

# CONSULTATION PAPER ON FRANCHISE LEGISLATION

## Manitoba Law Reform Commission\*

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## CHAPTER 1

### INTRODUCTION

#### A. BACKGROUND TO THE PROJECT

The Manitoba Law Reform Commission has noted that franchising is a growing and relatively unregulated field of business activity; there has been occasional media attention focusing on the inequality between franchisors and franchisees and recently, on alleged franchising frauds in Manitoba.<sup>1</sup> In recent years, three provinces and several countries have enacted new or revised franchise legislation. In January 2006, the Commission received a suggestion that a review of possible reforms to franchise law would be valuable in Manitoba,<sup>2</sup> and the Commission agreed to undertake the project.

#### B. SCOPE

This paper considers whether the regulation of franchises is desirable in Manitoba. It provides an introduction to the history and various models of franchising, an overview of existing franchise regulation in Canada and other countries and a comparison of the elements of Canadian legislative regimes. Finally, it asks whether franchise legislation is needed in Manitoba, and if so, what elements should be included in the legislation.

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\* Released May 2007.

<sup>1</sup> For example, A. Paul, "City man burned by pizza franchise scam" *Winnipeg Free Press* (February 12, 2007); P. Turenne, "Bitter business tale: Pizza franchise turned out to be scam" *Winnipeg Sun* (February 12, 2007). See also T. Davis, "A town tackles a giant" *Winnipeg Free Press* (June 17, 1995) A17; residents of the Town of Oakville organized a rally to protest a new General Motors policy that was forcing a dealer to close his dealership and to press for legislation that would make it more difficult for franchisors to dictate terms to franchisees. According to the report, GM was requiring dealers to undertake expensive renovations, and had refused approval for the Oakville dealer to sell his dealership instead. In the article, NDP MLA Jim Maloway and the President of the Manitoba Motor Dealers Association advocated for franchise legislation in Manitoba.

<sup>2</sup> The review was suggested by A.L. Weinberg, Q.C., Myers Weinberg LLP, Winnipeg, Manitoba.

### C. INVITATION TO COMMENT

The Commission invites public comment in the matters discussed in this paper and hopes that all interested persons and organizations will accept the invitation to share their thoughts on the issues raised. Once comments have been received, the Commission will consider them and prepare its final report. In accordance with *The Law Reform Commission Act*,<sup>3</sup> the Commission will then submit the report to the Minister of Justice and Attorney General for consideration.

Anyone wishing to respond to the issues raised, or to comment on any other relevant issue, is invited to write to the Commission at the following address:

Manitoba Law Reform Commission  
432- 405 Broadway  
Winnipeg, MB R3C 3L6

Submissions may also be sent by fax to (204) 948-2184 or by email to [lawreform@gov.mb.ca](mailto:lawreform@gov.mb.ca). We regret that we are unable to receive oral submissions.

Unless clearly marked to the contrary, the Commission will assume that comments received are not confidential, and that respondents consent to our quoting from or referring to their comments, in whole or in part, and attributing the comments to them. Requests for confidentiality or anonymity will be respected to the extent permitted by freedom of information legislation.

The deadline for submissions is August 20, 2007.

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<sup>3</sup> *The Law Reform Commission Act*, C.C.S.M. c. L95.

## CHAPTER 2

### FRANCHISING OVERVIEW

#### A. GENERAL

Franchises are widespread in today's society. Consumers do business daily with a broad range of franchised brands - buying fast-food, coffee, gas and real estate, hiring cleaning services, booking vacations and having their taxes prepared. However, the prevalence of franchising as a way of doing business is a relatively recent phenomenon.

In its earliest sense, a franchise was a "special privilege to do certain things conferred by government on an individual or corporation, and which does not belong to citizens generally of common right".<sup>1</sup> This meaning is still relevant; the government grants franchises to companies such as telecommunications and utility service providers to encourage the development of a 'public good' by the private sector. In the modern commercial environment, however, franchising now generally refers to a specific and prevalent method of doing business.

In its simplest terms, a franchise is a license from [the] owner of a trademark or trade name permitting another to sell a product under that name or mark. More broadly stated, a "franchise" has evolved into an elaborate agreement under which the franchisee undertakes to conduct a business or sell a product or service in accordance with methods and procedures prescribed by the franchisor, and the franchisor undertakes to assist the franchisee through advertising, promotion and other advisory services.<sup>2</sup>

A franchise is a contract between two businesses, in which the franchisor grants the franchisee the right to operate its business system in return for payment of fees and royalties. The business system typically includes intellectual property (such as trademarks, trade names and logos), the right to sell products or services, access to business

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<sup>1</sup> *Black's Law Dictionary*, 6<sup>th</sup> ed., s.v. "franchise". For example, in ancient England the monarchy would grant a subject the right to collect taxes; in more recent times a government may grant a utility company a monopoly franchise to encourage the development of a 'public good' by the private sector.

<sup>2</sup> *Ibid.*

knowledge and methods, and other physical and intangible assets.<sup>3</sup> Franchisors may operate some of their units directly and franchise others.

A key element of a franchise is the ongoing relationship between the parties. The franchisor often provides continuing support or direction regarding the operation of the business. The franchisee agrees to sell the franchisor's product, often exclusively, and to comply with the franchisor's standards. While the franchisee is an independent business, it will usually be required to operate in a way that is substantially similar to or indistinguishable from the operation of the franchisor and its other franchisees.<sup>4</sup>

Franchising has been described as "an organizational choice for distributing goods and services".<sup>5</sup>

As a form of business organization, franchising is seen as occupying a middle ground between two poles of the organizational continuum. At one end of the continuum is vertical integration (for example, a producer that owns its own retail outlets). At the other end is an isolated commercial transaction (for example, a producer that makes a one-time sale to a retailer). In franchising the vertical relationship, often between a supplier and a retailer, is continuous and sometimes intense. The franchisee may gain the good will associated with the franchisor's trademark, standards for the quality and style of operation associated with the mark, and perhaps from training and advice provided by the franchisor. Still, the capital and risk incentives for operation of individual outlets remain much like those of independently owned businesses. The franchisee risks its capital to own and operate an outlet. But, unlike in an independently owned

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<sup>3</sup> See A.J. Trebilcock, "Introduction to Franchising" in *Franchising 101*, Ontario Bar Association (2001), online: <<http://www.oba.org/en/pdf/Franchising101.pdf>> (date accessed May 3, 2007); J. Anthony Van Duzer, *The Law of Partnerships and Corporations* (2<sup>nd</sup> ed., 2003) at 20.

<sup>4</sup> Trebilcock, *supra* note 3; E.N. Levitt, *Distribution Networks and Agreements*, Gowling Lafleur Henderson LLP, Toronto, Ontario (May 2002), online: <[http://www.gowlings.com/resources/PublicationPDFs/Levitt\\_DistributionNetworks.pdf](http://www.gowlings.com/resources/PublicationPDFs/Levitt_DistributionNetworks.pdf)> (date accessed: May 3, 2007).

<sup>5</sup> W. Grimes, "Perspectives on Franchising: When Do Franchisors Have Market Power? Anti-Trust Remedies for Franchisor Opportunism" (1996), 65 *Antitrust L.J.* 105 at 107.

business, a franchisee generally relinquishes a great deal of control over the outlet and must share with the franchisor the revenue generated by the outlet. Many franchisees pay an up-front franchise fee, continuing royalties based upon sales, and subject themselves to the franchisor's monitoring.<sup>6</sup>

## B. HISTORY

The franchising concept dates back to the English Middle Ages, when the Crown, wanting to avoid the costs and administrative burden of hiring, paying and supervising tax collectors, granted to officials the right to collect and keep the Crown's taxes in return for a fee. Later, in North America, governments granted private individuals and corporations the right to carry out activities that would otherwise be restricted to the government, to facilitate the development of infrastructure and services such as railroads, utilities and banking.<sup>7</sup>

Modern private sector franchising first appeared in the 1850s. The first franchise model is often attributed to the Singer Sewing Machine Company, which created an independent distributor network for its sewing machines. Although the business model ultimately failed for Singer, the private sector franchising concept began to take hold.<sup>8</sup>

One of the first businesses to successfully employ the franchising concept was Coca-Cola. As the company expanded across the U.S., it licensed regional franchisee bottlers to produce and bottle soft drinks under its trademark. Coca-Cola's rapid expansion was funded by the franchisees, who in return received exclusive distribution territories and support.<sup>9</sup>

General Motors began distributing automobile inventory across the country through individual dealers in 1898. Dealers could purchase vehicles at a discounted price for resale and were granted regional franchise rights; in return they were required to sell only the products of a single manufacturer. This distribution method shifted to dealers some of the risks of market downturns, and proved to be successful for the automobile industry.<sup>10</sup>

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<sup>6</sup> *Ibid.*

<sup>7</sup> See D.F. So, *Canadian Franchise Law Handbook* (2005) at 9–17; Trebilcock, *supra* note 3; F. Zaid, *Franchise Law* (2005) at 2.

<sup>8</sup> So, *supra* note 7.

<sup>9</sup> *Ibid.*; Trebilcock, *supra* note 3.

<sup>10</sup> So, *supra* note 7.

In the 1930s, oil refiners licensed franchisee gasoline stations to distribute their products. Oil companies that leased their service stations to their former managers found that the owner-dealers had a more personal interest in the success of their locations, resulting in larger profits through higher gas sales and from the rent from the properties. In Canada, the Canadian Tire franchise was also successfully established in the 1930s.<sup>11</sup>

During the Depression, individual retail merchants grouped together in order to cope more efficiently with the difficult economy and compete with large business chains.<sup>12</sup> Following the Second World War, franchising expanded to a number of new industries, including fast food restaurants, hardware and drug retailing (including Shoppers' Drug Mart in Canada) and motel and hotel services. There were high-profile failures associated with rapid expansion "as growth continued unprincipled and unregulated",<sup>13</sup> but by the 1970s, franchising had become a popular method of doing business and an enduring part of the U.S. and Canadian economies.

### C. FRANCHISE ECONOMIC IMPACT

Franchising represents a significant portion of the Canadian economy. The Canadian Franchise Association has reported that franchising accounts for \$90 billion per year in sales nationally.<sup>14</sup> With respect to Ontario, Hoffman and Levitt have commented:

The importance and impact of franchising on Ontario's economy today cannot be overstated. Franchising's share of the retail dollar is fast approaching 50%. It has moved from a somewhat novel alternative distribution option to one of the first distribution choices considered by a wide variety of businesses.<sup>15</sup>

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<sup>11</sup> *Ibid.*

<sup>12</sup> Trebilcock, *supra* note 3.

<sup>13</sup> Zaid, *supra* note 7 at 2.

<sup>14</sup> According to the Canadian Franchise Association, franchising crosses 42 sectors of the economy: Ontario Legislative Assembly, Standing Committee on Regulations and Private Bills, *Hansard* (March 8, 2000: Hearing on Bill 33: *Franchise Disclosure Act*, 1999) at 1340 (R. Cunningham, Canadian Franchise Association), [http://www.ontla.on.ca/web/bills/bills\\_detail.do?locale=en&BillID=740%20%20%20%20&isCurrent=false&detailPage=bills\\_detail\\_related](http://www.ontla.on.ca/web/bills/bills_detail.do?locale=en&BillID=740%20%20%20%20&isCurrent=false&detailPage=bills_detail_related) (date accessed: May 8, 2007).

<sup>15</sup> J.P. Hoffman and E.N. Levitt, *Recent Developments of Importance in Franchise Law* Gowling Lafleur Henderson, Toronto, Ontario (December 17, 2005), online :

In the U.S., a study commissioned by the International Franchise Association examining 2001 data found that there were more than 767,000 franchised businesses directly employing 9.8 million people, with a payroll of \$229 billion and an economic output of nearly \$625 billion. When the indirect impact of franchised businesses was measured, they generated more than 18 million jobs, or nearly 14 percent of all private sector jobs, and accounted for 11% of the private sector payroll and 9.5 percent of the private sector economic output, or more than \$1.53 trillion. According to the study, when both direct and indirect forms of employment were combined, franchising generated one out of every seven jobs in the private sector.<sup>16</sup>

In Canada, it was reported in 2004 that there were 1,327 franchisors, 63,642 franchisees and annual franchising industry sales equivalent to approximately \$90 billion U.S.,<sup>17</sup> or approximately 10% of Canada's gross domestic product. Franchising has been reported to account for one out of every five consumer dollars spent in Canada on goods and services and to employ over one million Canadians.<sup>18</sup>

#### **D. TYPES OF FRANCHISE ARRANGEMENTS**

There are two primary types of franchise arrangements: business format and product distribution franchises. Some commentators also include business opportunity franchises.

##### **1. Business Format Franchise**

The business format franchise is the modern type of franchising that emerged in the 1960s and is most commonly recognized as a franchise today. The franchisee exclusively identifies with the franchisor, and adopts its entire business system, including its product, brand

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<<http://gowlings.com/resources/publications.asp?pubid=1156>> (date accessed: May 3, 2007).

<sup>16</sup> PriceWaterhouseCoopers, *The Economic Impact of Franchised Businesses: A Study for the International Franchise Association Education Foundation, Part II* (March 2004), online: <[http://www.franchise.org/Files/EIS6\\_2.pdf](http://www.franchise.org/Files/EIS6_2.pdf)> (date accessed May 3, 2007); "Franchises provide big boost to nation's economy: study measures jobs, payroll, overall output" 38:5 *Franchising World* (May 2006), online: <<http://www.allbusiness.com/retail-trade/1185340-3.html>> (date accessed May 3, 2007).

<sup>17</sup> So, *supra* note 7 at 5.

<sup>18</sup> D. Caldarone and D.J. Gray, "Advising the Start-up Franchisor" (Paper presented to The Domino Effect: 6<sup>th</sup> Annual Franchising Conference, Ontario Bar Association, November 16, 2006) at 2.

name, operating manual and marketing strategy. There is “an almost complete merging of the business identity of franchisee and franchisor, so that the public perceives each franchised outlet as part of a larger chain of identical outlets, all offering the same high quality goods and services”.<sup>19</sup> Examples include hotels and fast food outlets such as Tim Hortons™ and McDonalds™.

The unit franchise is the simplest and most popular business format franchise. In this model, the franchisor licenses the franchisee to operate a single franchise business in a specific location or territory. The franchisee usually pays an initial franchise fee and ongoing royalties based on a percentage of gross sales. The agreement usually requires the franchisee to contribute to an advertising fund, and may contemplate multiple franchises, so that the franchisee has the option to acquire additional franchises or rights of first refusal.<sup>20</sup> There are also variations:

- In an affiliation or conversion franchise, the franchisor absorbs an independent business in the same field. The business agrees to conduct future operations under the franchisor’s model.<sup>21</sup>
- A combination franchise joins “two or more distinct and complementary franchise systems in physical or functional conjunction”,<sup>22</sup> usually involving the installation of an outlet of one system into an outlet of the ‘host’ franchise system.

There are also forms of territorial franchising, in which rights are granted for an entire territory, such as a city, province or all of Canada:<sup>23</sup>

- In an area representation franchise, the franchisor retains an independent representative to seek prospective franchisees and carry out the franchisor’s obligations within a defined area, in return for a share of the revenue. However, the franchise agreement is between the franchisee and franchisor, and not the representative.<sup>24</sup>
- In an area development franchise, the franchisor grants a franchisee the right to set up multiple outlets within a

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<sup>19</sup> Trebilcock, *supra* note 3 at 2.

<sup>20</sup> See L.H. Polsky, “Search continues for multiple unit franchisees”, 24:21 *Lawyers Weekly* (October 8, 2004).

<sup>21</sup> Trebilcock, *supra* note 3 at 3.

<sup>22</sup> *Ibid.*

<sup>23</sup> Polsky, *supra* note 20.

<sup>24</sup> Trebilcock, *supra* note 3 at 3.

geographical area. The area development agreements generally deal with the terms of the franchise expansion and the number of outlets to be established, while the details of the individual outlets are governed by unit franchise agreements.<sup>25</sup>

- In a master franchising arrangement, the franchisor grants a master franchisee the right to recruit others and sell and service sub-franchises within a specified territory. The maintenance of exclusive rights to the territory depends on a performance schedule being met.<sup>26</sup> A master franchise creates a three-tiered relationship between the franchisor, master franchisee (or sub-franchisor) and sub-franchisee (or unit franchisee). There is a contract between the franchisor and the master franchisee and between the master franchisee and sub franchisees, but not between the sub-franchisee and the franchisor.<sup>27</sup> However, the franchisor receives revenues earned from the operations of the franchises and from sharing the franchise fees or royalty payments made to the master franchisee.

Finally, in a joint venture franchise, a franchisor and franchisee enter into a joint venture in which the franchisor grants a unit, area development, or master franchise to the joint venture entity.

## **2. Product Distribution Franchise**

In a product distribution franchise, the franchisee is identified with the manufacturer or supplier to some degree, but also retains a distinct identity; examples are soft drink bottlers and automobile dealerships.<sup>28</sup> The franchisee obtains a licence to market and sell products within an exclusive distribution area, and may be encouraged or required to deal primarily with the franchisor's goods or services. Otherwise, the franchisor exercises less control than in a business format franchise, and the franchisee is usually free to choose its business style and distribution technique.<sup>29</sup>

## **3. Business Opportunity Franchise**

In a business opportunity franchise, the franchisor grants the

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<sup>25</sup> *Ibid* at 2.

<sup>26</sup> Polsky, *supra* note 20.

<sup>27</sup> Trebilcock, *supra* note 3 at 2.

<sup>28</sup> Zaid, *supra* note 7 at 6; for example, an automotive group may operate a number of dealerships and be associated with several manufacturers, but maintain a distinct identity.

<sup>29</sup> Trebilcock, *supra* note 3 at 1-2.

franchisee the right to sell goods and services provided by the franchisor. The franchisor may also provide location assistance. Examples of business opportunity franchises are vending machines and amusement games.<sup>30</sup>

### **E. FRANCHISE ADVANTAGES AND DISADVANTAGES**

A significant attraction of the franchise arrangement for the franchisee, particularly for the first time business owner, is the opportunity to enter the marketplace without assuming the degree of risk usually associated with startup enterprises. Business risks can be reduced where there is an established franchisor that offers a solid image, a recognized product or service with a developed market and a successful business system for the marketing and sale of the product or service. The franchisor generally has a vested interest in the success of the franchisee, and often provides detailed training, ongoing advice and mentoring and assistance in the event of a crisis.<sup>31</sup> The franchisee continues to benefit from the franchisor's ongoing product research and development and often from volume discounts available with bulk purchasing through the franchisor. Financial institutions are also often more willing to provide business loans to franchised businesses.<sup>32</sup>

For the franchisor, franchising allows business expansion with little capital investment; expansion can be more rapid, as it is largely financed by franchisees.<sup>33</sup> Franchising also provides an ongoing source of revenue from franchise fees or royalties. Franchise unit owners may have a higher stake and level of commitment to the success of the business than do employed managers, and in the long term, the franchisor benefits from a competent franchisee's ability to attract future franchisees and increase the goodwill of the overall system.

While there are many examples of successful and profitable franchise relationships, the model also has disadvantages and risks. The franchisor gives up some control and profit opportunity by not operating its own outlets, in the expectation of greater profits through expansion.<sup>34</sup> The franchisor's reputation is at risk, as the general public will often not

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<sup>30</sup> Zaid, *supra* note 7 at 6.

<sup>31</sup> For a useful discussion of the advantages and disadvantages of buying a franchise see Canada Business Service Centre, *Tips on Buying a Franchise*, online:

<[http://www.cbcs.org/servlet/ContentServer?cid=1084286449074&pagename=CBSC\\_AB%2Fdisplay&lang=en&c=GuideFactSheet](http://www.cbcs.org/servlet/ContentServer?cid=1084286449074&pagename=CBSC_AB%2Fdisplay&lang=en&c=GuideFactSheet)>.

<sup>32</sup> So, *supra* note 7 at 7.

<sup>33</sup> *Ibid.* at 5.

<sup>34</sup> Caldarone and Gray, *supra* note 18 at 6-7.

distinguish between individual franchise outlets and the larger organization. Franchisee selection can be difficult and time consuming,<sup>35</sup> and an incompetent or unsuccessful franchisee can damage the established goodwill of the franchise by providing substandard products or services.

To manage these risks, the franchisor will usually attempt to ensure that each franchisee maintains minimum standards in relation to the appearance and operation of its business. Franchisees are generally required to comply strictly with the operational methods established by the franchisor,<sup>36</sup> and are frequently required to purchase supplies and inventory directly from the franchisor or from a designated supplier.<sup>37</sup>

The requirements imposed by the franchisor increase its ability to exercise quality control, limit the ability of franchisees to attempt “free-riding” (a franchisee’s attempt to benefit from the franchisor’s reputation without doing its part to maintain standards)<sup>38</sup> and often increase the buying power of the franchisees. However, requirements for strict compliance may also stifle creative initiative by franchisees that otherwise could enhance the overall business and reputation of the franchise.<sup>39</sup> A franchisor may impose onerous obligations, exercise an excessive degree of control, fail to carry out effective marketing and promotion activities or disproportionately shift business risks and impose unreasonable product costs to the franchisee, making it difficult or impossible for the franchisee to carry on the business effectively.

It has also been suggested that there is a “myth of high profitability”.<sup>40</sup> While there is a widespread perception of reduced risk, and mature and established franchise businesses may present lower risk and higher return to the investor than an independent start-up business (and as a result, command higher fees), new franchise outlets tend to be in high-risk areas of business with marginal return, and fail at a rate at

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<sup>35</sup> *Ibid.* at 7.

<sup>36</sup> Levitt, *supra* note 4. As a result franchise arrangements are frequently long and complex and include a large number of secondary agreements, such as subleases and trademark, security and confidentiality agreements.

<sup>37</sup> So, *supra* note 7 at 7. So notes that volume purchasing is frequently a contentious issue; while the associated discounts may benefit franchisees, in some cases rebates are paid directly to the franchisor and the franchisees do not directly benefit.

<sup>38</sup> Grimes, *supra* note 5 at 109-110.

<sup>39</sup> *Ibid.* at 110.

<sup>40</sup> *Ibid.* at 130.

or above the rate for other small businesses.<sup>41</sup>

In the end, both parties to the franchise relationship assume the ultimate risk of costly litigation should the franchise relationship prove unsuccessful.

## **F. THE FRANCHISE LEGAL RELATIONSHIP**

### **1. Potential for Conflict**

The relationship between the parties to a franchise agreement is often compared to a marriage: the parties depend on each other for their continued well being, the relationship is intended to continue for a lengthy period of time, and the arrangement is intended to be satisfactory to both parties.<sup>42</sup>

While franchisors and franchisees generally share a common desire to succeed, there is also considerable potential for conflict between them. The parties frequently have dramatically unequal bargaining power: the franchisor is often a large, sophisticated business organization with significant franchising experience and control over the terms of the franchise agreement, while the franchisee may have little business experience and, in any event, often must 'take or leave' the franchise agreement as offered. The franchisee must rely to some extent on the franchisor's representations with respect to the potential for business success. In some cases, disreputable franchisors use high-pressure sales tactics and provide inaccurate or misleading financial information. When problems occur in the franchise, a franchisee

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<sup>41</sup> *Ibid.* at 123-124 and 130-131. See also T. Bates, "Survival Patterns Among Newcomers to Franchising" (Paper prepared for the Center for Economic Studies, U.S. Bureau of the Census, May 1997, CES-WP-97-5), online: <[http://www.ces.census.gov/index.php/ces/1.00/cespapers?limit=10&search\\_w here=d2hlcmUgeWVhcihwdWJsaWNhdGlvb19kYXRlKT0xOTk3#table](http://www.ces.census.gov/index.php/ces/1.00/cespapers?limit=10&search_w here=d2hlcmUgeWVhcihwdWJsaWNhdGlvb19kYXRlKT0xOTk3#table)> (date accessed May 7, 2007); the study found that among 'true newcomers' (young franchisee units not owned by mature multi-establishment franchisees), franchise survival rates were low and that the purchase of a franchise was not likely to reduce the risks faced by a new business.

<sup>42</sup> L. Weinberg, "The Franchise Relationship" in *Franchising 101*, Ontario Bar Association (2001) at 1, online: <<http://www.oba.org/en/pdf/Franchising101.pdf>> (date accessed May 7, 2007); A 1995 review of the Canadian franchise industry noted "In some chains, especially those that are doing well, the connections can be quite strong, and stable. In others – and not necessarily just those franchises that are faring poorly – the relationship resembles a failing marriage, complete with suspicion, poor communications and the presence of lawyers.": J. Lorinc, *Opportunity Knocks: The Truth About Canada's Franchise Industry* (1995).

suffering business difficulties will be less likely than the franchisor to have the financial resources available to fund litigation.

There can be a significant imbalance in the amount and quality of information available to the parties during negotiations and at the time the franchise agreement is signed. For a franchisor that is so inclined, the pre-contract period can be viewed as one with substantial incentives for opportunism.

In recruiting an investor to open up a new franchise outlet a franchisor is, to a large degree, gambling with someone else's money... [F]ranchisors gain financially when an investor opens a new outlet, perhaps even if that outlet fails. Some franchisors may have invested minimally in the franchise system, but even those who have a large stake in the system may commit little or no resources to a new outlet. Indeed, the franchisor may receive an up-front franchise fee and, thus, may reap immediate financial gain even if the outlet fails quickly. In the event of failure the franchisor may be the only buyer for the franchisee's capital equipment, and may do so at a deeply discounted price, perhaps reselling it to a future franchisee at a substantial markup.<sup>43</sup>

The franchisee continues to be at a disadvantage in relation to the franchisor in terms of access to information and control of operations throughout the franchise relationship. In many cases, franchisees are somewhat locked into the relationship by high 'sunk costs', or invested funds that cannot be recovered if the franchise relationship ends. These costs mean that these franchisees will be disinclined to walk away from the franchise even in the case of reduced revenues and a poor relationship with the franchisor.<sup>44</sup>

Various reviews of franchisor-franchisee disputes in Canada, the U.S. and Australia have identified a number of areas of dispute relating

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<sup>43</sup> Grimes, *supra* note 5 at 124-125.

<sup>44</sup> Grimes, *supra* note 5 at 125. Grimes presents a thorough discussion of the incentives that may exist for a franchisor to act contrary to the interests of a franchisee. For example, a franchisor may decide to open an additional outlet in a territory, even if it decreases the sales of existing outlets, if the franchisor's overall revenue will increase. On the other hand, while the incentives of the franchisor may lean toward too much expansion, franchisees may have incentives leading them to oppose expansion, even when it has a very favourable impact to the overall franchise.

to the information and power imbalance in the relationship.<sup>45</sup> The issues include:

- lack of pre-contract disclosure;
- deceptive practices, including misrepresentation of the nature of the franchise, the range of supplies, equipment and training to be provided in the franchise package, the value and profitability of the franchise and the franchisor's stability and prior experience;
- unfair contract terms arising from a refusal by franchisors to negotiate the terms and conditions of contracts (the 'take it or leave it' contract);
- complexity of documentation;
- excessive prices charged for mandatory goods and equipment supplied by franchisors or other providers to franchisees, even when items are available more cheaply from alternative suppliers;
- secret rebates and commissions received by franchisors from required suppliers;
- encroachment by the franchisor on the franchisee's geographic trading area;
- franchisor-imposed system wide changes that bear significant cost;
- failure to provide adequate service and support to franchisees;
- substantial increases to renewal fees;
- use of advertising levies for non-advertising purposes;
- transfer and renewal restrictions and renewals on different and more onerous terms; and
- unfair terminations.<sup>46</sup>

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<sup>45</sup> See for example Lorinc, *supra* note 42; Grimes, *supra* note 5; U.S. Federal Trade Commission, "The Franchise Rule" (Statement before the U.S. House of Representatives Committee on Energy and Commerce, Subcommittee on Commerce, Trade and Consumer Protection, June 25, 2002), online: <<http://www.ftc.gov/os/2002/06/020625bealesfranruletest.htm>> (date accessed: May 7, 2007); Parliament of Australia House of Representatives Standing Committee on Industry, Science and Resources, *Finding a Balance: Towards Fair Trading in Australia* (May 1997), online: <<http://www.aph.gov.au/HOUSE/committee/Isr/Fairtrad/report/contents.htm>> (date accessed: May 7, 2007).

<sup>46</sup> Recent media reports of lawsuits filed by franchisees of the Quiznos food chain in the U.S. vividly illustrate some of the problems alleged by franchisees: see J. Creswell, "When Disillusion Sets In: Some Quiznos Franchisees Take Chain to Court" *The New York Times* (February 24, 2007), online: <<http://www.nytimes.com/2007/02/24/business/24quiznos.html?ex=1329973>>

On the other hand, franchisor representatives have noted that the characterization of franchising issues can be one-sided and ignore the difficulties that can be caused by franchisees.

[L]ittle mention is made in debate about potential franchisees wanting to 'get into' the franchise system by misrepresentation of part or more of their small business history, financial position, work experience, level of commitment, product or service knowledge and other necessary criteria. In mature franchise systems, there appears to be an increase in incidents of this.<sup>47</sup>

One commentator eloquently summed up his views:

Good franchising is very good. It is undoubtedly the most efficient, effective distribution system ever invented. It is the greatest invention of Western capitalism since the invention of the corporation. Good franchising is so much better than independent small business operation and bad franchising is so much worse.<sup>48</sup>

## 2. Legal Aspects

In the absence of franchise-specific legislation, the relationship between the franchisee and franchisor is governed by the terms of the franchise agreement and the law of contract. The rights and duties of each party arise from the contract, and general contract law principles, such as *caveat emptor* (buyer beware) and the right to act in one's own interests, apply. A party may have a right to rescission of the franchise agreement or to damages on grounds such as breach of contract, misrepresentation, breach of warranty or *error in substantialibus* (a fundamental error in the character or substance of a thing sold).<sup>49</sup>

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2008&en=2669991a0477e661&ei=5088&partner=rssnyt&emc=rss> (date accessed: May 7, 2007).

<sup>47</sup> Franchise Association of Australia and New Zealand, Submission No. 143 to the Parliament of Australia House of Representatives Standing Committee on Industry, Science and Resources, quoted in Standing Committee on Industry, Science and Resources, *supra* note 45 at 93 note 16.

<sup>48</sup> A. Terry, Transcript of Evidence to the Parliament of Australia House of Representatives Standing Committee on Industry, Science and Resources at 92, quoted in Standing Committee on Industry, Science and Resources, *supra* note 45 at 83.

<sup>49</sup> See for example *Esso Petroleum v. Mardon*, [1976] 2 All E.R. 5 (C.A.); *Kim v. Sheffield & Sons – Tobacconists Inc.* (1990), 30 C.P.R. (3d) 111 (B.C.C.A.); *Hossain*

Franchises have at times been asserted to create employment relationships (for example, in cases where the franchisor exercises significant control over daily operations),<sup>50</sup> and a study of Australian franchise failures found that “despite the franchise agreement stating very clearly that the franchisee is not an employee of the franchisor, it appears that some franchisees regard themselves as employees”.<sup>51</sup> As well, in some circumstances the franchisor-franchisee relationship has been argued to be fiduciary in nature, so that the franchisor owes a special duty of care toward the franchisee.<sup>52</sup> The Supreme Court of Canada addressed this issue in 1975, in *Jirna v. Mister Donut*,<sup>53</sup> affirming the finding of the Ontario Court of Appeal that no fiduciary relationship existed in the circumstances. Jirna’s representatives in the negotiations were experienced businessmen under no serious disparity relative to the franchisor, and the provisions in the agreement fell considerably short of the relationship of trust and confidence that would be necessary to create a fiduciary obligation. However, the Court did not rule out the possibility of a fiduciary relationship existing in a different franchise situation.

In most circumstances, a franchise agreement is a commercial contract between independent parties with no fiduciary or employment obligations. However, there is no hard and fast rule; a commercial agreement is not immune from the imposition of fiduciary duties,<sup>54</sup> and it is possible that fiduciary or employment obligations might be found to exist in a franchise relationship in exceptional circumstances.

The typical franchise relationship is distinct from other commercial relationships in some respects, however. In *Shelanu*,<sup>55</sup> a

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*Nasirbegh v. Triple 3 Holdings Inc. (c.o.b. 3 for 1 Pizza & Wings)*, [2003] O.J. No 751 (Ont. S.C.J.).

<sup>50</sup> Weinberg, *supra* note 42 at 3. Weinberg notes that claims of an employment relationship most frequently arise where employment-type severance and other termination benefits are being claimed by the franchisee, especially where the franchisee has little to no capital invested. In some cases, involving restrictive franchise agreements, the arguments have been successful: see *Head v. Inter Tan Canada Ltd.* (1991), 5 O.R. (3d) 192 (Gen. Div).

<sup>51</sup> J. Buchan, *When the Franchisor Fails* (Report prepared for CPA Australia, January 2006) at 3, online:

<[http://www.cpaaustralia.com.au/cps/rde/xbcr/SID-3F57FEDE-E9D973D1/cpa/200602\\_franchisor.pdf](http://www.cpaaustralia.com.au/cps/rde/xbcr/SID-3F57FEDE-E9D973D1/cpa/200602_franchisor.pdf)> (date accessed: May 7, 2007).

<sup>52</sup> Weinberg, *supra* note 42.

<sup>53</sup> [1975] 1 S.C.R. 2, aff’g (1971), 22 D.L.R. (3d) 639 (Ont. C.A.).

<sup>54</sup> *530888 Ontario Ltd. v. Sobeys Inc.*, [2001] O.J. No. 318 (S.C.J.) at para. 9.

<sup>55</sup> *Shelanu Inc. v. Print Three Franchising Corp.* (2003), 226 D.L.R. (4th) 577 (Ont. C.A.). Ontario’s *Arthur Wishart Act (Franchise Disclosure)*, 2000, S.O. 2000, c. 3

leading 2003 case, the Ontario Court of Appeal noted that, in accordance with *Jirna*,<sup>56</sup> the relationship between a franchisor and franchisee would not normally be characterized as a fiduciary one, but it does have unique characteristics that set it apart from an ordinary commercial relationship. The characteristics are similar to those outlined by the Supreme Court of Canada in *Wallace v. United Grain Growers*<sup>57</sup> that give rise to a good faith obligation in the context of an employment contract. A franchisee does not usually have equal bargaining power to the franchisor, the franchise contract is imposed on the franchisee, who is usually unable to negotiate more favourable terms, and the relationship continues to be affected by the power imbalance, in that the franchisee must submit to inspections and audits and otherwise comply with the franchisor's requirements. In *Shelanu*, the Court held that, in the absence of franchise legislation, these characteristics give rise to a common law duty upon the parties to a franchise relationship to act in good faith. The franchisor must have regard to the legitimate interests of the franchisee, but may act in its own interests so long as it deals promptly, honestly, fairly and reasonably with the franchisee. The Court found that the franchisor in *Shelanu* had breached its duty of good faith, but the breaches did not amount to a fundamental breach of the franchise agreement, and so the franchisee was not entitled to treat the agreement as at an end.

The distinctive nature of the franchise agreement also leads to certain principles of interpretation. Under the principle of *contra proferentem*, a court will construe an ambiguous clause in a contract against the person who prepared it.<sup>58</sup> A franchise agreement is also often a 'contract of adhesion'. This is, in general, a written contract drafted by one party on a form regularly used by the drafter and presented to the other party on a 'take it or leave it' basis; the other party enters into relatively few such transactions in comparison with the drafter and his or her principal obligation is the payment of money. *Contra proferentem* applies, but even in the absence of ambiguity a contract of adhesion is interpreted strictly against the party presenting it.<sup>59</sup>

As well, many other areas of law may affect a franchise, depending on the circumstances and the nature of the business

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requires parties to a franchise agreement to act in good faith. However, the facts giving rise to the dispute occurred before the Act came into force and the Court found that it was not necessary to decide whether the Act applied in this case.

<sup>56</sup> *Supra* note 53.

<sup>57</sup> *Wallace v. United Grain Growers Ltd. (c.o.b. Public Press)*, [1997] 3 S.C.R. 701.

<sup>58</sup> *Black's Law Dictionary*, 6<sup>th</sup> ed., s.v. "contra proferentem".

<sup>59</sup> See the discussion in *Halligan v. Liberty Tax Service Inc.*, [2003] M.J. 289 (Man. Q.B) at paras. 15-16.

conducted; these may include competition, consumer protection, privacy, tax, bankruptcy, intellectual property and personal property security law.<sup>60</sup>

### 3. Manitoba Experience

There do not appear to be reliable data on the experience of franchisors and franchisees in Manitoba. A review of court decisions does illustrate the nature of some disputes that reached resolution through litigation. For example, the recent case of *Halligan v. Liberty Tax Service Inc.*<sup>61</sup> provides a glaring example of franchisor intimidation tactics. The franchisor had decided to change the name of the franchise, and pressured the franchisee to change its business name. The franchisee refused, as he was entitled to do under the franchise agreement. The franchisor then withdrew its funding for tax discounting services without notice, purported to terminate the franchise agreement and established its own tax services within the franchisee's exclusive territories. The franchisor breached a court injunction that restrained it from acting in a manner inconsistent with the franchisee's rights and harassed the franchisee in a manner that the court noted "is indicative of the disdain Liberty has shown for Halligan and the court process throughout".<sup>62</sup> The court found that there was an attempt by the franchisor to "bludgeon Halligan into submission",<sup>63</sup> along with flagrant and repetitive breaches of the injunction. Liberty's actions were outrageous and high-handed and the imbalance of power was stark. In light of this, in addition to compensatory damages of nearly \$85,000, the court granted punitive damages of \$200,000.

The case of *Prairie Petroleum Products Ltd. v. Husky Oil Ltd.*<sup>64</sup> dealt with a unilateral change to business operations by an oil company.<sup>65</sup> A change in Husky's pricing formula for fuel meant that the distributor could not offer a competitive price during the peak

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<sup>60</sup> For a thorough discussion of these areas of law as they may impact on a franchise, see Zaid, *supra* note 7, and Snell and Weinberg, eds., *Fundamentals of Franchising – Canada* (2005). See also J. Rogers and A. Frith, "Piling On: Other Laws Affecting Franchising" (Paper presented to The Domino Effect: 6<sup>th</sup> Annual Franchising Conference, Ontario Bar Association, November 16, 2006).

<sup>61</sup> *Halligan v. Liberty Tax Service Inc.*, *supra* note 59 and supplementary judgment [2006] 8 W.W.R. 97 (Man. Q.B.).

<sup>62</sup> *Supra* note 59 at para. 11.

<sup>63</sup> *Supra* note 59 at para. 2.

<sup>64</sup> [2006] 11 W.W.R. 606 (QB).

<sup>65</sup> Although the agreement between the parties is not described as a franchise, many distributorship agreements are included in the definition of "franchise" in franchise legislation.

agricultural season, and the distributor lost sales. The court held that the change was a fundamental breach of contract and that the clauses in the contract that purported to exclude Husky's liability were not enforceable on the basis of unconscionability, unfairness and unreasonableness; the clauses benefited the large and commercially sophisticated company that had prepared the agreement, and enforcing them would lead to an unfair and unreasonable result. The plaintiffs were entitled to treat the agreement as terminated. In *2909333 Manitoba Ltd. v. 616768 Saskatchewan Ltd.*,<sup>66</sup> the matter under consideration was a motion related to examinations for discovery, but the allegations of the franchisees<sup>67</sup> included that the franchisor received benefits from suppliers contrary to its representations, wrongfully appropriated allowances for tenants' improvements, did not provide the required accounting and manuals and misrepresented sales and profits. In another case dealing with preliminary matters regarding where and how multiple claims would proceed, franchisee claims included "inaccurate forecast numbers, misrepresentation of profit, unreasonable construction costs, misrepresentation with respect to tenant inducements or improvements, payment of excess rent over actual rental costs, overstocking and failure to obtain the best possible prices from suppliers".<sup>68</sup>

A review of court decisions is unlikely to provide an accurate representation of franchise disputes, however. Some franchise agreements require arbitration and do not reach the courts. More importantly, litigation is costly, and the ability of a party to an unsuccessful business relationship, particularly the franchisee, to fund an action may be very limited.

Additional case examples were provided to the Commission during the preparation for this Consultation Paper. Among the franchisee allegations were statements that franchisors:

- used pressure tactics upon the signing of the agreement and failed to provide contact information for other franchisees as requested;
- misrepresented that business assets were free of liens and trade accounts were satisfied;
- did not provide promised business support and training;

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<sup>66</sup> (2006), 200 Man. R. (2d) 161(QB).

<sup>67</sup> Note that the facts had not been determined by the court.

<sup>68</sup> *1279022 Ontario Ltd. v. Posen* (2003), 179 Man. R. (2d) 108 (QB), rev'd (2004) 184 Man. R. (2d) 308 (C.A.). See also *Print Three Franchising Corp. v. McLennan Printing Inc.* (2001), 153 Man. R. (2d) 32 (C.A.).

- misrepresented establishment and operating costs;
- required the use of suppliers that provided substandard equipment and that paid a rebate to the franchisor;
- did not supply promised equipment or supplied faulty equipment; and
- did not respond to requests for a meeting to discuss the problems.

The Commission is very interested in receiving the views of those with franchise experience in Manitoba, whether from the point of view of franchisors or franchisees.