franchises of material facts that are relevant to the franchisor and the franchise system. This means that certain items of disclosure may be simplified with a newly-incorporated Canadian subsidiary acting as “franchisor”.

3. Are there any rules that would restrict the setting up of branches or subsidiaries or joint ventures by a foreign-owned business?

No.

4. Will there be any difficulties in a domestic franchisee making payment to a foreign franchisor either in local currency or in the currency of the franchisor's country? Are there any exchange controls in operation?

No, unless the franchisor's home jurisdiction is subject to applicable economic or trade sanctions by the government of Canada.

For information on sanctions, see the government of Canada's website at *www.international.gc.ca/sanctions/countries-pays/index.aspx?lang=eng*. The home jurisdiction of the franchisor may also impose restrictions on payments coming from Canada.

Regulation of franchising

5. Is franchising specifically regulated by law? Is any legislation pending, which is likely to affect franchising? Are there any formalities that a franchisor must comply with when setting up a franchise system (for example, any registration or disclosure requirements)?

Franchise legislation in the Statutory Provinces
In Canada, each province has jurisdiction to regulate franchising. To date, six provinces have adopted franchise legislation (the Statutory Provinces):

- Alberta.
- British Columbia.
- Manitoba.
- Ontario.
- New Brunswick.
- Prince Edward Island.

Pre-sale disclosure: Franchise Disclosure Documents. While there are subtle and important differences between the Statutory Provinces, the franchise legislation in each of the provinces is focused on pre-sale disclosure. It is common for franchisors in Canada to use national Franchise Disclosure Documents (FDDs) where they grant franchises in more than one Statutory Province.

A franchisor granting franchises in one of the Statutory Provinces must provide a prospective franchisee with an FDD not less than 14 days before the earlier of either the:

- Signing of the franchise agreement.
- Payment of consideration by the franchisee.

FDDs must contain all material facts, including:

- Facts that are specifically prescribed in the regulations passed under the applicable franchise statute.
- All other facts which can reasonably be expected to have a significant impact on the value of the franchise or the franchisee's decision to purchase the franchise.

For example, the regulation passed under the Ontario franchise statute currently prescribes over 25 different categories of information that must be included in an FDD.

Some of the key subject areas include:

- Detailed background information about the franchisor, its directors and officers.
- Upfront costs to the franchisee to establish the franchise.
- Information concerning the closure of other franchisees in the system.
- Information about specific policies and practices of the franchisor, including:
  - those imposing restrictions on goods and services to be sold;
  - those relating to volume rebates for purchases of goods;
  - information regarding expenditures of the advertising fund; and
  - policies dealing with exclusive territories.

The FDD must also include all agreements relating to the franchise as well as all other material facts.

A number of court decisions have interpreted Canadian franchise legislation as requiring an FDD to include facts and information that are material to the individual location being granted to a franchisee, for example:

- An FDD must include the headlease entered into between the franchisor and the landlord where:
  - the franchisor has entered into a sublease with the franchisee; and
  - the sublease requires the franchisee to satisfy the terms of the headlease.

- An FDD which failed to disclose that the previous owner of the franchise seriously mismanaged the location was held to be deficient.

As a result of these decisions, FDDs in Canada are drafted to include not only facts that are material to the franchisor and the franchise system, but also facts that are material to the individual franchise being granted.

Additionally, every FDD must contain the franchisor's financial statements in either audited or review-engagement form for the most recently completed fiscal year, unless an exemption is available to the franchisor. The FDD can include an opening balance sheet for the franchisor if either:

- The franchisor has been operating for less than one year.
- 180 days have not yet passed since the end of the franchisor's first fiscal year.

Each of the Canadian franchise statutes currently contains an exemption from the requirement to include financial statements for large, mature franchisors who meet the prescribed criteria.

Where a "material change" occurs between the delivery of an FDD and the signing of the franchise agreement or the payment of consideration, a franchisor must also provide the prospective franchisee with a Statement of Material Change describing those material changes. This must be delivered as soon as practicable after the change has occurred.

Exemptions. Canadian franchise legislation contains a number of exemptions from the requirement to deliver an FDD. There are differences in the exemptions available in the various Statutory Provinces and the courts have generally interpreted the exemptions narrowly. Generally speaking, most of the exemptions are limited to the following situations:

- The franchisee already has intimate knowledge of the franchise system.
- The financial risk to and investment by the franchisee are relatively small.
- The franchisee acquires the franchise from a third party without any active involvement of the franchisor.

All Canadian franchise legislation expressly prohibits parties to a franchise agreement from contracting out of or waiving any of the rights or duties contained in the legislation.

Remedies. Statutory rescission is the primary remedy to a franchisee who fails to receive an FDD or who receives a deficient FDD. It gives the franchisee the right to both:

- Terminate all franchise and ancillary agreements with the franchisor without penalty or further obligation.
- Financial compensation.

The financial compensation includes:

- Reimbursement of all monies paid to the franchisor.
- The franchisor's obligation to purchase all inventory, supplies and equipment that the franchisee purchased for the franchise at the price paid by the franchisee.
- Compensation to the franchisee for any other net losses incurred in acquiring, setting up and operating the franchise. In Alberta, only these "net losses" are recoverable.

Given the scope of the rescission remedy, franchisors granting franchises in the Statutory Provinces have strong motivation to ensure their FDDs are fully compliant. The length of time during which the franchisee may seek rescission depends on the gravity of the deficiency in the FDD:

- 60-day limitation period for minor, non-material deficiencies.

- Two-year limitation period for serious deficiencies.

Duties of good faith and fair dealing. In addition to pre-sale disclosure, Canadian franchise legislation also establishes reciprocal duties of good faith and fair dealing for parties to a franchise agreement. This duty requires the franchisor to consider the legitimate interests of its franchisees before exercising contractual rights, and imposes a standard of commercial reasonableness on the parties.

The application of the duty is highly fact-dependant and there is a large body of case law that has interpreted the duty in the context of different types of franchise disputes.

Franchisors are also prohibited from interfering with or restricting franchisees' statutory right to associate with one another in any way and any provision in a franchise agreement that attempts to restrict association between franchisees is void. This provision has been interpreted by the courts to provide franchisees with the right to join together in litigation against the franchisor, for example in a class action.

Quebec Civil Law

While there is no specific franchise legislation in force in Quebec, the Civil Code of Quebec (CCQ) may impose substantive obligations on franchisors.

Under the CCQ, "external clauses" (that is, contractual terms and conditions contained in ancillary documents outside the franchise agreement) must be brought to the attention of prospective franchisees at the pre-contractual phase to be enforceable against the franchisees. This may apply to certain provisions of a franchisor's Operations Manual which contain what are akin to contractual terms and conditions.

The Quebec Court of Appeal has held that the duty of good faith under the CCQ requires a franchisor to bring to the attention of a prospective franchisee any information that might have a decisive impact on the prospective franchisee's willingness to enter into the franchise agreement (*9150-0595 Québec inc. v. Franchises Cora inc. , 2013 QCCA 531*). This constitutes a form of pre-sale disclosure obligation embedded within the CCQ's duty of good faith.

Once a franchise agreement has been entered into, the CCQ may also impose substantive implied obligations on franchisors, outside the written terms of the contract. In the franchising context, Quebec courts have recognised fairly broad implied duties on franchisors arising from the nature of the franchise relationship, including:

- To inform.
- To provide technical and commercial assistance.
- To cooperate and collaborate.
- Loyalty.
- To respect the other party's reasonable expectations and commercial interests.
- To treat parties in similar situations consistently.
- To assist a co-contractor in difficulty and mitigate contractual damages despite clear contractual terms.
- Not to create false expectations.
- To exercise one's rights reasonably.

The Quebec courts have applied these implied duties to sanction conduct by franchisors, even where the franchise agreement did not expressly prohibit the applicable conduct.

For example, in one of the leading cases on the duty to co-operate in franchising, the franchisor developed a market strategy which put certain of its own corporate stores in direct competition with its franchisees. Nothing in the franchise agreement prevented the franchisor from competing with its franchisees and, in fact, the franchise agreement expressly favoured the franchisor on this issue. However, the Quebec Court of Appeal held that the franchisor had breached its "implied obligations which form part of the broader contractual scheme". In the court's view, the franchisor's liability flowed from failing to assist its franchisees in adapting to the system change. The court held that the franchisor, bound by an obligation of good faith and loyalty to its franchisees, had a duty to work with them to prevent economic harm or at least minimise the impact of the system change (*Provigo Distribution inc. v. Supermarché A.R.G. inc., 1997 CanLII 10209 (QC CA)*).

In 2015, the Quebec Court of Appeal applied its earlier decision in *Provigo* in the context of a dispute between franchisor Dunkin Brands and some of its Quebec franchisees. Based on the theory of implied obligations and the duty of good faith, the court read into the franchise agreement an implied obligation on the part of the franchisor to protect and enhance its brand and found that the franchisor had failed to do so. The franchisor was found liable for its failure to do anything in the face of the collapse of the brand in the regional market. Rather than respond to the franchisees' concerns regarding its declining brand, the franchisor sought to impose an expensive renovation programme and required franchisees to sign a release preventing them from bringing a lawsuit of any kind against the franchisor. The court held that the franchisor had breached its implied duty to its franchisees and awarded substantial damages (*Dunkin' Brands Canada Ltd. c. Bertico inc. , 2015 QCCA 624*).

6. Are there any laws, regulations or case law that apply to distributorship or agency relationships that might be interpreted in such a way as to apply to the franchise relationship?

There is no specific legislation that targets distributorships or dealerships in Canada, although certain industries are regulated to protect the public. For example, agricultural equipment dealerships are subject to specialised dealer protection laws in many Canadian provinces.

Depending on the nature of a particular distributorship or dealership, it may fall within the definition of "franchise" in the pre-sale franchise disclosure legislation in force in the Statutory Provinces. For example, some cases in Canada have treated automotive dealers as "franchisees" for the purpose of Canadian franchise legislation.

A number of courts in Canada have ruled that because distribution relationships require mutual trust between the parties, either party may terminate a distribution agreement by giving reasonable notice to the other party in the event of a breakdown in that trust. To enforce this common law right in court, the terminating party would normally need to put forward evidence to demonstrate that the relationship of trust between the parties is broken.

There is also a line of case law dealing with claims brought by customers and other third parties who claim that a franchisor or manufacturer is legally responsible for the acts of its dealers, distributors and/or franchisees. While it is rare in Canada for a franchisee to be treated as an "agent" of its franchisor (and franchise agreements will normally disclaim an agency relationship), the case law has developed a principle known as "apparent authority" (also referred to as "agency by estoppel"). Under this principle, where a franchisor causes third parties who transact with franchisees to reasonably believe they are transacting with the franchisor, the franchisor may be directly liable to

the third party. In order to mitigate the risk of this outcome, franchise agreements and/or operations manuals in Canada would normally require franchisees to identify themselves as being owned and operated independently from the franchisor.

7. **Is there an obligation on franchisors and/or franchisees to comply with any voluntary code? What are the main obligations imposed in such code? Is it usual practice to incorporate the code into the franchise agreement?**

If a foreign franchisor becomes a member of the CFA, it must agree to comply with the spirit of the CFA's *Code of Ethics* in its relationships with franchisees. The CFA lists the following as important elements of ethical franchising practices:

- A franchisor should provide prospective franchisees with full and accurate written disclosure of all material facts and information relating to the matters required to be disclosed in advance to prospective franchisees about the franchise system a reasonable time (at least 14 days) before the franchisee executes any binding agreement relating to the award of the franchise.
- All matters material to the franchise relationship should be contained in one or more written agreements, which should clearly set out the terms of the relationship and the respective rights and obligations of the parties.
- A franchisor should select and accept only franchisees who, after reasonable investigation, appear to possess the basic skills, education, personal qualities and financial resources adequate to perform and fulfill the needs and requirements of the franchise.
- Franchise systems should not discriminate based on:
  - race;
  - colour;
  - religion;
  - national origin;
  - disability;
  - age;
  - gender; or
  - any other factors prohibited by law.
- A franchisor should provide reasonable guidance, training, support and supervision over the business activities of franchisees for the purposes of safeguarding the public interest and the ethical image of franchising, and of maintaining the integrity of the franchise system for the benefit of all parties having an interest in it.

- Fairness should characterise all dealings between a franchisor and its franchisees. Where reasonably appropriate under the circumstances, a franchisor should give notice to its franchisees of any contractual default and grant the franchisee reasonable opportunity to remedy the default.
- A franchisor and its franchisees should make reasonable efforts to resolve complaints, grievances and disputes with each other through fair and reasonable direct communication, and where reasonably appropriate under the circumstances, mediation or other alternative dispute resolution mechanisms.
- A franchisor and franchise support services should encourage prospective franchisees to seek legal, financial and business advice before signing the franchise agreement.
- A franchisor should encourage prospective franchisees to contact existing franchisees to gain a better understanding of the requirements and benefits of the franchise.

A franchisor should encourage open dialogue with franchisees through franchise advisory councils and other communication mechanisms. A franchisor should not prohibit a franchisee from forming, joining or participating in any franchisee association, or penalise a franchisee who does so.

Competition law

8. **Are there any national laws or regulations that would affect the following business practices:**

- **Exclusive dealing?**
- **Territorial restrictions?**
- **Customer restrictions?**
- **Resale price maintenance?**
- **Minimum purchase targets?**
- **Imposition by the franchisor of restrictions on the sources of supply to franchisees?**
- **Discrimination by the franchisor among franchisees for fees, royalties, payment for goods, services, and so on?**

All franchise and distribution relationships in Canada are subject to the federal Competition Act, Canada's competition (antitrust) legislation. The Competition Bureau is responsible for enforcing the Competition Act. The business practices considered above (to the extent they are vertical in nature, that is, as between the franchisor and the franchisee) are reviewable practices under civil law, according to the Competition Act.

Therefore, they are only subject to review if they negatively impact competition in the relevant market. However, these business practices are unlikely to lead to scrutiny under the Competition Act unless the franchise system has market power, which typically requires considerable market share. The Competition Tribunal is the adjudicative body that hears reviewable practices cases.

Non-price vertical restraints. The following non-price vertical restraints fall within a single provision of the Competition Act:

- Exclusive dealing (that is, where the franchisor is the exclusive supplier).
- Tied selling, for example where minimum purchase targets and restrictions on sources of supply are required by the franchisor for the franchisee to purchase a separate product.
- Market restriction, for example where the franchisor mandates territorial or customer restrictions.

  (*Section 77, Competition Act*.)

Again, these practices are unlikely to lead to scrutiny under the Competition Act unless the franchisor is considered to have "market power".

A critical requirement for a successful application by the Competition Bureau or private parties is proof that the practice is likely to (or already does) substantially lessen competition in the relevant product or services market. To meet that burden it must be proved that the conduct materially creates, enhances or preserves market power, a difficult threshold to meet. A 35% market share is generally considered to be the minimum threshold for the Competition Bureau to initiate an action. There are no monetary penalties available, but the Competition Tribunal can make an order prohibiting the franchisor from engaging in the conduct and order any other requirement considered necessary to restore competition in the relevant market.

Refusal to deal (section 75). This is another type of non-price vertical restraint, for example where a franchisor refuses to supply a franchisee. The potential consequences are the same for the restraints discussed above. Among other requirements, it must be proved that the victim's business has been substantially affected and that they are willing to meet the usual trade terms. There must also be an adverse effect on competition in the relevant market. While an "adverse effect" on competition is a lower threshold than a "substantial lessening" of competition, a finding that market power has been created, enhanced or preserved is still required. As such, a franchisor with less than 35% market share will not typically attract any scrutiny from the Competition Bureau.

Resale price maintenance. This is a vertical price restraint and is known as price maintenance under the Competition Act (section 76). A typical example is where the franchisor sets a minimum price or otherwise causes an increase in the prices that the franchisee charges to customers. Price maintenance used to be a per se criminal offence until 2009, when it was changed to become a practice reviewable under civil law. As a reviewable practice, it requires proof that the conduct has an adverse effect on competition in the relevant market, the same standard as for refusal to deal (discussed above), which requires that market power has been created, enhanced or preserved. There are no monetary penalties for price maintenance either, but the Tribunal can make an order prohibiting the franchisor from engaging in the conduct.

Discrimination. Discrimination by the franchisor among franchisees will not typically raise competition issues. The Competition Act's price discrimination provision was repealed in 2009.

Abuse of dominance. The abuse of dominance provisions in the Competition Act (sections 78 and 79) are also important. They function as a catch-all and can encompass conduct that meets the definitions of other reviewable

practices under civil law. Abuse of dominance occurs where a party (or joint parties) with market power engages in a practice of anti-competitive acts that substantially prevents or lessens competition, or is likely to do so.

In short, while competition risk exists in franchise arrangements, the requirements for market power and a negative effect on competition mitigate that risk. Additionally, the absence of monetary penalties, except for abuse of dominance, also tempers the potential downside.

Where a franchisor operates a dual-distribution model and can be interpreted as competing against its franchisees, we recommend that the Competition Bureau's *Competitor Collaboration Guidelines* be reviewed. Moreover, any agreements or arrangements between individual or groups of franchisees relating to pricing or other competitive issues may well contravene the Competition Act's criminal prohibition on conspiracies/arrangements between competitors.

9. **Are there any local provisions relating to the imposition of minimum or maximum prices?**

See *Competition law*. The imposition of minimum prices would be subject to the price maintenance provision of the Competition Act, which is only engaged where the practice has an adverse effect on competition in the relevant market.

There is no restriction on the imposition of maximum prices by franchisors.

10. **Are there any laws or regulations relating to restrictive covenants or covenants not to compete during the franchise agreement? To what extent is it possible to continue the restrictions after the agreement has expired? In particular, to what extent does the geographical extent and or the length of time of the restriction affect its enforceability?**

Under Canadian common law, which applies in all provinces other than Quebec, restrictive covenants and covenants not to compete are considered restraints on trade and are unenforceable unless they meet the following test:

- The **franchisor** must establish that the restrictive covenant is reasonable between itself and the franchisee. This requires the franchisor to demonstrate that the scope of the clause in terms of territory, duration and subject matter is necessary for the protection of the franchisor's legitimate or proprietary interests.
- If the covenant survives the first inquiry and the franchisee still wants to challenge its enforceability, the **franchisee** must establish that the restrictive covenant is contrary to the public interest or otherwise

offends public policy. This inquiry tends to focus on the wider economic and market context and as a practical matter is rarely engaged or dispositive in the case law.

The Supreme Court of Canada has recently recognised that the substance of this test also applies in the Province of Quebec (*Payette v. Guay Inc., 2013 SCC 45 at paragraph 40*).

Canadian courts have confirmed that a number of business interests are entitled to protection through restrictive covenants, including:

- Trade secrets.
- Confidential information.
- Trade connections.
- Books of business.
- Information about customers' preferences.
- Proprietary pricing models.
- Unique merchandising styles.

In the context of franchise litigation dealing with the enforceability of a restrictive covenant, courts will require evidence from the franchisor that it has a true interest that is worthy of protection through the restrictive covenant and will not simply accept that the franchising business model automatically requires protection.

In assessing the overall reasonableness of restrictive covenants, Canadian courts consider their scope in three different respects:

- **Temporal scope.** In recent years, the majority of restrictive covenants examined by the courts in the franchising context have had a temporal scope of up to two years, although longer terms have also been enforced in appropriate cases.
- **Spatial or geographic scope**. The geographic scope of the covenant must correspond to the franchisor's legitimate business interest. A franchisor will likely have to establish that it intends to grant another franchise or operate a corporate within the territory of the former franchisee to enforce the restrictive covenant.
- **Subject matter scope**. The activities that are specifically prohibited by the restrictive covenant must also go no further than necessary to protect the franchisor's legitimate interests. If the market in which the franchisor operates is highly segmented, a best practice may be to narrow the scope of the covenant to the segment in which the franchisor truly competes.

The same legal test applies to non-competition covenants that operate during the term of the franchise agreement ("in-term" covenants) as to covenants that apply for a period of time after the termination or expiry of the franchise agreement ("post-term" covenants). The only notable difference between these two types of covenant is the fact that the temporal scope of in-term covenants will by definition be narrower. Therefore, the courts may treat in-term covenants as more reasonable overall.

To the extent that a franchisor would otherwise compete with its franchisees, there are additional considerations under the Competition Act. While naked agreements between competitors or potential competitors not to compete are criminal, non-competition agreements within a large franchise arrangement would likely be considered ancillary

to a legitimate business purpose. As such, if the Competition Bureau chose to investigate in that context, it would be under a civil provision of the Competition Act that prohibits agreements that substantially prevent or lessen competition, or are likely to do so. The potential consequences do not include monetary penalties.

11. **Does national law allow the franchisor to retain for its own exclusive use volume rebates, commissions, allowances paid by suppliers of products or services to franchisees?**

Canadian law does not prohibit franchisors from retaining for their sole benefit all volume rebates, commissions, allowances or other financial benefits that they receive from suppliers or vendors that provide products or services to franchisees. However, to mitigate the risk of a breach of contract claim from the franchisee, it is best practice to expressly provide the franchisor with the right to retain these benefits in the franchise agreement.

Moreover, the pre-sale disclosure legislation in force in the Regulated Provinces requires the franchisor to disclose (in the FDD) any practices and policies with regard to the retention of monetary or other financial benefits that the franchisor receive from vendors or suppliers of its franchisees.

On its own, such conduct by the franchisor should not raise competition issues.

Intellectual property

12. **How are trade marks protected under national law?**

The Federal Trade-marks Act protects trade marks that identify the source of goods or services. At present, rights in a trade mark are created through use in Canada or, in the case of foreign owners, by use abroad and eventual registration in their home country. It is possible to reserve rights in Canada on the basis of an intention to use a trade mark in Canada in the future. Registration provides the exclusive right to use the mark throughout Canada and facilitates enforcement.

Without a registration, an owner's rights are limited to the territory where the mark has been used. If the trade mark owner intends to license the mark for use by others, even by a subsidiary company, it must retain the right to control its use by the licensee in order to maintain registration. It is possible for a trade mark registration to be attacked on the basis of non-use or an invalid registration. The first term of a registration is for 15 years and is renewable for successive 15-year terms on payment of a renewal fee.

Canada is not a member of the Madrid Agreement, the Madrid Protocol, or the Singapore Treaty, but is taking steps toward accession through legislation that is expected to come into force in 2019. These amendments will expand protection to novel "signs" or "combinations of signs" which have become distinctive as of the application filing date, including:

- Letters.
- Numerals.
- Figurative elements.
- Three-dimensional shapes.
- Colours.
- Holograms.
- Sounds.
- Scents.
- Tastes.
- Textures.

The amendments will also effectively remove the requirement for an applicant to have made "use" of a trade mark in Canada or elsewhere before obtaining registration. In addition, the amendments will implement the Nice Classification and shorten the initial term and renewal term to ten years. Last, they provide fuller remedies for infringement, especially in respect of the importation of goods into Canada.

13. **In the event that the franchisor is based abroad, is it necessary that the franchisee is registered as owner or user of the trade mark in order to be able to import goods bearing the trade mark?**

No, the foreign franchisor will virtually always register the applicable trade mark(s) in Canada and license those to its franchisees. Franchisees may import goods bearing the trade marks without being registered as an owner or user of those trade marks.

Case law applicable in Canada also explains that use in Canada by a wholesaler or distributor of goods bearing the trade mark of a foreign trade mark owner was "use" by the foreign owner, not the Canadian importer. This case law has been employed to strike trade mark registrations improperly reserved by such intermediaries who ought to have been acting on behalf of the foreign owner.

14. **What intellectual property rights are typically licensed in a franchise agreement?**

Franchise agreements typically license to franchisees the franchisor's trade marks as well as any other intellectual property that is necessary for the franchisees' participation in the franchise "system". Franchise "system" is typically a defined term in the franchise agreement and depending on the system may include the following distinctive features of the franchisor's business and operations:

- Trade secrets.
- "Know-how".
- Trade dress.
- Copyright materials.
- Confidential information.

15. **What provisions are usually made in respect of trade marks in addition to any licensing of their use?**

There are a number of provisions that commonly appear in a franchise agreement:

- The franchisee agrees not to contest validity or ownership of marks by the franchisor (either directly or indirectly through assisting a third party).
- Control provisions to maintain the "quality and character" of the associated goods or services. These provisions are necessary in order for the trade mark owner to benefit from the franchisee's use under section 50 of the Trade-marks Act and include:
    - a standard of use;
    - a right to inspect or audit;
    - an obligation to follow branding guidelines; and
    - other similar features.
- An obligation to notify the franchisor of any suspected unauthorised use or any challenge. The franchisor has exclusive right to initiate, direct or control relevant proceedings.
- An express right for the franchisor to add to, change, discontinue or substitute any of the marks.
- A number of specific rules such as "only use as authorised", "do not use as part of corporate name".
- Intellectual property indemnities (in the event of third party lawsuits).

16. **Does the franchisee become entitled to any rights in a trade mark (or any other intellectual property right) by virtue of selling the trade marked products in its territory?**

No, the franchise agreement will invariably provide that the franchisee shall in no circumstances become entitled to any legal rights or goodwill in a trade mark or other intellectual property (other than the limited rights of a licensee). As noted above, caselaw has been employed to strike trade mark registrations improperly reserved by intermediaries who ought to have been acting on behalf of a foreign owner.

17. **What provisions are usually made in respect of goodwill?**

Franchise agreements in Canada will typically provide that all goodwill that is generated from use of the trade marks and other intellectual property licensed to the franchisee will inure to the sole benefit of the franchisor.

18. **Can the franchisor impose restrictions on the use of the franchisor's know-how and other confidential information by a franchisee either during or after the expiration of the franchise agreement?**

Yes, franchisors can impose these restrictions through restrictive covenants and confidentiality and non-disclosure provisions in the franchise agreement which can survive termination or expiry for a reasonable period of time. These types of provisions are subject to the legal principles as to enforceability discussed in *Question 10*.

19. **Are there any competition law implications of licensing intellectual property rights?**

In practice, the Competition Bureau will not intervene in respect of the mere exercise of an intellectual property right. However, where there is "something more" than the mere exercise of an intellectual property right (for example, the accumulation of intellectual property rights in order to control a market) that is lessening or preventing competition in the relevant market, the Competition Bureau may investigate under the provisions on practices reviewable under civil law of the Competition Act. Nonetheless, intellectual property rights are typically respected by the Competition Bureau.

Details on the Competition Bureau's views on the interface between intellectual property law and competition law are found in its *Intellectual Property Enforcement Guidelines*.

Real property

20. **Are there any restrictions on ownership or leasing of immoveable property that may arise in a franchising situation?**

In certain industries in the franchising context, such as quick service restaurants, it is common for the franchisor to enter into headleases directly with landlords (especially for key locations). In this situation, the franchisor will sub-lease the premises to franchisees. In other contexts, landlords prefer to have the franchisor as headleasee rather than individual franchisees.

Where the franchisee leases the premises directly from the landlord, the franchisor will sometimes attempt to cause certain terms to be inserted into the lease which benefit the franchisor or which provide the franchisor with certain controls over the location. The Franchise Agreement may oblige the franchisee to attempt to have such terms inserted into the lease, although as a practical matter the landlord may refuse. The key term that franchisors seek to have inserted into the lease in this respect is an option in favour of the franchisor to take over the lease in the event of expiry or termination of the lease or of the Franchise Agreement.

Employment issues

21. **Is there a risk that franchisees may be treated as employees of the franchisor?**

Many different statutory regimes apply across Canada in the following areas:

- Labour relations.
- Employment standards.
- Workers' compensation.
- Occupational safety.
- Human rights.

These regimes have different ways of addressing the concept of employment. Generally speaking, labour relations boards and courts in Canada have recognised that the typical level of control that a franchisor exerts over its franchisees is not sufficient to establish the franchisees as "employees" of their franchisor. Instead, in the typical franchise relationship, franchisees are generally considered to be independent contractors under Canadian common law principles.

Similarly, in the context of the typical franchise relationship, labour relations boards and courts in Canada have generally refused to find franchisors to be joint employers of their franchisees' employees, except for exceptional circumstances.

However, courts and tribunals in Canada always examine in detail the facts surrounding the individual franchisor/franchisee relationship in a case. They have been prepared in appropriate cases to find an employment relationship where the franchisor's level of control over the franchisee is extraordinary or where the franchisee effectively functions as a manager rather than an owner.

Some examples of circumstances where Canadian courts and tribunals have departed from the general rule that franchisees are independent contractors include:

- A franchise arrangement where the franchisor paid the franchisee a fixed sum for compensation, owned the franchisee's inventory, and paid the franchisee's employees.
- A franchisor who owned the franchisee's premises, inventory and proceeds of sale was found to be in an agency relationship with the franchisee (and therefore liable under provincial workers' compensation legislation).
- A franchisor who assumed direct management over a franchisee's location has been found to be the co-employer of the franchisee's employees during the period of direct management.

The franchise agreement

22. **Are any particular formalities required for a franchise agreement to be enforceable under national law?**

Under Canadian law, subject to pre-sale disclosure legislation in the Statutory Provinces, a franchise agreement is governed by general contract law principles. To be enforceable, a franchise agreement must meet the normal requirements for the enforceability of commercial agreements.

23. **What rights does the franchisor usually grant to the franchisee?**

In Canada, franchise agreements typically grant a franchisee the right to operate the business using the franchisor's trade marks and system standards, at a particular location and/or within a particular territory, for a specified period. The right to use the franchisor's system usually includes the right to access the franchisor's confidential Operations Manual.

24. **Is it usual for the franchisor to grant exclusivity? Does this have any competition implications?**

Although practice varies by industry, many franchisors will grant the franchisee some form of limited exclusivity, traditionally restricted to a reasonable geographic scope and for the duration of the franchise agreement's term. However, some franchisors provide no exclusivity.

Where broader exclusivity is granted, franchisors will typically restrict the protection to the same type of outlet being operated by the franchisee and will reserve for themselves the right to other types of outlets, such as non-traditional locations (for example, hospitals and sports arenas) or the right to distribute branded products and services through non-traditional channels (for example, e-commerce, telephone sales and grocery stores).

In practice, exclusive territories rarely raise competition law issues, although the growth of e-commerce and omni-channel distribution networks may see a narrowing of rights traditionally reserved to the franchisor and territorial encroachment claims against franchisors.

25. **What term is commonly agreed for a franchise? Is it common to include a test period?**

The term of a franchise agreement will vary depending on the type of business and industry at issue and the amount of initial investment required by the franchisee. In the quick service and casual dining restaurant industries, it is common to grant ten-year initial terms, with one or two renewal periods of five years each. However, in other industries, for example, automotive retailing, terms can be significantly longer or evergreen, although we have also seen shorter terms.

It is common to include test period provisions in master franchise and area franchise agreements, but less so in unit franchise agreements. In unit agreements a notional "test period" is commonly incorporated through the training programme offered to new franchisees. The franchisor reserves the right to terminate the grant or require the franchisee to complete additional training, as necessary, if the franchisee fails to complete the initial training programme (that is, the notional "test period") to the franchisor's satisfaction.

26. **What rights of renewal are commonly included in the agreement? Is a charge made for renewal?**

Most franchise agreements include renewal rights. It is common for franchise agreements to provide the franchisee with a specified number of renewal options, which can only be exercised by satisfying certain express conditions.

The number and length of the renewal options varies by industry, but a common formula is an initial term of ten years, with two renewal options of five years each. The franchise agreement may provide for payment of a renewal fee as a condition of renewal, however, in practice, franchisors may waive or reduce the fee. Other common renewal conditions include:

- Notifying the franchisor of the intention to renew within the designated time period.
- Having substantially observed and performed all obligations under the franchise agreement and any other agreement signed with the franchisor.
- Ensuring the remaining term of the lease for the premises is at least as long any renewal term granted.
- Renovating the premises.
- Entering into the franchisor's then-current form of franchise agreement.
- Signing a general release of claims against the franchisor (although this requirement is unenforceable in the Statutory Provinces unless statutory claims are exempt from the release).

27. **Does national law impose any obligations on the franchisor?**

Federal law does not impose any specific requirements on franchisors with respect to franchise agreements, as franchise law is provincially regulated in Canada. However, competition (anti-trust) law and intellectual property and trade marks law are federally regulated in Canada and are addressed in other portions of this guide.

28. **What events will be regarded in law as justifying termination of the franchise agreement? Do any statutory obligations arise on termination? What provision is usually made in the agreement for termination?**

In the Statutory Provinces, franchisees have time-limited rights to terminate (rescind) a franchise agreement where there has been a breach of the disclosure requirements of the franchise legislation (*see Regulation of franchising*).

The rights of franchisors to terminate franchise agreements are not directly regulated by statute in Canada and instead are addressed by the express terms of the contract and common law principles.

In the Statutory Provinces, the duty of good faith and fair dealing also limits franchisors' rights to terminate, but this duty is generally considered to codify the common law.

Franchise agreements in Canada commonly give the franchisor the right to terminate "for cause" (that is, where certain specified events or circumstances occur). Generally speaking, courts will enforce contractual terms that provide franchisors with the right to terminate, provided the termination process is procedurally fair to the franchisee and termination in the circumstances is not grossly disproportionate to the franchisee's conduct.

Less commonly, franchise agreements may provide the franchisor with the right to terminate "without cause" (that is, for any reason), provided that notice is provided to the franchisee as set out in the franchise agreement. These provisions have generally been enforced by the courts.

The provisions on termination "for cause" usually deal with two different scenarios:

- The right to terminate is immediate upon the occurrence of the specified event or circumstance, with the franchisee having no right to receive advance notice. This scenario is limited to the most serious types of defaults or events, for example:
  - franchisee bankruptcy or insolvency;
  - abandonment of the business; and
  - fraud.
- For less serious defaults, the franchisor may typically only exercise its termination rights upon providing advance notice to the franchisee and an opportunity to cure. These provisions tend to be lengthy and deal with a myriad of potential defaults under the franchise agreement and other circumstances. For routine or non-serious defaults, these provisions typically contemplate the franchisee having been provided with a period of time during which to cure the default before the franchisor will have a basis to terminate.

It is also increasingly common for franchise agreements to contain a "three strikes" termination clause, which allows for termination where the franchisee has been in breach or default of the franchise agreement on three separate occasions during the preceding 12-month period or some other specified period.

29. **What rights does the franchisee have to compensation on termination of the franchising agreement? How is compensation for termination calculated?**

Generally, franchisees have no legal right to compensation on termination of the franchise agreement where the franchisor's termination decision complied with the franchise agreement. However, some franchise agreements contain repurchasing provisions giving the franchisor the option to elect to purchase certain assets of the franchisee in the event of termination. Where such buy-back provisions exist, there will often also be a formula prescribing how the assets of the business are to be valued.

Where the franchise agreement is wrongfully terminated (that is, where the termination was in breach of the franchise agreement), the franchisee can seek legal remedies, including compensatory damages or injunctive relief. Compensatory damages are quantified on the basis of the franchisee's lost profits for the remaining term of the franchise agreement, subject to mitigation principles and other contingencies. Injunctive relief is subject to the court's discretion and equitable principles.

Finally, in the Statutory Provinces, if the franchise agreement is terminated by the franchisee due to the franchisor's misrepresentations or failure to meet disclosure obligations, the franchisee may be entitled to damages or a rescission remedy as permitted by the governing provincial legislation (*see Regulation of franchising and Question 6*).

International taxation

30. **What is the tax treatment of the initial fee paid by the franchisee?**

Canadian income taxation is a complex topic involving federal, provincial and territorial taxing authorities. The responses to Questions 30 through 42 below are limited to Canadian federal income taxation considerations, are general in nature and are not intended to be, nor should they be considered, definitive tax or legal advice. Any franchisors wishing to do business in Canada should consult professional tax advisors before undertaking any such venture.

Generally, foreign franchisors will either:

- Grant franchising rights directly to Canadian resident franchisee(s).
- Incorporate a Canadian subsidiary, which will in turn exercise master franchising rights throughout Canada.

A foreign franchisor's decision in this respect will be influenced by a number of legal and business considerations. The income of a wholly-owned Canadian subsidiary is subject to normal domestic income tax. Unless otherwise stated, the answers to Questions 30-42 below are based on the assumption that the foreign franchisor has elected to grant franchising rights directly to unrelated Canadian resident franchisee(s).

The tax treatment of the initial fee paid by the franchisee to the foreign franchisor will depend on whether the foreign franchisor is considered to be carrying on business in Canada (*see Question 33*).

If the foreign franchisor is regarded as carrying on business in Canada and enters directly into a franchise agreement with a Canadian franchisee, all franchise income received by the foreign franchisor (including the initial franchise fee) is generally treated as ordinary taxable income.

Where a franchisor is not regarded as carrying on business in Canada, the initial franchise fees, and any other payments to be made under the franchise agreement, are subject to Canadian withholding tax at a statutory rate of 25% if the payments are properly characterised as payments of "rent, royalty or similar payments". These amounts would include a payment for the right to use in Canada any:

- Property.
- Invention.
- Trade name.
- Patent.
- Trade mark.
- Design or model.
- Plan.
- Secret formula.
- Process or any other thing.

Specific analysis of the payment provisions of the relevant franchise agreement will need to be undertaken to assess the proper characterisation of the applicable fees for Canadian withholding tax purposes.

The statutory withholding tax rate in many instances will be reduced by a tax treaty between Canada and the jurisdiction in which the non-resident recipient resides. For example, under the tax treaty between Canada and the United States (the US Treaty) the withholding tax rate on qualifying royalties is reduced to 10%. A franchisee is personally liable for any failure to withhold the required amount of taxes from a payment.

31. **How will management and other continuing fees from the franchisee to the franchisor be treated in the franchisee's hands and, in particular, are there any tax deductions that have to be made?**

Payments of ongoing management fees and other continuing fees received by a franchisor will be taxed in a manner similar to that described above in *Question 30*.

While Canada's tax legislation does provide for the application of withholding taxes to management fees paid to non-residents, under many of Canada's tax treaties these fees are treated as business profits and are not subject to Canadian tax (withholding or otherwise) if the non-resident does not have a permanent establishment in Canada (*see Question 33*).

From the franchisee's perspective, management fees and other continuing fees paid to the franchisor (including any portion withheld and remitted to the Canada Revenue Agency in respect of withholding taxes) are generally deductible business expenses for the purpose of calculating the franchisee's Canadian federal income tax.

32. **What is the tax treatment of intellectual property royalties paid by the franchisee?**

See *International taxation* and *Question 31* above.

33. **Will a foreign franchisor who appoints a franchisee directly in your national territory be regarded as carrying on business in the national jurisdiction and therefore subject to the national tax regime?**

Under Canada's domestic tax legislation, any non-resident person carrying on business in Canada will be subject to Canadian income tax on the business profits associated with that business. The statutory definition of what constitutes a Canadian business is not exhaustive in nature but sets out a series of included activities such as:

- Soliciting orders.
- Offering anything for sale in Canada through an agent or servant whether the transaction is to be completed inside or outside Canada.

The threshold for carrying on business in Canada is therefore very low and a foreign franchisor entering into arrangements with Canadian franchisees could fall within the Canadian tax system, depending on the nature of the arrangements.

Generally, a non-resident in Canada will be taxable on its business profits earned in Canada only to the extent that these profits are attributable to a permanent establishment situated in Canada if it is both:

- A resident of a jurisdiction that has entered into a tax treaty with Canada.
- Entitled to the benefits of that treaty.

Under certain of Canada's income tax treaties, a non-resident may have a significant business presence in Canada without being deemed to have a permanent establishment in Canada. Whether a franchisor's Canadian activities or presence will be viewed as giving rise to a permanent establishment is a question of fact which depends on both:

- The nature of the obligations and activities contemplated by the applicable franchise agreement.
- The specific provisions of any applicable tax treaty.

34. **Is it possible to make use of tax haven companies in international franchising?**

It may be possible to reduce the withholding tax rate on payments made to non-resident franchisors by using a corporation formed in a jurisdiction with a more favourable tax treaty with Canada than the tax treaty between Canada and the franchisor's jurisdiction of residence. However, Canada is increasingly scrutinising these types of arrangement and is using anti-avoidance provisions contained in its domestic tax legislation to combat any activity it perceives to be abusive "treaty shopping".

Consistent with these trends is Canada's participation in a number of global initiatives to address concerns related to base erosion and profit shifting (BEPS). These initiatives include:

- The introduction of country by country reporting for large multi-national enterprises in taxation years beginning after 2015.
- The adoption of the OECD common reporting standard in respect of financial accounts held by non-residents.
- Canada's adoption of the OECD's multilateral conversion to implement measures to prevent BEPS.

These developments should be considered carefully when assessing the desirability and ongoing viability of any treaty based planning.

35. **Is there a withholding obligation on dividends paid to foreign companies/ individuals?**

Dividends paid to a non-resident shareholder by a Canadian corporation are subject to a 25% withholding tax. This withholding tax is typically reduced to 15% (or 5% where the recipient is a corporation holding 10% or more of the voting stock of the corporation paying the dividend) under Canada's tax treaties.

36. **Are there any other differences in the tax treatment of dividends paid to foreign companies/individuals as opposed to domestic shareholders?**

When calculating the Canadian tax income liability of domestic corporations and individuals, any dividends received are included in the recipient's income. In many cases where the dividend recipient is a Canadian resident corporation it is entitled to an offsetting deduction which allows dividends to move between corporate entities without the imposition of tax.

Dividends paid by domestic corporations to domestic recipients are not subject to withholding tax.

37.**Are there circumstances in which the (undistributed) profits of a foreign subsidiary can be taxed in the hands of a parent company that is tax resident in your jurisdiction (controlled foreign company legislation)?**

If a Canadian corporation owns an interest in a "controlled foreign affiliate", the Canadian parent must include in its income its share of any undistributed "foreign accrual property income" (FAPI) of the foreign affiliate.

Generally speaking, the FAPI regime is intended to prevent the deferral of tax on passive investment income earned outside Canada by affiliated non-resident entities. However, the FAPI rules apply to a broad range of income earning activities and the rules governing the calculation of FAPI and the related surplus items are extremely complex.

In addition to the FAPI provisions, under Canada's transfer pricing rules, transactions between a parent and subsidiary, if not on arm's length terms, can create profits in the subsidiary that will be attributed to the Canadian parent for income tax purposes.

38. **Does national law permit a franchisor to make loans to a franchisee? Does national law dictate any terms of such a loan, for example, rate of interest? Does national law/ regulation impose any debt/equity restrictions?**

There is no provision in Canada's federal tax legislation that prevents a franchisor from making loans to a franchisee. However, Canadian tax law generally requires the rate of interest charged on the loan to be an arm's length rate of interest. That is, a rate that would have been charged in similar transactions between unrelated parties.

39. **Is there a withholding obligation on interest paid to foreign companies/individuals?**

Generally, there is no Canadian withholding tax on interest paid by a Canadian resident to arm's length non-residents of Canada. The exception to this is participating interest that is contingent on the use of or production from property in Canada, or interest that is calculated by reference to revenue, profit or cash flow.

The statutory rate of withholding tax on participating interest or on interest paid to non-arm's length creditors (such as a controlling shareholder) is 25%. An applicable income tax treaty may reduce or eliminate the statutory withholding tax. For example, the US Treaty eliminates any withholding tax liability in respect of ordinary interest payments made to any creditors, including non-arm's length parties.

40. **Are there any restrictions on the capital structure of a company incorporated in your country with a foreign parent (thin capitalisation rules)?**

The debt/equity structure of a Canadian subsidiary corporation of a foreign parent will be subject to certain provisions of Canada's tax legislation which operate to deny the deduction of interest payable to specified non-residents by the subsidiary to the extent that the subsidiary is "thinly capitalised".

The subsidiary is considered to be thinly capitalised where the amount of debt owed to the non-resident shareholder is more than 1.5 times the aggregate of the:

- Retained earnings of the subsidiary corporation.
- Subsidiary corporation's contributed surplus that was contributed by the non-resident shareholder.
- Paid-up capital of the shares of the subsidiary owned by the non-resident shareholder.

Interest that is not deductible because of the thin-capitalisation rules is deemed to have been paid as a dividend and is subject to withholding tax as such.

41. **How does national law define a "branch"? How are its profits taxed? What taxes are payable on the repatriation of profits by a foreign branch?**

The term "branch" is not specifically defined in Canada's income tax legislation. However, subject to the provisions of any applicable income tax convention, a non-resident corporation will be subject to Canadian income tax on business profits from carrying on business in Canada (*see Question 33*) .

A non-resident carrying on business in Canada must also pay a branch tax. The branch tax essentially takes the place of the withholding tax that would have been payable on dividends paid by a Canadian subsidiary carrying on the business. As the withholding tax is imposed on dividends when they are paid and the branch tax is imposed when the profits are earned, this factor may, in some circumstances, favour the establishment of a subsidiary by the foreign business rather than a branch.

Generally, the income of the branch will be calculated under the same rules that are applicable to the calculation of the subsidiary's income, including the thin-capitalisation rules.

If the Canadian operation will incur start-up losses, it may be possible for the non-resident to deduct these losses in calculating its income for its domestic tax purposes if the Canadian business is carried on through a branch operation. When the Canadian business becomes profitable at some future time, it may be possible to transfer the branch operation to a newly incorporated Canadian subsidiary with no significant adverse Canadian income tax consequences.

42. **Are there any special tax considerations when a joint venture is used as a franchise vehicle?**

The tax considerations applicable to the use of a joint venture will depend on the form of the joint venture vehicle. A jointly owned Canadian corporation is directly taxable on its own income and its dividends are taxed in the manner described above in *Question 35* and *Question 36*.

Partnerships are not taxable entities in Canada. Partnership income is calculated at the partnership level and then allocated to the partners in accordance with the partnership agreement. Generally speaking, for the purpose of calculating the tax liability of a partner, the allocated income is treated as if the partner had earned the income directly.

Unincorporated joint ventures that are not partnerships can also be used in Canada. These types of ventures are not given any special tax status and the venturers are viewed to be carrying on the business of the joint venture directly in accordance with the terms of the applicable agreement.

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