Pitblado LAW

# Franchising in Manitoba

## Considerations for business owners

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# Why Franchise Your Existing Business?

**Franchising can be an attractive business model for restaurants, retailers, service providers, and other business owners.** Franchising is often a cost-effective means of growth and distribution for businesses. It allows businesses to expand without the capital investment required in other business models, as it relies on franchisees to help fund development. Although the franchisor will have to make substantial initial investments to develop the system, once a viable franchise system exists, further development is generated by investment from franchisees. This allows the franchisor to minimize risk in the development process, and allows growth to happen more rapidly than in certain other business models.

Because franchisees are owners, they typically have more of a vested interest in the success of the venture, which can increase the likelihood that the franchise as a whole will succeed. It also means that the franchisor can have a smaller and more efficient administrative team than would be required if the franchisor were to develop and own all the locations. Over time, this may allow the franchisor to enjoy a "hands off" approach to business. For individuals who might be interested in starting their own business, entering into a franchise arrangement with an established franchise can be an attractive opportunity because the success of a proven business model can help to minimize risk.

A franchisor that develops a successful franchise system can realize numerous benefits. These include expanded growth and distribution, increased public recognition of the brand, and financial benefits. Franchisors can generate various streams of revenue through initial franchise fees, training fees, royalty fees, product sales, and various other services provided by the franchisor to the franchisee. Franchisors may also be able, over time, to enjoy increased buying power through economies of scale, as well as reduced operating, distribution, and advertising costs.

## Preparing for Success

A successful business owner may consider franchising their business when they have developed a strong system and brand. Key factors that should exist before a business owner considers franchising include: strong brand or name recognition, the development of a system for operating the business successfully, the ability to provide ongoing training and support to franchisees, and the ability to provide advertising and marketing support to franchisees.

Ultimately, a business owner should only consider franchising if he/she expects prospective franchisees to be successful, as a franchisor's success will be dependent on the success of the franchisee. Despite the many benefits that can be realized through franchising, franchising may expose the business owner to new challenges outside of their typical business operations. The franchisor will have to expend significant effort in the following areas: (i) developing new and broader marketing programs, (ii) identifying, recruiting and negotiating with prospective franchisees, (iii) identifying new locations and dealing with lease negotiations, (iv) dealing with marketing fund management, expanded supplier programs, and training programs, and (v) ensuring compliance with legal requirements.

The initial costs of setting up a franchise can be substantial, so the business owner must ensure they have adequate funds to cover development costs. These costs include: development of operations manuals, supplier programs and systems, marketing materials, franchise disclosure documents, and professional fees for consulting, accounting, tax, and legal advice.

# Forms of Franchising

Franchising can be used in a variety of different businesses and can take several different forms:

## Business Format Franchising

The typical form of franchising that comes to mind is "business format franchising". This is a type of franchising system where a franchisor provides a franchisee with an established business form, together with the franchisor's trademarks and name which the franchisee runs independently. In this form, it is the manner in which the product is delivered - rather than simply the product itself - that creates brand recognition and drives success. Most fast food outlets are operated in this manner.

## Product Franchising

Another form of franchising is called "product franchising". In product franchising, it is the product rather than the form of delivery of that product which attracts brand recognition. In this form of franchising, the franchisor allows retailers to distribute products and use the franchisor's trademarks and name. Typically, the franchisee has a great deal of flexibility with respect to the delivery of the product and operation of the franchise.

## Single-Unit, Master, and Multi-Unit Franchising

A franchise system can be developed in a traditional "single-unit" franchising model, where the franchisor recruits franchisees and develops each franchise location one by one. Some franchisors may be able to expand on a large-scale basis rather than developing on a single-unit franchising model. "Master franchising" and "multi-unit franchising" are other methods that can be used by a franchisor, allowing a franchisee to enter into subfranchise agreements with third parties or allowing a franchisee to develop multiple units within a given territory. Methods such as these are often used when the franchisor wants to expand into an unknown market, such as in another country.

# The Franchise Act – Manitoba

## Overview

In 2012, Manitoba became the fifth Canadian province to enact comprehensive franchise legislation. Previous attempts had been made by the Manitoba Legislature in the early 1990s to enact franchise legislation through a private member's bill, however, the proposed bill did not pass into legislation.

Like legislation in other Canadian provinces, the Manitoba legislation places significant obligations on franchisors, including the requirement to deliver a detailed franchise disclosure document (FDD) to prospective franchisees.

## The Franchise Disclosure Document (FDD) and Rights of Recission

The FDD must be provided to a prospective franchisee at least 14 days before the franchisee signs the franchisee agreement or any related agreement, or before the franchisee pays any money to the franchisor. The purpose of this requirement is to give the prospective franchisee all material information needed to make an informed decision before entering into an agreement. A failure on the franchisor's part to (i) comply with the 14 day requirement, or (ii) give a disclosure document that contains the items required by the legislation, gives the prospective franchisee a right of rescission.

Rescission is a significant remedy as it provides for the undoing of the contract, essentially restoring the parties to the positions that they would have been in had no contract been formed. This can be a significant burden for a franchisor, as it can mean that a franchisor will not only have to refund any franchise fees that have been paid, but also buy back all inventory, supplies and equipment bought by the franchisee pursuant to the franchise agreement. Additionally, the franchisor may have to compensate the franchisee for any losses incurred in setting up and operating the franchise.

For franchisors, it is very important to ensure that the franchise disclosure document contains all elements required by the legislation. Additionally, franchisors should ensure that the FDD has been properly delivered as required by the legislation, in order to avoid the possibility of the franchisee obtaining rescission rights. In some instances, rescission has been granted by the courts even when a franchise disclosure document was delivered on time because it contained such significant deficiencies that it did not effectively constitute a franchise disclosure document for the purposes of franchise legislation.

## The Franchises Act (Manitoba)

Although franchise legislation is generally similar across the country, there are subtle and important differences from province to province. A franchisor who expands into another province should engage legal advisors to ensure that they are in compliance with the applicable legislation, particularly with the disclosure obligations. Manitoba's legislation contains some unique provisions that differ from other provinces. For instance, it does not require that the disclosure document be delivered all at once as one complete document; the disclosure document can be delivered in parts.

The legislation sets out specific items that must be included in the FDD, and dictates methods for how it must be delivered. Some of the items that must be provided as part of the franchise disclosure document include: prescribed risk warning statements, financial statements of the franchisor, and the business background of the franchisor, its directors, and officers. The franchisor must also disclose whether it or any of its directors or officers have been convicted of fraud, unfair or deceptive business practices in the last ten years, have been found liable in a civil action for misrepresentation, engaged in unfair or deceptive business practices in the past ten years, or have been the subject of any bankruptcy or insolvency proceedings in the last six years.

Another important element of the legislation is that it imposes a general duty of fair dealing on franchisors and franchisees in the performance and enforcement of franchise agreements, which includes a duty to act in good faith and in accordance with reasonable commercial standards.

# Steps in the Franchising Process

1. **Develop a successful business.** Before a business owner should begin to consider franchising, they should have already developed a successful business that enjoys sufficient brand recognition and a replicable business model. This is easier said than done! Often the most successful franchisors have developed multiple locations before deciding to franchise to prove that the business model is successful, and to test whether expansion is feasible.

2. **Raise capital.** The initial start-up costs associated with developing a franchise can be significant, so business owners must ensure they have enough capital to cover the costs of developing the franchise system in its entirety. This includes budgeting for both the short term and long term.

3. **Assemble the team.** The business owner will need the assistance of various professionals in order to prepare for franchising. This includes internal business stakeholders, franchise consultants/brokers, accountants and tax advisors, legal advisors, and insurance advisors. These advisors can assist with considerations such as risk management, corporate structuring, trademarking, and preparing franchise materials and documentation.

4. **Develop standardized systems.** In order to ensure that the business model is replicable, the business owner will have to spend significant time developing standardized systems and programs for the franchise system. These include supplier programs and systems, operational manuals, quality control procedures, training programs, and accounting and point-of-sale systems and procedures.

5. **Develop franchise materials.** The business owner will also have to develop all of the documentation associated with the systems identified above. In addition, a significant amount of time will need to be allocated into the development of marketing and recruitment tools, such as promotional materials and application forms for franchisees. In consultation with advisors, the business owner will also need to develop financial statements, the franchise disclosure document, and other documents required to be provided by legislation, as well as standard forms of franchise agreements and ancillary agreements.

6. **Marketing and recruitment of franchisees.** In conjunction with the development of recruitment tools and promotional materials, the business owner should formalize a marketing and business development plan to identify and recruit prospective franchisees. A franchise broker or consultant may be able to assist with these efforts. Significant effort should be put into attracting the right type of people to become franchisees. This involves spending time getting to know the prospective franchisees and conducting background checks.

# The Advisory Team

The business owner will need the assistance of various professionals in order to prepare for franchising. Some of the professionals that a business owner should or may wish to engage are identified below.

## Franchise Consultants and Brokers

Franchise consultants can assist with strategic planning, franchise development, development of operations manuals, training manuals and marketing materials, and can consult on sales and operations, recruitment, and other organizational issues. Franchise brokers can assist with franchise development by matching prospective franchisees with a suitable franchise system based on the franchisee's experience, interests, and financial circumstances. Franchise brokers are typically compensated by franchisors upon the prospective franchisee entering into a franchise agreement. Employing franchise consultants and brokers can benefit franchisors by increasing the speed and efficiency of development, and lowering internal marketing and business development costs.

## Legal Advisors

Legal advisors can assist with the development of your franchise disclosure document and related documents to ensure compliance with franchise legislation. Legal advisors are also essential for developing standard forms of franchise agreements and all ancillary agreements. They can provide expertise in negotiating the final terms of the franchise agreement, assisting with trademarking, and advising on leases and other agreements.

## Accounting and Tax Advisors

Accountants and tax advisors can assist with corporate structuring and preparing any necessary financial statements. Once the franchise system is developed, these professionals are necessary to assist you with maintaining proper records with respect to all franchise revenues and expenses.

## Lenders

Franchisors that require additional capital in order to assist with the initial development costs of the franchise system may need to consult with their bank or other financial lenders.

## Insurance Advisors

Franchisors should consult their insurance advisors on how to mitigate risk. A franchisor will want to ensure that the business, products, the franchise itself, the franchisor, and the franchisees are protected from claims for damages. An insurance advisor can advise on the appropriate forms of insurance that the franchisor may wish to carry, including (but not limited to) business interruption, and professional liability and casualty insurance. They may also advise on forms of insurance that the franchisor will require franchisees to maintain.

# Common Risks and How to Mitigate Them

There are a number of risks that arise as a result of being a franchisor and operating a franchise system.

**Violating Franchise Legislation.** The first is the risk of violating franchise legislation. The risks associated with violating such legislation are significant. As identified previously, the possibility of rescission is a significant outcome that franchisors will want to avoid. As the right to rescission typically arises from improper disclosure made by the franchisor to the franchisee, care and prudence should be exercised during the disclosure stage.

> **How to mitigate:** The risk of violating franchise legislation can be mitigated by engaging legal advisors in the development of disclosure documents, as well as engaging legal advisors whenever a subsequent disclosure is to be made to a prospective franchisee. This is especially true where a franchisor seeks to expand into another province, as franchise laws across Canada have subtle differences from province to province.

**Financial Risk.** Another significant risk that a franchisor is subject to is financial risk. The considerable capital investment required to build a franchise system can be a risk, especially if franchisors underestimate the amount of this investment.

> **How to mitigate:** Franchisors can mitigate this risk through feasibility assessments and business planning to ensure that they have appropriate resources for developing the franchises, and for recruiting and supporting franchisees. The business owner must also ensure that the development of the franchise system is manageable. The risk of developing the franchise system in a manner that outpaces the ability of the franchisor to service existing franchisees will only end up harming the brand.

**Risks to the Brand.** Franchising also creates risk as it means that a business owner will give up an element of control over their brand. Allowing franchisees to use the business owner's names, logo and system creates the risk of rogue franchisees harming the brand.

> **How to mitigate:** This risk can be mitigated by selecting the right franchisee candidates through comprehensive application requirements, identifying franchisee selection criteria, and conducting background checks. Additionally, the franchise agreement should give the franchisor termination rights in the event a franchisee does anything to harm the brand. Similarly, there is a risk associated with providing franchisees with confidential business information. Again, this risk can be mitigated through proper franchisee selection processes and by incorporating non-competition covenants into the franchise agreement.
> Depending on the nature of the franchised business, there is typically always a risk that a customer or employee becomes injured on franchise premises, or that a product could harm a user. Insurance planning is an important element of risk mitigation.

**Contractual Disputes.** Finally, there are risks that arise simply by entering into arrangements with the franchisees. Despite comprehensive selection processes and background checks, disputes between franchisors and franchisees are always possible. Some of the typical scenarios in which disputes arise between franchisors and franchisees are identified below.

**These risks can be mitigated through the appropriate drafting of the franchise agreement, and simply by being cognizant of these typical types of disputes:**

A. The franchisee believes the franchisor has infringed upon a franchisee's territory rights.

B. Similarly, the franchisee believes the franchisor has infringed upon a franchisee's development rights, such as a first right of refusal to develop additional locations.

C. The franchisee believes the franchisor has provided preferential treatment to certain franchisees.

D. Financial disputes such as:

(i) The franchisee believes the franchisor has misused a collective advertising or marketing fund.

(ii) The franchisee believes that earnings projections provided by the franchisor were not reflective of expected performance.

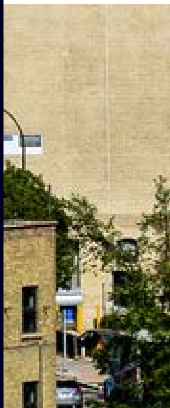
(iii) The franchisor believes the franchisee has been dishonest about earnings results, or the franchisee defaults or makes late payments to the franchisor.

(iv) Disputes with respect to the renewal of franchise agreements, as the franchisee may be required to make capital investments to update the franchise location and to enter into a new form of agreement which may have new, and possibly less favourable financial terms.

## Interested in franchising your existing business?

**Speak to Niall today to explore your options.**

**CONTACT NIALL**



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