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FRANCHISE EXPANSION ACROSS OUR BORDERS: CANADA AND MEXICO

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FRANCHISE EXPANSION ACROSS OUR BORDERS: CANADA AND MEXICO

I. INTRODUCTION: OVERVIEW OF FREQUENTLY ENCOUNTERED FOREIGN EXPANSION ISSUES

Upon first deciding to expand internationally, many franchisors based in the United States (the "U.S.") will proceed with caution because of the cost and risk associated with venturing outside their home market. Apart from completely unexpected opportunities that may arise in countries outside North America, a good way to test the international waters is to look just across the northern and southern borders of the U.S. to, respectively, Canada and Mexico, which are widely perceived as natural and logical venues for growing a U.S.-based franchise system. This paper will survey some of the common practical and legal issues which U.S. franchisors should anticipate when granting franchise rights abroad as well as the unique challenges associated with franchising in Canada and Mexico.

A. Entering a Non-U.S. Market

U.S. franchisors seek to expand their systems internationally through franchising for many of the same reasons that they engage in domestic expansion through franchising. In franchising, a franchisor may expand its market penetration without taking on the full burden of capital investment needed for such expansion, instead sharing that burden with its franchisees. Before expanding internationally, U.S. franchisors frequently have developed and tested the franchise concept in the domestic market, making adjustments as necessary to achieve acceptance of the system's goods and services by the consuming public.

With a domestic franchise system, the franchisor normally has reached a level of comfort with the laws and regulations that affect its operation, the legal and contractual controls required to maintain system uniformity and the business and practical aspects of providing marketing and operational support to its franchisees. For a wide variety of reasons, it is virtually impossible for franchisors to achieve the same balance of resource allocation and system controls in international programs. In addition, for a number of reasons it may be unwise even to attempt to do so.

Many franchisors' international expansion programs reflect a "knee-jerk" response to a perceived opportunity. More viable programs, however, reflect careful thought and analysis. To a great extent, international expansion of a franchise system will depend on the nature of the business opportunity to be franchised, the franchisor's strengths and limitations, extrinsic factors over which the franchisor may have no direct control, and the local franchise partner's strengths and limitations.

Franchisors who take care in developing international expansion programs and expansion business plans initially will evaluate the nature of their system, their own strengths and weaknesses, and extrinsic factors to identify the best structure for expansion. They will develop a profile of the ideal foreign partner for that expansion and seek partners who fit that profile as closely as possible.

B. Adapting to a Non-U.S. Market

Entering a market outside the U.S. may well require adaptations to a different business, economic and cultural environment than prevailed in the home market at the time the franchise concept was developed. Such adaptation may require such fundamental shifts as adjustments of language, menu items, franchise agreement restrictions, days and hours of operation, logos and other items used in identifying and promoting the franchise system. In order to learn what adaptations are appropriate, many franchisors rely on franchise and marketing consultants in the target country, but some franchisors believe that there is nothing like experience – through the operation of test units and otherwise – to determine how the franchise concept will be received in the new country.

Assuming that the franchisor relies on the franchise method of expansion, finding suitable "partners" or franchisees is critical to the success of that expansion. Once the right partners are found, franchisors are faced with the issue of determining the appropriate form of legal relationship with the in-country partner – a relationship that could be structured as individual unit operations, multiple unit operations, agreements providing for area development, area representative or master franchise commitments or joint ventures with partners who may operate through one of the other expansion forms. Each form of relationship has its own benefits and risks, and no one form is appropriate for every country or system. These issues and others are touched on in this paper in relation to the unique considerations of expanding into Canada and Mexico.

Other issues that a franchisor may confront in expanding to these or other countries could include all of the foundational and operational parameters for a franchise system, ranging from establishing a qualified and reliable supply chain, to real estate and financing issues, to determining how franchisor support can be provided in-country. Beyond these operational issues, franchisors will be learning a new regulatory lexicon, learning that in the new country the franchisor simply is "not in Kansas anymore." The balance of this paper will examine some of the most important concerns addressed in entering the franchise markets of our neighbors to the north and south.

II. CANADA

A. Introduction

1. The Canadian Landscape - The Great White North

When U.S. franchisors look to expand their franchise systems internationally, they often look to Canada as one of their first target destinations, as it offers them a secure and robust economy, a relatively affluent and sophisticated marketplace, significant cultural similarities, and a welcoming business environment. In addition, approximately 80% of the Canadian population lives within a two-hour drive of the U.S.-Canada border,[1] so proximity to Canadian markets[2] is

[1] Royal Canadian Mounted Police, *Border Integrity*, http://www.rcmp-grc.gc.ca/bi-if/index-eng.htm (last updated December 10, 2010).

[2] The City of Toronto, the province of Ontario's capital city, is the fifth most populous city in North America and the densely populated region in Southern Ontario known as the Golden Horseshoe, has a population of nearly 9 million people as of 2011. A 2010 Toronto Food Sector Update prepared for the City of Toronto's Economic Development & Culture Division claims that the food and beverage cluster in Toronto is "the largest sector of its kind in Canada and

another important motivation for U.S. franchisors to expand into Canada. As the U.S. economy continues to experience a slow recovery, its indigenous franchisors will undoubtedly seek greener pastures in which to sell their goods and services, and Canada is justifiably seen by franchisors as an ideal jurisdiction in which to make their first international foray.

Notwithstanding its seductive appeal, bringing a franchise system into Canada is a complicated enterprise requiring Canadian legal, accounting and other professional expertise. While franchising in Canada certainly has the potential to yield healthy returns and is a welcoming jurisdiction in which to first expand internationally, U.S. franchisors are cautioned to conduct their due diligence, and to appreciate the risks as well as the rewards involved, before doing so. Failure to respect the differences between franchising in Canada and in the U.S. is a reckless endeavor; not only does it have the potential of creating liability, but a failed expansion into Canada may also divert a franchisor's attention from its domestic and other international operations and stymie any further expansion into Canada, particularly if the goodwill associated with the brand suffers as a result.

2. Franchising in Canada

Canada currently hosts approximately 1,100 franchise systems and 78,000 individual franchised units,[3] a significant portion of which represent some of the U.S.'s most recognized and best-loved brands. Franchising accounts for 10% of Canada's Gross Domestic Product and accounts for one out of every five consumer dollars spent in Canada in goods and services.[4] Canadians appear to appreciate the value proposition associated with franchised concepts, and this trend does not appear to be waning at this time, nor is there any expectation that this trend will decline in the future.

3. Canadian Franchise Association

The Canadian Franchise Association (CFA) is a not-for-profit national trade association which represents close to 500 franchise systems as well as the professionals who support the industry. Many U.S. franchisors have joined the CFA for lead generation, educational, networking and other benefits offered by this association, which serves as the Canadian domestic equivalent to the International Franchise Association.

All members of the CFA are bound to abide by its Code of Ethics.[5] If a CFA member fails to comply with the Code of Ethics, the CFA reserves the right to suspend the membership privileges of the CFA member or altogether terminate its membership with the association,

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one of the largest in Canada or the U.S., rivalling Chicago and Los Angeles as a major continental center for the industry."

[3] Canadian Franchise Association, *Fast Franchise Facts*, http://www.cfa.ca/Publications_Research/FastFacts.aspx (last visited July 19, 2012).

[4] Manitoba Law Reform Commission Report No. 116, Franchise Law Consultation Paper (May 2008), available at: http://www.manitobalawreform.ca/pubs/pdf/116-full_report.pdf (last visited July 19, 2012).

[5] Canadian Franchise Association, http://www.cfa.ca/About_Us/Code_of_Ethics/ (last updated March 19, 2007). The CFA's membership form requires that the applicant confirm that it "endorses and subscribes to the CFA Code of Ethics including CFA disclosure requirements." *See* Joseph Adler, *The Ethics of Franchising: How Codes of Ethics Compare and What to Consider in Deciding Whether to Subscribe to Them*, 29 FRANCHISE L. J. No. 2 (2009).

without refunding any dues to the member. Further, the CFA's Disclosure Document Guide[6] provides that franchisor members are required to disclose the CFA Code of Ethics to its prospective franchisees. The CFA's Code of Ethics[7] further requires that its franchisor members provide prospective franchisees with a disclosure document "at least fourteen (14) days prior to the franchisee executing any binding agreement" relating to the franchise, even in provinces and territories where no franchise disclosure statute is in effect. CFA members are required to use either: (i) CFA's form of disclosure document which, of course, needs to be tailored to comply with all applicable franchise disclosure statutes; or (ii) the form of disclosure document that the franchisor uses in the other provinces where disclosure is mandatory, or in the U.S., provided that the franchisor also attaches the Code of Ethics and supplements the disclosures by making "appropriate changes to expand upon disclosures which pertain to only one or more specified jurisdictions" and to "make the disclosures pertinent to the actual franchises being offered." See Section II.E.11 below for further details and best practices regarding the preparation of disclosure documents in non-franchise disclosure provinces.

4. The Province of Québec

Québec is Canada's largest province by land area and the second most populous. Its GDP is over $300 billion CDN, the second highest after Ontario, representing 20% of the national economy.[8] Québec's population is predominately French-speaking, and it is the only province in Canada whose sole official language at the provincial level is French. The province of Québec is governed by the *Civil Code of Québec* (Civil Code).[9] The Civil Code is the body of all laws and regulations for Québec. It contains over 3,000 sections which govern, for example, property rights, private law, family law, the rules of court and evidence, and other areas of the law regulating corporate and personal affairs. The Civil Code sets Québec significantly apart from the other provinces of Canada, which follow the common law tradition. Accordingly, a U.S. franchisor who seeks to do business in Québec should obtain specialized legal advice from Québec counsel to assist it with tailoring its franchise agreement, operation manuals and franchise system to better equip the franchisor to enter this unique market. Simply treating Québec like any other Canadian province or territory is a very risky endeavor, which will likely create havoc in a U.S. franchisor's Canadian expansion plans. See Section II.H.4 below for additional information regarding the Civil Code and franchising in the province of Québec.

B. Intellectual Property Protection and Licensing Considerations

1. Trademarks, Patents and Copyrights

An integral part of any franchise system is protecting the franchisor's intellectual property. It is, therefore, necessary to ensure that U.S. franchisors protect their applicable trademarks, copyrights, industrial designs, trade secrets and patents in Canada.

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[6] *See* Canadian Franchise Association, *Commentary On The CFA Disclosure Document Guide,* http://www.cfa.ca/About_Us/Disclosure_Documents/disclosurecommentary.aspx (last visited July 19, 2012).

[7] Canadian Franchise Association, *supra* note 5, item 2.

[8] Statistics reported by the province of Québec, http://www.gouv.qc.ca/portail/quebec/pgs/commun/portrait/economie/PIB/?lang=en (last updated January 24, 2012).

[9] Civil Code of Québec, S.Q. 1991, ch. 64 (Can.).

Trademarks. Canada is not a party to the Madrid Protocol and, as such, a separate application is required to register foreign trademarks in Canada. As Canada is a signatory to the International Convention for Protection of Industrial Property (the Paris Convention), applicants from member countries can base Canadian trademark applications on use or proposed use in Canada and, if applicable, registration and use in a foreign jurisdiction. Entitlement to trademark registration in Canada is based on first usage, and will not be granted to marks that are similar or easily confused with existing marks.

Canadian trademark law differs significantly and in many respects from its U.S. counterpart. For example:

(a) Unlike in the U.S., Canada does not distinguish between a service mark used in association with services, and a trademark used in association with wares, and, as such, the term "trademark" refers to both wares and services in Canada.

(b) No affidavits of use are required to be filed in Canada on a periodic basis, unlike in the U.S., though, if not used, a Canadian mark can be expunged by the Registrar or at the request of a third party after three years from the date of registration.[10]

(c) The Canadian federal government governs the trademark registration process in Canada, while trademarks in the U.S. may be registered at both the state and federal levels.

(d) Canada is not a signatory to the *Nice Agreement Concerning the International Classification of Goods and Services for the Purposes of the Registration of Marks*[11], and accordingly, one registration fee will cover as many classes of wares and services as the trademark applicant desires.

(e) The owner of a Canadian trademark must exert control over the character or quality of the wares or services associated with the trademark,[12] even where a trademark is licensed to a wholly-owned subsidiary or related company of the trademark owner. Failure to do so exposes the trademark owner to an expungement proceeding pursuant to Section 45 of the Trade-marks Act. As such, it is critical that a U.S.-based owner of a trademark enter into a trademark license agreement with its Canadian subsidiaries or affiliates to control the use, character or quality of the goods and services associated with the licensed Canadian marks by the licensees. Such a license agreement would not be typically required if the trademark license is directly with a Canadian franchisee, because such licensing rights should be covered by the applicable franchise agreement. The U.S. owner of a trademark should also require that Canadian licensees give public notice of the fact that the use of the trademark is a licensed one and provide notice of the identity of the owner, in each case to satisfy Section 50(2) of the Trade-marks Act. Finally, a U.S. trademark owner and its Canadian sublicensors, if any, should expressly require that their Canadian

[10] Trade-marks Act, R.S.C. 1985, ch. T-13, § 45 (Can.).

[11] June 15, 1957, International Bureau of World Intellectual Property Organization, available at http://www.wipo.int/treaties/en/classification/nice/trtdocs_wo019.html (last visited on Aug. 4, 2012).

[12] Nice Agreement Concerning the International Classification of Goods and Services for the Purposes of the Registration of Marks, *id.* § 50.

franchisees disclaim any rights that they may have pursuant to Section 50(3) of the Trade-marks Act, which may give licensees of a trademark the right to institute infringement proceedings in their own name, if the owner of the marks refuses or neglects to pursue such proceedings within two months of being asked to do so.

(f) In Canada, unlike in the U.S., a trademark applicant cannot file a trademark application on both a use *and* proposed use basis.

(g) Canadian trademark applications can be based on the use of the trademark in Canada, registration and use in the "country of origin" of the applicant and proposed use, as in the U.S. However Canada also permits trademark applications filed on the basis of "making the mark known."

Patents. Canadian patent law, unlike its U.S. counterpart, currently operates on a first-to-file rather than a first-to-invent basis.[13] Registration of a patent grants the patent owner the exclusive right of making, constructing and using the invention for a period of 20 years from the date of filing, which effectively gives the owner a monopoly and excludes the world from using the invention in Canada during the term of the patent. "Invention" means any new and useful art, process, machine, manufacture or composition of matter, or any new and useful improvement in any art, process, machine, manufacture or composition of matter. In other words, to be valid, a patent must be new, useful and non-obvious. The *Patent Act*[14] expressly excludes mere scientific principles and abstract theorems from patent protection. With regard to business method patents which may be relevant to franchisors interested in patenting their franchise systems, it is noteworthy that the Canadian Federal Court of Appeal did not reject the possibility that a business method can be patented.[15] Accordingly, U.S. franchisors may wish to consider the value of pursuing business method patents when entering into the Canadian marketplace to protect their proprietary business methods and systems. U.S. franchisors should also refrain from representing to Canadian prospective and existing franchisees and others that they own patents for business methods if they have not sought and obtained Canadian patents for such methods, as ownership of such patents in the U.S. will not extend coverage into Canada.

Copyrights. Copyright protection in Canada, unlike in the U.S., is afforded to works even if not registered. For copyright to subsist in a work, the work must be original, the work must be an expression of an idea rather than an idea itself, and the work must fall into one of the enumerated categories of works protected under the Copyright Act.[16] The originality requirement does not mean creativity - the work does not have to be novel or unique, as long as it is more than a mere copy. Originality involves an exercise of skill and judgment, a minimum of

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[13] Though not for much longer, as the *Leahy-Smith America Invents Act* will change the U.S. patent system to resemble the Canadian patent system. The changes are being implemented in 2012-2013 and patents in the U.S. will be granted on a first-to-file basis. Nevertheless, the first filer's priority will be subject to subsequent challenges through a new procedure called a derivation proceeding. *See* The United States Patent and Trademark Office, Leahy-Smith America Invents Act Implementation, available at: http://www.uspto.gov/aia_implementation/index.jsp (last visited on July 18, 2012).

[14] Patent Act, R.S.C. 1985, ch. P-4 (Can.).

[15] Amazon.com Inc., Re, 2011 FCA 328, 97 C.P.R. 4th 171, 209 A.C.W.S. 3d 674, 423 N.R. 337, 340 D.L.R. 4th 577, ¶ 60 (Can.).

[16] Copyright Act, R.S.C. 1985, ch. C-42 (Can.).

some intellectual effort meaning that purely mechanical work is not enough.[17] Furthermore, copyright law protects expression in a work and not the bare ideas, methods of operation or mathematical concepts. The work must also fall into one of the enumerated categories in order to be protected. These include literary, dramatic, musical and artistic works which may be expressed in a variety of modes or forms such as compilations, books, movies, songs, translations, illustrations and others. Copyright subsists for the term that is the life of the author, the remainder of the calendar year in which the author dies, and a period of fifty years following the end of that calendar year.

Generally, the author is the first copyright owner of the copyright in the work. The author is the person who writes, draws or composes the work, or is otherwise responsible for putting it into a concrete form. It is the author who expresses the ideas in a work in an original form. There are exceptions to this rule. For example, in the absence of an agreement to the contrary, works made in the course of employment by the employee belong to the employer. Similarly, copyright in a photograph or an engraving will remain with the person who commissions it rather the person who creates the work. Copyright law gives owners a number of exclusive rights to deal with the work which include the exclusive right to produce or reproduce all or any substantial part of a work in any material form whatsoever, to perform, publish, and record the work, and to communicate the work to the public by telecommunication. It is an infringement of copyright for anyone other than the owner to undertake any of these actions without consent. The Copyright Act lists a number of civil remedies that are available and provides a number of exceptions to the infringement rule such as fair dealing for the purposes of research, private study and news reporting.

2. Domain Name Protection

Internet domain names have become incredibly valuable assets for businesses, especially for franchisors whose success is largely tied to their brand names and trademarks. A U.S. franchisor looking to expand into Canada should register a ".ca" domain name as soon as practicable to protect and enhance its brand in the Canadian market and to prevent a cyber-squatter or a competitor from doing so instead. The ".ca" domain is the Internet country code top-level domain for Canada and must be registered with the Canadian Internet Registration Authority (CIRA). CIRA has set certain Canadian presence requirements which must be met in order to register a ".ca" domain name. In general, a registrant must be either a Canadian citizen or a corporation registered to do business in Canada. However, the owner of a trademark that is registered in Canada may also register for a ".ca" domain name, as long as the name consists of, or includes the exact word component of that registered trademark.[18] Therefore, a U.S. franchisor who has registered one or more marks in Canada could apply for a ".ca" domain name even though it is domiciled in the U.S. or otherwise outside of Canada.[19]

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[17] *CCH Canadian Ltd. v. Law Society of Upper Canada*, 2004 SCC 13, 236 D.L.R. 4th 395, 317 N.R. 107, 30 C.P.R. 4th 1, [2004] 1 S.C.R. 339 (Can.).

[18] CIRA, *CIRA Policies, Rules, and Procedures: Canadian Presence Requirements for Registrants*, http://www.cira.ca/assets/Documents/Legal/Registrants/CPR.pdf (last visited July 19, 2012).

[19] The precise legal nature of domain names remains a live issue in Canada. Recently, in *Tucows.com Co. v. Lojas Renner SA*, 2011 ONCA 548, ¶ 69 (Can. Ont.), the Ontario Court of Appeal held that domain names are "intangible property" and recognized that domain names may represent valuable assets of a business. This decision is currently being appealed to the Supreme Court of Canada.

C. Methods of Expansion

There are various considerations that U.S. franchisors should take into account when determining the most suitable method of expansion into Canada.[20] A U.S. franchisor may, for example, sell unit franchises (or area representative or development rights) directly into Canada, using its U.S.-based franchisor or an affiliate dedicated for Canadian or international expansion purposes. Alternatively, the franchisor may wish to incorporate a Canadian subsidiary or affiliate to demonstrate to its Canadian franchisees and customers and suppliers that it is committed to expansion into Canada and to the Canadian marketplace. Other U.S. franchisors may find it more prudent to incorporate a Canadian entity to address certain of the franchisor's logistical needs, meet Canadian regulatory requirements or serve to insulate the U.S. franchisor from liability associated with granting franchise rights into Canada.

Apart from the above-noted important factors, a U.S. franchisor may pursue a particular method of entry into Canada largely or solely on account of the substantial tax benefits or consequences associated with a particular method of conducting business in Canada. Of course, U.S. domestic considerations must be taken into account as well when conducting the Canadian tax analysis. As such, a U.S. franchisor should seek cross-border tax and accounting advice that addresses its particular domestic tax position and circumstances, as well as its long term Canadian and international plans. At times, these marketing, tax, liability and other considerations may conflict with each other and, in such cases, a U.S. franchisor may be forced to adopt one method of entry over another. For example, a U.S. franchisor may find it beneficial to choose a method of entry into Canada that is motivated by tax reasons exclusively and disregard all other factors. All too often, however, a U.S. franchisor's choice of market entry into Canada is dictated by none of the above considerations, but simply by the offer being made by the Canadian prospective licensee. Though the offer of financial reward is often very tempting to franchisors, such an approach is not an advisable one to pursue, as it often causes U.S. franchisors to ignore or downplay the strategic issues associated with the offer under consideration.

Finally, U.S. franchisors will from time to time, view Canada as one territory to be licensed to a master franchisee, for example. Treating Canada as one distinct franchised opportunity can provide tangible advantages for U.S. franchisors as doing so increases the likelihood of receiving a higher master franchise fee and is less onerous to manage administratively, as compared to managing several unit franchises, area developers or master franchisees throughout Canada. However, there are significant disadvantages associated with this approach as well. Canada's expansive size, being the second-largest country in the world by total area, makes it difficult for a master franchisee to manage and develop this large swath of territory and to do so economically. Furthermore, the higher the master franchise fee, the more difficult it may be for U.S. franchisors to source qualified and financially sound Canadian master franchisees suitable for the franchise systems.

[20] *See* Joseph Y. Adler & Paul Jones, *Bringing a Foreign Franchise System to Canada*, Ontario Bar Association Fifth Annual Franchise Law Conference (Sept. 2005), for a more detailed elaboration of these structural considerations when expanding into Canada.

D. Tax Considerations

U.S. franchisors looking to expand their systems into Canada should consider the Canadian income, goods and services and provincial sales tax issues surrounding such cross-border expansion.

Sales Taxes. The Canadian federal government imposes a Goods and Services Tax (GST) which is a value-added tax on the goods and services supplied or deemed to have been supplied in Canada. The provinces of Ontario, New Brunswick, Newfoundland and Labrador, British Columbia[21] and Nova Scotia have each combined their provincial sales tax (PST) with the GST, to create a harmonized sales tax (HST), while the balance of the Canadian provinces and territories apply their own PST in conjunction with the GST. The HST is collected by the Canada Revenue Agency (CRA), which remits the appropriate amounts to the participating provinces. The HST differs slightly across the five participating provinces, as each province sets its own PST rates within the HST.[22]

A U.S. franchisor deemed to be "carrying on business" in Canada, is required to register for GST/HST purposes and, once registered, is required to charge, collect and remit such taxes to the federal government. Registrants, however, are entitled to certain input tax credits for any tax paid on their purchases, which directly reduces the amount of GST required to be remitted to the federal government. A U.S. franchisor will be deemed to be "carrying on business" in Canada for GST/HST purposes if, among other things, it concludes contracts in Canada. While most goods and services are subject to GST/HST, some are exempt or zero rated.

Income Tax. Similarly, under the Canadian Income Tax Act ("ITA"),[23] a U.S. franchisor may be taxed in Canada if it is deemed to be "carrying on business" in Canada,[24] though the test for carrying on business under the ITA differs slightly from the test applicable for GST/HST purposes. Even a very minimal degree of business activity in Canada may satisfy the "carrying on business" test for income tax purposes and may expose a U.S. franchisor to Canadian tax liability. For example, if a U.S. franchisor concludes a franchise agreement in Canada, or has other indicia of it generating profits from a location in Canada, then this relatively low threshold for the "carrying on business" test will be met. The Canada-United States Income Tax Convention (the "Treaty"),[25] however, provides that a U.S. entity that qualifies for Treaty benefits will not generally be subject to tax for carrying on business in Canada unless such business is carried on through a "permanent establishment." The Treaty, therefore, effectively raises the threshold level of business activity necessary to subject the franchisor to Canadian tax.

[21] Note that BC is transitioning back to PST commencing next year and so will no longer be a harmonized province.

[22] Each of Ontario, New Brunswick and Newfoundland and Labrador charge HST of 13%, while British Columbia charges 12% and Nova Scotia charges 15%.

[23] R.S.C. 1985, ch. 1 (5th Supp) (Can.).

[24] In addition, a U.S. franchisor may be taxed in Canada if it had a taxable capital gain in Canada or if it is required to pay tax on taxable income that it earns in Canada under ITA, *id.* § 115, including payments for services rendered in Canada for which taxes were withheld under the Income Tax Regulations, C.R.C., ch. 945, Regulation 105.

[25] Implemented in Canada by the Canada–United States Tax Convention Act, 1984 S.C. 1984, ch. 20 (Can.).

A key question for tax purposes, therefore, is whether a U.S. franchisor's business in Canada creates a permanent establishment.[26] A permanent establishment will generally be considered to exist if there is a fixed place of business in Canada at which the business of the U.S. franchisor is carried on or if the U.S. franchisor has an agent who acts on its behalf in Canada (other than an agent of independent status acting in the ordinary course of its business) and that agent has and habitually exercises an authority to conclude contracts in the name of the U.S. franchisor. A U.S. franchisor who sends its personnel into Canada to train its Canadian franchisees on a regular and recurring basis may inadvertently establish a permanent establishment for income tax purposes.[27] In addition, recent changes to the Treaty may deem a permanent establishment to exist in certain circumstances where the non-resident taxpayer provides services in Canada to a single customer or in connection with a single project for an extended period of time, generally 183 days or more in a 12-month period (referred to as a "services PE").

Accordingly, while a U.S. franchisor selling franchises to Canadian franchisees may meet the "carrying on business" in Canada test, it will not generally amount to a "branch" or a "permanent establishment" provided that it does not have a fixed location or an active agent acting on its behalf in Canada. A permanent establishment, while technically defined in Article V(2) of the Treaty to include a branch, may be broader for tax purposes (i.e., a permanent establishment includes, for example, a place of management, office, factory or workshop). Therefore, cross-border payments made to the U.S. franchisor in the form of royalties and marketing contributions, for example, will be characterized and treated for tax purposes in the manner described below as "Specific Transactions."

When expanding into Canada, U.S. franchisors will typically pursue one of the following four methods of expansion:

(a) By indirectly carrying on business in Canada through a Canadian subsidiary of the franchisor or an affiliate of the franchisor, which subsidiary or affiliate is legally distinct from the franchisor ("Subsidiary");

(b) By indirectly carrying on business in Canada through a Nova Scotia, British Columbia or Alberta unlimited liability corporation ("ULC"). A ULC is treated as a corporation, and is subject to tax at the corporate level, for Canadian tax purposes, but may qualify for disregarded entity or partnership status for U.S. tax purposes, and may therefore be treated as transparent.[28] The flexibility of this hybrid entity provides U.S. franchisors with certain benefits which should be considered when deciding upon the appropriate entry vehicle for expansion into Canada;

(c) By directly carrying on business in Canada through a branch operation that is a division of the franchisor ("Branch"); or

(d) Without carrying on business in Canada through a Subsidiary, ULC or Branch, but by directly entering into periodic business transactions in Canada (e.g.,

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[26] "The theory underlying the idea of permanent establishment is to distinguish between trading <u>in</u> a country and trading <u>with</u> a country." Vern Krishna, Canadian International Taxation (Carswell Legal Publishers,1995).

[27] *See Fowler v. MNR*, 90 DTC 1834, [1990] 2 C.T.C. 2351 (Can. T.C.C.).

[28] Under the U.S. Internal Revenue Code, it is possible to check-the-box to treat the ULC as a corporation, but the default classification is as a flow-through.

directly granting unit franchises and receiving royalties and other payments from its franchisees in Canada) ("Specific Transactions").

Under the ITA, a Subsidiary is subject to taxation if it has taxable income. A U.S. franchisor parent may be subject to withholding taxes under the ITA with respect to payments from the Subsidiary. The basis for this taxation is payment by a resident of Canada to a non-resident. Interest, dividends, rents, royalties, management and administration fees and income from property from Canadian sources are payments that are commonly subject to this tax. A Canadian Subsidiary that makes a payment to a U.S. franchisor parent is responsible for collecting and remitting the withholding tax, failing which, the resident Subsidiary becomes personally liable for the amount not so withheld. The withholding tax is on gross payments without deduction for expenses. The domestic rate of Canadian non-resident withholding tax is 25%, however, the Treaty provides for no or a reduced withholding rate, depending upon the type of payment being made to the U.S. franchisor. Dividends to the U.S. franchisor parent are taxed at 5% (assuming the parent holds 10% or more of the shares of the subsidiary), while interest payments are no longer subject to withholding tax.

A U.S. franchisor parent will generally capitalize its Subsidiary by way of share capital or loan. While dividends are subject to withholding tax, intercompany interest payments are not, provided the debt to equity ratio maintained for purposes of the Canadian thin capitalization rules (1.5:1) is respected.

The Treaty provides an exemption for withholding tax on management or administration fees paid by a Subsidiary to a U.S. franchisor parent for managerial services rendered by the U.S. franchisor on behalf of the Subsidiary. Managerial services include the functions of planning, direction, control and coordination. As noted above, the Treaty exempts "business profits" earned in Canada by the U.S. franchisor parent from tax for so long as the profits are not earned through a "permanent establishment" in Canada of the U.S. franchisor parent. Management fees are protected from withholding tax because the Subsidiary is not generally considered to be a permanent establishment and management fees are considered to be business profits. Both the expense and profit elements of a management fee are shielded by the exemption. To be exempt, any payment of management fees must be for legitimate managerial services actually rendered, must be reasonable under the circumstances, and should be evidenced in writing at the time of the transactions to substantiate the basis of the payment.

As noted above, a Subsidiary of a U.S. franchisor is liable to pay income tax under the ITA. A U.S. franchisor operating directly in Canada through a Branch, as opposed to indirectly through a Subsidiary, is also subject to this tax. A U.S. franchisor parent is taxed because it is carrying on business in Canada through the Branch operation. The Part I tax therefore arises in the case of both a Subsidiary and a Branch. In the former case, the Subsidiary is taxed; in the latter case the U.S. franchisor is taxed.

In addition to the income tax payable under the ITA, a U.S. franchisor parent operating through a Branch is also subject to a branch tax. The general purpose of the branch tax is to equalize the Canadian tax position on business in Canada through a branch operation with that of a non-resident who does so through a Canadian Subsidiary. Although income tax on the Canadian operations of a U.S. franchisor parent will be identical whether such operations are structured in the form of a Branch or a Subsidiary, the amount of withholding tax paid in the two scenarios will obviously differ.

Branch tax and income tax are imposed upon taxable income earned in Canada by the Branch. Under the ITA, the branch tax is imposed at the domestic rate of 25%, but the Treaty reduces the branch tax rate to 5%[29] and creates a cumulative exemption with respect to the first $500,000.00 CDN of earnings in Canada. In addition to this exemption, there is an advantage to commencing business in Canada by way of a Branch so as to facilitate deduction of Canadian losses against U.S. income with respect to initial start-up losses. For this reason, projected earnings in Canada and U.S. income levels are important factors to consider when examining whether to expand into Canada by way of a Branch or a Subsidiary.[30]

If neither a Subsidiary nor a Branch exists in Canada, then withholding tax applies to the corporation in specific transactions, depending upon the nature of the transaction and the payment. Withholding tax is reduced from 25% to 10% under the Treaty on most royalties in the franchising context. Payments by Canadian franchisees to a U.S. franchisor for product purchased by such franchisees generally do not attract withholding tax, but any royalties or other licensing fees, rent, marketing contributions or other payments to the U.S. franchisor will subject the franchisees to withholding tax.

Transfer Pricing. If a U.S. franchisor chooses to operate through a Subsidiary, and provides management, marketing and accounting services or supplies certain intangible property such as trademark rights to the Subsidiary, it will be required to comply with the ITA's transfer pricing requirements, which impose certain reporting and filing requirements with the CRA. In general, these rules require the U.S. franchisor and the Subsidiary to maintain contemporaneous documentation establishing the basis upon which the intercompany charges have been determined and supporting that this methodology is consistent with an arm's length standard.

Regulation 105 Withholding. Every person who pays a fee, commission or other amount to a non-resident in respect of services rendered in Canada, of any nature whatsoever, must deduct or withhold 15% tax from such payment and remit it to the CRA.[31] "Every person" includes any individual, corporation, trust, partnership, legal representative or third party, whether resident or non-resident of Canada. Furthermore, the CRA broadly interprets the wording "in respect of" to mean that the payment for which the withholding is required need not be paid only for services or be paid to the person who performed the services.[32]

This withholding tax for non-residents is not a final determination of their tax obligation; rather it is a way to ensure that the non-residents fulfill their Canadian income tax obligations. Once the non-residents file their Canadian income tax returns, they may be refunded all or part of the withheld amount. Regulation 105 thus operates as a back-up withholding tax.

[29] Treaty, *supra* note 25, Article X(6).

[30] Use of losses is also important here. In addition, it is often possible to incorporate a branch subsequently on a tax-deferred basis.

[31] ITA, *supra* note 23, ¶ 153(1)(g); and Income Tax Regulations, C.R.C., ch. 945, Reg. 105 (Can.).

[32] Canada Revenue Agency Income Tax Information Circular No. 75-6R2, *Required Withholding from Amounts Paid to Non-Residents Providing Services in Canada* (Feb. 23, 2005), available at: http://www.cra-arc.gc.ca/E/pub/tp/ic75-6r2/ic75-6r2-e.html (last visited July 19, 2012). For more information on payments to non-residents for services provided in Canada see the CRA's website: http://www.cra-arc.gc.ca/E/pub/tg/rc4445/rc4445-e.html (last visited July 19, 2012).

A U.S. franchisor may apply to have the tax withholding waived or reduced. A waiver application must be filed at least 30 days before the period of service begins, or 30 days before the first payment for the related services. The U.S. franchisor must show that the withholding is more than its potential tax liability in Canada, either due to treaty protection or income and expenses. If the waiver application is approved, the CRA will authorize the applicable payers to not withhold tax or withhold tax at a reduced rate. However, the waiver is also not a final determination of a U.S. franchisor's tax liability in Canada and the U.S. franchisor is still required to file an income tax return.

E. Regulation of Franchise Offers and Sales

1. Disclosure Laws – An Introduction

Though there is no existing federal franchise legislation in Canada, the provinces of Ontario, Alberta, Prince Edward Island, New Brunswick and Manitoba (the "Franchise Disclosure Jurisdictions") have enacted specific legislation regulating franchising in their respective jurisdictions (the "Canadian Disclosure Laws"). It is unlikely that the remaining provinces will pass franchise disclosure legislation in the foreseeable future.

The Canadian Disclosure Laws are predominantly pre-contractual disclosure based, with a sprinkling of some relationship provisions. The relationship among franchisors and franchisees is increasingly becoming more litigious, though not to the extent found in the U.S. There is, however, a growing perception that the Canadian Disclosure Laws and the developing case law surrounding these laws are making Canada an inhospitable jurisdiction for U.S. (as well as other foreign and Canadian) franchisors. While there certainly have been some court decisions that would buttress that perception, there are two counter-arguments to assuage U.S. franchisors. First, it is a well-known maxim that bad facts make bad law, and the Canadian courts have certainly seen their fair share of bad facts in franchise disclosure cases. Second, while Canadian courts have interpreted the Canadian Disclosure Laws in a manner quite favorable to franchisees, there are signs that the pendulum is swinging in favor of franchisors.[33]

At first glance, the Canadian Disclosure Laws in each of the Franchise Disclosure Jurisdictions appear to be very similar to each other in both form and substance. A deeper analysis, however, reveals that there are significant variations among these statutes from both a procedural and substantive point of view, variations that will have a significant impact on the rights and obligations of franchisors and franchisees. These variations are substantial enough to be a trap for the unwary and uninitiated.

It is a commonly held view that, as among the franchise disclosure statutes in Canada, the Ontario Arthur Wishart Act (Franchise Disclosure) 2000[34] (the "Ontario Act") and regulations[35] ("Ontario Regulations") is the most poorly drafted piece of legislation. The provincial legislatures in the provinces of Prince Edward Island, New Brunswick and Manitoba, however, have made significant strides in addressing and improving some of the more problematic provisions found in the Ontario Act.

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[33] *See Fairview Donut Inc. v. TDL Group Corp*., 2012 ONSC 1252 (Can.), *TA & K Enterprises Inc. v. Suncor Energy Products Inc*., 2011 ONCA 613 (CanLII) and *Vijh v. Mediterranean Franchise Inc*., 2012 ONSC 3845 (CanLII) for three relatively recent examples of franchisor-friendly decisions.

[34] S.O. 2000, ch. 3 (*Ontario Act*).

[35] Arthur Wishart Act Regulations 581/00 (*Ontario Regulation*).

2. Application of Canadian Disclosure Laws

Each of the Franchise Disclosure Laws in the provinces of Ontario,[36] New Brunswick,[37] Prince Edward Island [38] and Manitoba[39] provide that the statute will apply if the business operated by the franchisee under the franchise agreement is to be "operated partly or wholly in" in the said province,[40] whereas the Alberta Act[41] requires the same as well as some measure of residency or a permanent establishment in Alberta.[42] The Ontario Court of Appeal; however, upheld the lower court's decision in *405341 Ontario Limited v. Midas Canada Inc.*,[43] that held that parties to a franchise agreement may choose the laws of one province to govern the validity, construction, performance and enforcement of the agreement applicable to franchises operating in another province as if the business of the franchise was operated in such province, even though it were not so "operated partly or wholly in the said province."

3. Exemptions to Canadian Disclosure Laws and Exceptions to Disclosure Requirements

The Canadian Disclosure Laws each have various exemptions to the application of the statutes in their entirety,[44] exceptions to the disclosure obligations,[45] as well as financial disclosure exceptions.[46] Some of the Franchise Disclosure Jurisdictions provide certain exceptions to the 14-day rule in the case of receiving a fully refundable deposit or the entering into of a site location or territory agreement.[47] Section 1(1)(f) of the Alberta Act further exempts from the definition of a "franchise fee" (and therefore from the application of the Alberta Act) a purchase of or an agreement to purchase a reasonable amount of goods or services at a reasonable bona fide wholesale price.[48]

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[36] *Ontario Regulation* and *Ontario Act*.

[37] Franchises Act, S.N.B. 2007, ch. F-23.5 (*NB Act*) and Disclosure Document Regulation, N.B. Reg. 2012-92 (*NB Regulation*).

[38] Franchises Act, R.S.P.E.I. 1988, ch. F-14.1 (*PEI Act*) and Franchises Act Regulations, P.E.I. Reg. EC232/06 (*PEI Regulation*).

[39] Franchises Act, C.C.S.M. ch. F156 (*Manitoba Act*) and Franchises Regulation 29/2012 (*Manitoba Regulation*).

[40] § 2(1) of each of the *Ontario, PEI,* and *Manitoba Acts*, and § 2(2)(b) of the *NB Act*.

[41] Franchises Act, RSA 2000, ch. F-23 (*Alberta Act*).

[42] *Id.* at § 3(1), which provides that the Act will apply: (a) if the franchised business is to be operated either partly or wholly in Alberta, and (b) if the purchaser of the franchise is an Alberta resident or has a permanent establishment in Alberta for the purposes of the *Alberta Corporate Tax Act*, R.S.A. 2000, ch. A-15.

[43] 2010 ONCA 478 (CanLII).

[44] § 2(3) of each of the *Ontario, PEI* and *Manitoba Acts*, § 2(4) of the *NB Act*, and a ministerial exemption only in § 6(1) of the *Alberta Act*.

[45] § 5(7) of each of the *Ontario* and *PEI Acts*, § 5(8) of the *NB Act*, § 5(11) of the *Manitoba Act*; and § 5(1) of the *Alberta Act*.

[46] § 11 of the *Ontario Regulation*, § 8 of the *NB* and *Manitoba Regulations*, § 6 of the *PEI Regulation*; and § 1 of the Franchises Act Exemption Regulation, Alta Reg 312/2000 (*Alberta Regulation*).

[47] § 4(6)-(8) of the *Alberta Act* and § 5 of the *Alberta Regulation*, § 5(12) & (14) of the *Manitoba Act* and § 5(11) of the *NB Act*.

[48] As well as "a payment of a reasonable service charge to the issuer of a credit or debit card by an establishment accepting the credit or debit card, as the case may be."

4. Purpose and Some Additional Principles of Interpretation of the Canadian Disclosure Laws

The purpose of franchise disclosure legislation is to "protect the interests of franchisees".[49] This rationale for such legislation has been affirmed by the Ontario Court of Appeal in several decisions and has been one of the guiding principles of the Ontario courts.[50]

Furthermore, the Ontario Court of Appeal in *Dollar It* cites with approval another decision of the same court,[51] that "one of the prime purposes of the Act is to obligate a franchisor to make full and accurate disclosure to a potential franchisee so that the latter can make a properly informed decision about whether or not to invest in a franchise."

Pre-contractual disclosure to prospective franchisees was clearly not the only purpose of the legislation. Courts have held that the franchise disclosure legislation is "remedial legislation," deserving of a broad and generous interpretation whose purpose is to redress the imbalance of power as between franchisor and franchisee, to provide a remedy for abuses stemming from this imbalance and as an important ancillary purpose, to level "the playing field by imposing a reciprocal duty of fair dealing and a right of free association of franchisees." [52] Accordingly, the disclosure requirements and the penalties imposed for non-disclosure will be broadly construed[53] and interpreted in a manner that is commercially reasonable and that balances the rights of both franchisor and franchisee.[54]

5. A Summary of Canadian Disclosure Laws

Although the legislation in each of the Franchise Disclosure Jurisdictions is similar in many respects, the Prince Edward Island, New Brunswick and Manitoba franchise disclosure statutes are the most alike since they are substantially based on the Uniform Law Conference of Canada's Model Franchise Act. Of the provinces with legislation currently in force, the Ontario Act and Regulations are generally perceived as imposing the most onerous disclosure obligations and as being the most ambiguous and problematic of the Canadian Disclosure Laws.

14-Day Rule and Summary of Disclosure Obligation. Franchisors are obligated to provide disclosure to prospective franchisees in the form of a disclosure document on the earlier of 14 days prior to the execution of a "franchise agreement" or payment of any monies by the franchisee to the franchisor or franchisor's associate.[55] The definition of a "franchise" in each of

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[49] *Personal Service Coffee Corp. v. Beer*, 2005 CanLII 25180 (Can. O.N.C.A.), (2005), 256 D.L.R. 4th 466, ¶ 28 (Ont. C.A.).

[50] *See* Ontario Ministry of Consumer and Commercial Relations, Ontario Franchise Disclosure Legislation (Toronto: June 1998); *6792341 Canada Inc. v. Dollar It Limited*, 2009 ONCA 385; *405341 Ontario Limited v. Midas Canada Inc.*, 2010 ONCA 478; *1490664 Ontario Ltd. v. Dig this Garden Retailers Ltd*., 2005 CanLII 25181 (Can. O.N.C.A.); *MDG Kingston Inc. v. MDG Computers Canada Inc*., 2008 ONCA 656, ¶ 1.

[51] *1490664 Ontario Ltd. v. Dig this Garden Retailers Ltd.*, *id.* ¶ 16.

[52] *Salah v. Timothy's Coffees of the World Inc*., 2010 ONCA 673 (Can.).

[53] *Personal Service Coffee Corp. v. Beer*, *supra* note 49, and *4287975 Canada Inc. v. Imvescor Restaurants Inc*., 2009 ONCA 308, 73 C.P.R. 4th 297, 247 O.A.C. 391, 305 D.L.R. 4th 193, ¶ 40 (Can.).

[54] *779975 Ontario Limited v. Mmmuffins Canada Corporation*, [2009] O.J. No. 2357, ¶ 32 (Can. S.C.J.).

[55] § 5 of each of the *Ontario, PEI,* and *NB Acts*. Note that the *Alberta and Manitoba Acts* permits payments if they are fully refundable.

the Canadian Disclosure Laws casts a fairly wide net and inadvertently captures certain distributors and licensors that would not typically be viewed as offering a franchise in the traditional sense of the term.

Each of the Canadian Disclosure Laws (with some minor variations)[56] provides that the disclosure document shall contain: (a) all material facts, including material facts as prescribed; (b) financial statements as prescribed; (c) copies of all proposed franchise agreements and other agreements relating to the franchise to be signed by the prospective franchisee; (d) statements as prescribed for the purposes of assisting the prospective franchisee in making informed investment decisions; and (e) other information and copies of documents as prescribed.

In the provinces of Ontario, Prince Edward Island and New Brunswick, the disclosure document must be delivered to the prospective franchisee at one time, with all relevant information contained in one document.[57] The disclosure document must be accompanied by a signed and dated certificate verifying that it contains no untrue information, representations or statements and includes every material fact, financial statement and other information required by the applicable Canadian Disclosure Laws.[58] By virtue of the definition of "material fact," all information contained in the disclosure document must be up-to-date and accurate, and must contain all information about the business, operations, capital or control of the franchisor or franchisor's associate or the franchise or the franchise system that would reasonably be expected to have a significant effect on the value or price of the franchise to be granted or the prospective franchisee's decision to acquire the franchise. A list of key disclosures of information to be included in the disclosure document is provided in the regulations to each of the Canadian Disclosure Laws, however, it is important to recognize that the lists are not designed to be exhaustive.

Disclosure of All Material Facts. U.S. disclosure laws require that U.S. franchisors strictly follow the mandated form of disclosure - inclusion of any additional information is prohibited. As such, this would seem to suggest that the U.S. disclosure obligation requires that franchise disclosure documents be prepared on a generic and system-wide basis. In contrast, Canadian Disclosure Laws require franchisors to provide prospective franchisees with disclosure of "all material facts, including material facts as prescribed," thereby suggesting that the "material facts" as prescribed are simply a subset of the larger category of "material facts" that need to be disclosed. In other words, the Regulations to the Canadian Disclosure Laws lists only some of the required disclosures, but they are not to be viewed as all-inclusive lists, as there may be "material facts" that are not specifically enumerated in the regulations which franchisors may be required to disclose. The definition of "material facts" therefore is not a self-

[56] § 5(4) of each of the *Ontario, PEI,* and *NB Acts* and § 5(5) of the *Manitoba Act*. Each of these statutes prescribes nearly identical disclosure obligations, with some minor variations. The *Alberta Act* is unique in this regard as it simply requires that a disclosure document contain "all material facts including material facts as prescribed," but does not elaborate on the other disclosures that are required to be made, as do the Canadian Disclosure Laws of the other Franchise Disclosure Jurisdictions.

[57] § 5(3) of each of the *Ontario, PEI,* and *NB Acts.* Note that the *Manitoba Act* permits disclosure in parts, and that the Alberta Act is silent in this regard.

[58] § 7 of the *Ontario Regulation*, § 4 of the *PEI Regulation*, § 6 of the *NB Regulation*, §§ 2(3) and (4) of the *Manitoba Regulation*, and § 2(3) of the *Alberta Regulation*.

contained one, but is broader than its statutory definition.[59] Of course, what constitutes a "material fact" will vary depending on the franchise system or the franchise offering under consideration. As such, U.S. franchisors should seek local Canadian legal advice concerning the question of materiality before deciding whether or not they are required to make certain disclosures in their disclosure documents.

Location-Specific Disclosure. Furthermore, the definition of "material facts" in each of the Canadian Disclosure Laws makes reference to providing disclosure of material facts pertaining specifically to "the franchise." Accordingly, a franchisor providing a disclosure document to a prospective franchisee in any of the Franchise Disclosure Jurisdictions is not only required to disclose those items that are specifically identified by regulation and that would constitute a "material fact" relating to the system as a whole, but also any other information "that would reasonably be expected to have a significant effect on the value or price of the franchise to be granted or the decision to acquire *the franchise*," that is, the franchise actually being offered. This rather wide definition of materiality would require franchisors to tailor each disclosure to the specific franchise being offered. The obligation to provide location-specific disclosures would require that franchisors disclose, if known at the time of disclosure, the prospective franchisee's territory, the more material terms of the lease and sublease and the identity of the landlord, if applicable, the purchase price of the franchise, the closing date, the length of time that the franchisor had been operating the franchise if it is being transferred, and whether any deposits are payable or indemnities are to be provided by the franchisee. Making location-specific disclosures would appear to further the legislative purposes of the Canadian Disclosure Laws, as articulated and interpreted by the courts to date, namely, to protect franchisees and to ensure that they make informed investment decisions. Ontario courts have consistently substantiated this broad interpretation of the Canadian disclosure obligation in general, and the need for location-specific disclosure in particular.[60]

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[59] Some examples of facts that may be deemed "material" yet are not explicitly required to be disclosed by the Canadian Disclosure Laws include the following:

- The market for the goods and services and the nature of the competition in the market.
- Obligations of the franchisor, such as whether it provides site selection and development services, opening assistance and general advice or guidance.
- Obligations of the franchisee, such as pre-opening advertising, providing records and reports to franchisor and compliance with system standards.
- Material obligations of both the franchisor and franchisee under related or collateral agreements such as a sublease or license agreement.
- Additional information about the franchisor's intellectual property, such as trademarks, copyrights and other relevant intellectual property, any objections, oppositions, judgments or known infringing uses or pending litigation that affect or may negatively impact the intellectual property.

Any risk warnings that prospective franchisees should be made aware of. For example, any of the following: if the franchisor is inexperienced or undercapitalized, the franchisor doesn't own the licensed trademarks, the trademarks are not registered in Canada or the franchisor owes a substantially large payable to an affiliate or a third party.

[60] In *6792341 Canada Inc. v. Dollar It Ltd*., 2009 ONCA 385, ¶¶ 36-39 & 77-78, the Ontario Court of Appeal held that the franchisor's failure to: 1) describe the territory to be granted to the prospective franchisee, and 2) provide a copy of the head lease for the proposed location, were material deficiencies in the franchisor's disclosure that, taken together with other deficiencies such as no financial statements and no signed certificate, amounted to no disclosure at all under the Act. In *6862829 Canada Ltd. v. Dollar It Ltd*., 2008 CarswellOnt 6948, ¶¶ 27-29 (rev'd in part on other grounds, 2010 ONCA 34), the Ontario Superior Court of Justice held that the franchisor's failure to disclose: 1) the offer to lease, 2) the head lease, and 3) the fact that the sub-landlord under the sublease was a subsidiary of the

Taken together with other material deficiencies, the failure to provide location-specific disclosure may give a franchisee a 2-year rescission right. However, it remains to be seen whether any of the deficiencies considered by the Ontario courts, on its own, would give rise to the powerful rescission remedy, or whether it would simply constitute a lesser form of deficient disclosure that may give a franchisee the weaker 60-day rescission right. In the absence of a bright-line rule on this issue, it is generally recommended that franchisors provide as much location-specific disclosure as possible.

Evergreen Disclosure Requirement. A corollary of the above is that Canadian Disclosure Laws impose an evergreen disclosure requirement upon franchisors. Disclosure documents must be materially up-to-date at the time of each and every disclosure. A disclosure document must contain all material facts as prescribed, and the determination of what constitutes materiality is to be made immediately before each and every disclosure.

Statement of Material Change. A franchisor must also issue "as soon as practicable after the change has occurred," a statement of material change if there is any "material change" to the franchise system or the franchise to be purchased following the date of disclosure but prior to the earlier of: (a) the signing by the prospective franchisee of the franchise agreement or any other agreement relating to the franchise; and (b) the payment of any consideration by or on behalf of the prospective franchisee to the franchisor or franchisor's associate relating to the franchise. Under Section 5(5) of the Ontario Act, for example, a "material change" means, in part, a:

> "change in the business, operations, capital or control of the franchisor or franchisor's associate, a change in the franchise system or a prescribed change, that would reasonably be expected to have a significant adverse effect on the value or price of the <u>franchise to be granted</u> or on the decision to acquire <u>the franchise</u>." [Emphasis added]

As with the definition of "material fact," the definition of "material change" encompasses changes that not only pertain to the system as a whole, but also to the "value or the price of the franchise to be granted" or the "decision to acquire the franchise." In each case, therefore, reference is made specifically to the franchise under consideration by the prospective franchisee.

Therefore, a franchisor is required to issue a material change statement when there is a change in the franchise system or a prescribed change that would reasonably be expected to have a significant adverse effect on the value or price of the franchise to be granted or on the decision by the prospective franchisee to acquire the franchise. Yet, if there is a material change that is not significantly adverse and that occurs before a franchisor enters into an agreement or receives any monies from a prospective franchisee, then the franchisor is required to provide a new full disclosure document (reflecting the change) and wait an additional 14 days before

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franchisor, were material deficiencies which, taken together with other such deficiencies in the disclosure document, gave rise to the franchisee's 2-year rescission remedy. The Ontario Superior Court of Justice *in 2189205 Ontario Inc. v. Springdale Pizza Depot Ltd*., 2010 ONSC 3695, ¶¶ 16-20, held that the absence of a head lease for the premises was one of several material deficiencies which together gave rise to the 2-year rescission remedy. Finally, the Ontario Superior Court of Justice in *Melnychuk v. Blitz Ltd*., 2010 ONSC 566, ¶ 11, found several deficiencies in the franchisor's disclosure that gave rise to the 2-year remedy, including the following: 1) no lease or sublease was disclosed, and 2) the proposed territory to be granted to the franchisee was not described.

executing any agreement or receiving any monies. It is unclear whether Canadian legislators had this result in mind when imposing these uneven statutory waiting periods.[61]

Except for Ontario, Canadian Disclosure Laws require that a material change statement include a certificate in a prescribed form,[62] and, except for Alberta, that each such statement be accurate, clear and concise.[63] Furthermore, each of the Canadian Disclosure Laws requires that a franchisee receive the material change statement as soon as practicable after the change occurred, and before signing the franchise agreement or any other agreement relating to the franchise and before paying any consideration relating to the franchise.[64] Nonetheless, none of the Canadian Disclosure Laws identify the specific period of time that must pass following the delivery of a material change statement, but franchisors issuing such statements should provide their prospective franchisees with an opportunity to review the statements with their legal counsel before signing any agreement or making any payment.

6. <u>Waiver of Rights under the Canadian Disclosure Laws and Releases</u>

Each of the Canadian Disclosure Laws voids any purported waiver or release by a franchisee of a right given under the legislation or of an obligation or requirement imposed on a franchisor or its associate by or under the legislation.[65] Courts are, however, willing to uphold a release where it has been given in contemplation of the settlement of a dispute,[66] but will not enforce a release where it was signed prior to the claim first arising.[67]

7. <u>Remedies for Non-Compliance with Disclosure Rules.</u>

If a franchisor fails to provide a disclosure document or a statement of material change in accordance with the requirements of the applicable franchise disclosure statute, or fails to provide a disclosure document at all, it may face serious legal consequences, including:

(a) **Right of Action for Damages**. A franchisee has a right of action for damages if it suffers a loss because of a misrepresentation contained in the disclosure document,

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[61] Changes to a franchise agreement or to certain disclosures that are required as a result of improper or inaccurate disclosures or omissions in a disclosure document may need to be provided either in a new disclosure document (thereby resetting the 14-day waiting period) if such information is specifically required to be disclosed by regulation, or in a material change statement if such information is deemed to be significantly adverse.

[62] § 2(3) of the *Alberta Regulation*, § 4(2) of the *PEI Regulation*, § 9 of the *NB Regulation*, and § 6(2) of the *Manitoba Regulation*.

[63] § 5(6) of each of the *Ontario* and *PEI Acts*, § 5(7) of the *NB Act*, and § 5(9) of the *Manitoba Act*.

[64] § 4(5) of the *Alberta* Act, § 5(5) of each of the *Ontario* and *PEI Acts*, § 5(6) of the *NB Act*, and § 5(8) of the *Manitoba Act*.

[65] § 11 of each of the *ON* and *Manitoba Acts*, § 12 of the *PEI* and *NB Acts*, and § 18 of the *Alberta Act*.

[66] The Ontario Superior Court of Justice in *1518628 Ontario Inc. v. Tutor Time Learning Centres, LLC*, 2006 CanLII 25276 (Can. O.N.S.C.) ruled that § 11 of the *Ontario Act* "does not have application to a release given (with the advice of counsel) by a franchisee in the settlement of a dispute for existing, known breaches of the Act by the franchisor in respect of its disclosure obligations, which would otherwise entitle the franchisee to a statutory rescission."

[67] *405341 Ontario Limited v. Midas Canada Inc.*, *supra* note 50,¶ 28: "if the exercise of a franchisee's rights under a franchise agreement requires a release of rights given by the AWA, the release will, at least prima facie, be void by virtue of section 11. I say "prima facie" in order to leave open the possibility of cases such as Tutor Time, or other circumstances in which it would be inequitable to permit a franchisee to rely on that provision of section 11."

in a statement of a material change or as a result of the franchisor's failure to comply in any way with the statute's disclosure requirements. This right of action may be commenced against the franchisor, the franchisor's agent, the franchisor's broker, being a person other than the franchisor, franchisor's associate, franchisor's agent or franchisee, who grants, markets or otherwise offers to grant a franchise, or who arranges for the grant of a franchise, the franchisor's associate and every person who signed the disclosure document or statement of material change.

(b) **Right of Rescission.** If late or incomplete disclosure is provided to the prospective franchisee, it may rescind the franchise agreement for a period of 60 days after receiving the disclosure document. Late disclosure occurs if a franchisor fails to provide a disclosure document or a statement of material change within the time prescribed by the Canadian Disclosure Laws. Incomplete disclosure occurs if the contents of the disclosure document do not meet the requirements of the Canadian Disclosure Laws, but the deficiency is not so significant that it triggers the two-year right of rescission.

A franchisee also has a right to rescind a franchise agreement for a period of two years after entering into the franchise agreement if a franchisor fails entirely to provide a disclosure document to the franchisee or the disclosure document is so materially deficient that it would be deemed a nullity. It is important to note that courts have invalidated disclosure documents on the basis of finding certain technical or procedural deficiencies in disclosure documents. Such deficiencies have included the following: absence of a signed certificate by the franchisor, disclosure document having not been provided in a single document and at one time,[68] and failure to include a statement specifying the basis for the earnings projections in the disclosure document.

8. Procedural Disclosure Requirements

Methods of Delivery of the Disclosure Document. The Canadian Disclosure Laws specify the means by which a disclosure document may be delivered. The Alberta Act simply states that a franchisor must "give the document," which arguably provides a franchisor with the widest latitude possible in terms of its choice of method of delivery of the disclosure document.[69] At the other extreme, the Ontario Act requires that the disclosure document may only be delivered in person or by registered mail, which presents problems for franchisors who, for example, wish to deliver disclosure documents which exceed Canada Post's weight requirements for registered mail.[70] Each of the Prince Edward Island Franchises Act (PEI Act), the New Brunswick Franchises Act (NB Act) and the Manitoba Franchises Act (Manitoba Act) provide that a disclosure document may be delivered in person, registered mail, courier (if a written acknowledgment of receipt is received from the prospective franchisee under the PEI Act and by prepaid courier under the NB Act and Manitoba Act) or email (under certain stipulated conditions).[71] Finally, the Manitoba Act also permits delivery by fax.[72]

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[68] Note that Manitoba permits delivery of a disclosure documents in parts.

[69] § 4(1) of the *Alberta Act*.

[70] § 5(2) of the *Ontario Act*.

[71] § 5(2) of each of the *PEI* and *NB Acts*, and § 5(4) of the *Manitoba Act*.

[72] § 5(4) of the *Manitoba Act*. Note that in Prince Edward Island, a disclosure document may be delivered electronically so long as it is: (a) delivered as a single, integrated document or file, (b) has no links to external

There are clearly a number of benefits to providing disclosure documents in electronic format and through electronic means. Franchisors are becoming increasingly sensitive to the environmental issues associated with lengthy disclosure documents, namely, the printing and shipping costs associated with disclosure documents, as well as the ease and time related advantages of delivering disclosure documents electronically. There are, however, certain risks associated with delivering disclosure documents on electronic media and by email.

The obvious risk in providing electronic disclosure in those jurisdictions that do not explicitly permit doing so, is that a prospective franchisee may later argue that it did not receive the disclosure document altogether or that such disclosure was not provided in accordance with applicable law, thereby invalidating the disclosure. In addition, a prospective franchisee who is not technologically savvy may simply not understand how to navigate through an electronic disclosure document, thereby not fully appreciating the franchise offering. In a recent decision of the Ontario Superior Court of Justice,[73] the court rejected the franchisee's argument that it was entitled to a two-year right of rescission simply because the disclosure document was delivered by email, on the basis that it was not a serious breach of the Ontario Act. The court did, however, grant the aggrieved franchisee the 60-day rescission right, though the franchisee could not avail itself of this right due to the passing of time, as well as the right to claim damages under the Act.

One Document and at One Time Rule. Except for the Manitoba Act, which permits delivery in parts, and the Alberta Act, which is silent in this regard, each of the Canadian Disclosure Laws provides that the disclosure document need be delivered as one document and at one time.[74] This rule is not an "empty formal requirement,"[75] but the purpose of the legislation, namely, to ensure that a prospective franchisee's decision to enter into a franchise agreement is an informed one, "would best be fulfilled by giving prospective franchisees the opportunity to review a single document or documents, so that all the information is before them at the same time".[76]

Calculation of 14-day Time Period. U.S. franchisors should pay special attention to how to calculate accurately the 14-day time period in each of the Franchise Disclosure Jurisdictions, as the time periods vary depending on the province where the disclosure is made. In particular, the date upon which disclosure is made or received may not be included in the 14-day calculation and time periods that would otherwise expire on a holiday, for example, may be extended to include the next day that is not a holiday.

The Accurate, Clear and Concise Rule. A U.S. franchisor may attempt to anticipate when preparing its disclosure document each and every possible permutation of its franchise offering by including various riders to its franchise agreement. The rationale for doing so is

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content, (c) has no extraneous content beyond what is required by law, (d) conforms to the content and format requires of the law, and (d) is delivered in a form that intrinsically enables the recipient to store, retrieve and print the information. On the other hand, New Brunswick and Manitoba permit electronic delivery by separate electronic files so long as the disclosure document contains an index listing the file name of each file, and a statement of the subject matter of each file (if the file name is not sufficiently descriptive).

[73] *Vijh v. Mediterranean Franchise Inc*., *supra* note 33, ¶6.

[74] § 5(3) of each of the *Ontario*, *PEI* and *NB Acts*.

[75] *1490664 Ontario Ltd. v. Dig this Garden Retailers Ltd.*, supra note 50, ¶ 18.

[76] *Id*.

certainly understandable, as it allows a franchisor the flexibility that it needs to prepare and issue unified and standardized documents and makes it easier to amend and upgrade the form of the disclosure document over time. Conversely, the alternative, namely, preparing disclosure documents that are tailored for the specific offering at hand, is often seen as being unduly expensive in terms of administrating the disclosure process and the associated legal costs. Yet, a standardized form of disclosure document carries with it certain risks, as it may breach the "clear and concise" rule found in the Canadian Disclosure Laws.[77] The "clear and concise" requirement dictates that the information in the disclosure document and in the statement of material change must be set out accurately, clearly and concisely. Canadian courts have yet to rule on whether a lengthy disclosure document that is designed to address various franchise offerings in one standardized form would violate the "clear and concise rule," and it remains to be seen what remedy a court would offer to an aggrieved franchisee in such event.

Ontario-Specific "One Part of the Document" Rule. Disclosures in the province of Ontario need to be presented together in one part of the disclosure document.[78] This requirement was interpreted strictly by the Ontario Court of Appeal when it considered the question of whether certain financial and other key information should be located together in one part of the disclosure document. It held that this requirement was designed to "enable a reader to clearly grasp what is required and to avoid the confusion and difficulty that may arise where reference must be had to numerous other documents where the information may be located".[79]

Receipts. Though not required by any of the Canadian Disclosure Laws,[80] obtaining a receipt from a prospective franchisee upon the delivery of a disclosure document is critically important in Canada, as it may be determinative of the timeframes applicable to a franchisee's 60 day or 2-year right of rescission.

Certificate of Disclosure. Each of the Canadian Disclosure Laws requires that the certificate of disclosure be signed and dated by (i) the franchisor if unincorporated, (ii) its director or officer if incorporated and has only one director or officer or (iii) at least two persons who are officers or directors if incorporated and the franchisor has more than one officer and director.[81] In each case, however, the legislation mandates slightly differing language for the certificate, and it is therefore very important to utilize the correct wording for the disclosure being made. The certificate of disclosure is arguably one of the most critical components of a disclosure document, yet is often erroneously completed and occasionally omitted altogether. Such errors and omissions can be fatal as the absence of a signed certificate has been held to be not a technical deficiency, but a substantive one.[82]

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[77] § 5(6) of each of the *Ontario and PEI Acts,* § 5(7) of the *NB Act*, and § 5(9) of the *Manitoba Act*.

[78] § 6 of the *Ontario Regulation*.

[79] *6792341 Canada Inc. v. Dollar It Ltd*., 2009 ONCA 385, 95 O.R. 3d 291, 250 O.A.C. 280, 60 B.L.R. 4th 1, 310 D.L.R. 4th 683 ¶ 56 (Can. Ont.).

[80] Except in the case of electronic delivery, where receipts would be required in each of the provinces of Prince Edward Island (§ 2(b)(iii) of the *PEI Regulation*) and Manitoba (§ 5(1)(b)(ii) of the *Manitoba Regulation*).

[81] § 7(2) of the *Ontario Regulation*, § 6(2) of the *NB Regulation*, § 4(3) of the *PEI Regulation*, § 2(3) of the *Alberta Regulation*, and § 2(4) of the *Manitoba Regulation*.

[82] *Hi Hotel Limited Partnership v. Holiday Hospitality Franchising Inc*., 2008 ABCA 276 (CanLII).

9. Other Substantive Disclosure Requirements

Ancillary Agreements. It is not sufficient to simply include the franchise or other related and ancillary agreements within a disclosure document and to reference those agreements, but a disclosure document needs to specifically include certain prescribed information within the body of the disclosure document.[83] The Ontario Court of Appeal in *Dollar It* held that "The description of the territory is required to be in the disclosure document and the obligation is not met by putting it in the franchise agreement where that document is not part of the disclosure document."

Disclosure to Existing Franchisees. Amendments to a franchise agreement or requiring an existing franchisee to sign additional or supplemental agreements will trigger a disclosure obligation. In Canada, franchisors are obligated to disclose to "prospective franchisees." The definitions of *prospective franchisee* and *franchise agreement* are rather broad, as they include any person who is invited by a franchisor or its associate, agent, or broker to execute an agreement or who has indicated an interest to enter into any agreement that relates to a franchise between a franchisor or its associate and a franchisee. These definitions, therefore, are sufficiently expansive to impose a disclosure obligation on a franchisor even with respect to existing franchisees.[84]

Substantial Completion. Some of the Canadian Disclosure Laws provide what appears to be a saving mechanism to franchisors who may have not entirely complied with their disclosure obligations. In particular, Section 2(4) of the Regulations to the Alberta Act states that "a disclosure document is properly given for the purposes of section 13 of the Act if the document is substantially complete." Section 3(3) of the Regulations to the PEI Act provides that a "disclosure document is properly given for the purposes of section 6 of the Act if the document is substantially complete." Finally, Section 5(10) of the Manitoba Act provides that a franchisor complies with its disclosure obligations under the statute if "the franchisor's disclosure document substantially complies with this Act; and (b) even if the disclosure document contains a technical irregularity or mistake not affecting the substance of the document." Notwithstanding this apparent flexibility, the Alberta Court of Appeal in *Hi Hotel*[85] held that a disclosure document "cannot possibly be "substantially complete" under Section 2(4) of the Regulation" where there is a complete absence of signatures on the certificate of disclosure, though this deficiency was a technical and not a substantial one. This decision suggests that franchisors cannot assume that the Alberta courts (and perhaps the Prince Edward Island and Manitoba courts under similar circumstances) will provide franchisors with much latitude in terms of meeting their disclosure obligations, on the basis of the "substantially complete" defense. The Alberta Court of Appeal did not feel compelled to resort to the "substantially complete" defense in the case of a technical deficiency, so it is highly unlikely that it would do so in the event of a substantive deficiency.

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[83] *6792341 Canada Inc. v. Dollar It, supra* note 79, ¶ 55.

[84] The issue of whether disclosure is required to be made to an existing franchisee was entertained by the Ontario Superior Court of Justice in *Trillium Motor World Inc. v. General Motors of Canada Limited*, 2011 ONSC 1300, ¶ 73 (CanLII), though the court did not rule on the issue: "one could certainly argue that an amendment that involves the franchisee divesting itself of its investment, and surrendering important rights under its franchise agreement is every bit as significant as its initial decision to invest in the first instance," and that it was not unreasonable to suggest that the franchisor "had an obligation to make full and fair disclosure of all material facts known to it that might reasonably affect the franchisees' decision." This decision has been appealed to the Ontario Court of Appeal.

[85] *Hi Hotel Limited Partnership v. Holiday Hospitality Franchising Inc.*, *supra* note 82.

10. Use of Adapted U.S. Disclosure Documents

Each of the Franchise Disclosure Jurisdictions except for the province of Ontario explicitly permits the use of a foreign-based disclosure document and a domestic wraparound to ensure compliance with the applicable Canadian Disclosure Laws. While the Ontario Act does not explicitly prohibit the use of a wraparound, it does require that certain disclosures be presented together in one part of the disclosure document, thereby making it virtually impossible to use a wraparound. Furthermore, by utilizing a wraparound, a U.S. franchisor risks breaching the "clear and concise" rule, as (i) it is far more difficult to read a disclosure document when being forced to refer to a separate schedule to read the wraparound portions of the document and (ii) there are some irrelevant disclosures in a U.S. franchise disclosure document that need not be disclosed in a disclosure document for use in a Franchise Disclosure Jurisdiction. Finally, U.S. franchisors who seek to use one disclosure document for all of Canada will find it much easier to prepare a document that does not contain four separate wraparounds for the provinces of Alberta, Prince Edward Island, New Brunswick and Manitoba.

11. Preparing a Canada-Wide Disclosure Document for Use in Disclosure and Nondisclosure Provinces

Given the above, franchisors in Canada commonly prepare and disclose Canada-wide disclosure documents for use in each of the Franchise Disclosure Jurisdictions as well as in non-disclosure provinces as well. They may do so for the sake of expediency, i.e., so that they need not revise separate disclosure documents when they require updating or revision and to better manage the accuracy of the disclosure process. Franchisors who are members of the CFA, however, will also use Canada-wide disclosure documents because they are required to provide a disclosure document in every jurisdiction across Canada, regardless of whether there is a franchise disclosure statute in effect in a particular province.

When preparing a Canada-wide disclosure document, it is important to adopt the strictest disclosure requirements, namely those prescribed by the Ontario Act, to ensure that the Canadian Disclosure Laws are properly met. However, some requirements in the Canadian Disclosure Laws may conflict with each other. For instance, while each of the Regulations to the Alberta, Prince Edward Island, New Brunswick and Manitoba franchise legislation require that franchisors provide a "concise summary" of all of the termination, renewal and transfer provisions in the franchise agreement and a list of where these provisions are found in the agreement, the Ontario Regulations require a "description of all restrictions or conditions in the franchise agreement" relating to such scenarios, suggesting that a concise summary may not in fact suffice.

12. Important Distinctions between U.S. Franchise Disclosure Documents (FDD) and Canadian Disclosure Documents

When expanding into Canada and attempting to conform an FDD to Canadian law, U.S. franchisors should be aware of the various and significant distinctions between these documents and the differences in disclosure practices and requirements as between the U.S. and each of the Franchise Disclosure Jurisdictions. The following represents a cursory summary of some of those distinctions:

(a) There are no registration requirements for disclosure documents in Canada, nor any other form of government intervention or involvement. Any rights of action in Canada are simply between the parties to the franchise relationship.

(b) U.S. financial statements may not meet the standards required by the Canadian Disclosure Laws and they should be reviewed by Canadian accountants to confirm that they do or to revise the statements to ensure that they so comply.

(c) As discussed, the methods of delivery of the disclosure document will vary.

(d) Certain disclosures required in the U.S. are not required in Canada and vice versa. Simply keeping all U.S. disclosures in the Canadian disclosure document may in fact violate the "clear and concise" rule.

(e) While wraparounds may work in the provinces of Alberta, Prince Edward Island, New Brunswick and Manitoba, they will not comply with the Ontario Act.

(f) Unlike in the U.S., the disclosure obligation in the Franchise Disclosure Jurisdictions is an evergreen one, and location specific disclosures are required.

(g) The definition of a "material fact" is arguably far broader in the Franchise Disclosure Jurisdictions than it is in the U.S.

(h) In Canada, unlike the U.S., the statutory duty of good faith is expressly incumbent upon both parties, not merely the franchisor.

(i) Providing a certificate of disclosure is a critical requirement in Canada, and failure to do so could render the disclosure document a nullity. There is no such requirement to provide a certificate of disclosure in the U.S.

(j) The full extent of the kind of disclosure is to be made in an FDD are explicitly delineated by U.S. law, unlike in the Franchise Disclosure Jurisdictions, where the concept of "material fact" widens the scope of the disclosures required to be made and creates a certain measure of uncertainty and ambiguity in this regard.

(k) Finally, Canadian courts have interpreted the Canadian Disclosure Laws and have enforced the relatively draconian laws in a manner that is quite favorable to franchisees, though the pendulum has begun to swing in favor of franchisors.

F. Other Canadian-Specific Amendments to the Franchise Agreement

Although Canadian franchise agreements are not substantially different from those found in the U.S., U.S. franchisors when expanding a franchise system into Canada will need to conform their agreements to Canadian laws and regulations, including, the Canadian Disclosure Laws. U.S. franchisors are therefore required to "Canadianize" not only their disclosure documents to address Canadian Disclosure Laws, but their franchise agreements as well. Some franchisors prefer to use and amend their U.S. franchise agreements to comply with Canadian law, though at times it may be more economical to prepare entirely new documents.

The following is a sampling of some of the relevant provisions and issues which arise in this regard:

(a) **Licensor of Trademarks**. It is important to identify the correct licensor of the trademarks throughout the form of the franchise agreement for Canada if the U.S. franchisor is not the owner of such marks. It is important to note that if a U.S. franchisor franchising in Canada does not own the trademark, then it should be sure to enter into a license agreement for the purpose.

(b) **Currency, Economic Modeling and Currency Fluctuations**. Where a U.S. franchisor operates its franchise system in Canada through a Canadian Subsidiary, it will most typically require that any payments to be paid by its Canadian franchisees be made to it in Canadian dollars. Where, however, a U.S. franchisor is directly dealing with its Canadian franchisees through a U.S. entity, it will need to consider whether such payments should be in Canadian or U.S. currency. A U.S. franchisor should also examine whether all fees to be paid by its Canadian franchisees should be identical to the U.S. offering, or adjusted to address the specifics of the Canadian offering and marketplace to ensure that it is economically viable from both franchisor's and franchisees' points of view. Finally, where payments are made in U.S. dollars, a U.S. franchisor should seek comfort that any risks in currency fluctuation as between the dates upon which the payments were to be made and when they are in fact made, should be borne by the franchisees.

(c) **Withholding and Sales Taxes**. As noted above,[86] a U.S. franchise agreement should be amended to require Canadian franchisees to withhold the applicable withholding taxes and to remit them to the Canadian tax authorities when they make their cross-border payments to their U.S. franchisor.

(d) **Interest and the Interest Act (Canada)**. It is customary for U.S. franchisors to charge their franchisees a monthly interest rate on outstanding amounts due to the franchisors. Under the federal *Interest Act* (*Canada*),[87] however, whenever any interest is, by the terms of any contract made payable at a rate or percentage for any period less than a year, no interest exceeding the rate or percentage of five per cent per annum may be charged on any part of the principal money, unless the contract contains an express statement of the yearly rate or percentage of interest to which the other rate or percentage is equivalent. In other words, should a U.S. franchisor require an interest rate that is greater than five percent, it is important to ensure that it is expressed in the form of an annualized rate.

(e) **Establishing a Separate Canadian Marketing Fund.** U.S. franchise agreements will often make reference to the existence of certain marketing funds established by the franchisors, but such funds are inevitably established in the U.S. to address the specific marketing needs of their U.S. franchisees. When expanding to Canada, U.S. franchisors should consider the need to establish a marketing fund designed to address the needs of their Canadian franchisees. Where such a fund is established, the franchise agreement should be amended to delineate the fact that such a Canadian marketing fund has in fact been established.

(f) **Governing Law, Forum and Dispute Resolution Provisions.** The governing law, forum and dispute resolution provisions of U.S. franchise agreements need to be Canadianized in order to make them enforceable and otherwise to facilitate the enforcement of certain legal remedies.

(g) **References to Consumer Price Index, U.S. Banks and U.S. Measuring System.** Though not having a legal impact per se, it is prudent to consider utilizing the Canadian equivalents to any specific U.S. method of measurement or institution. Canadian franchisees appreciate the attempts by U.S. franchisors to be sensitive to the cultural, business and legal nuances of conducting business in Canada and the agreements are often the first indicators of such sensitivities.

[86] Section II.D of this paper.

[87] R.S.C., 1985, ch. I-15.

(h) **References to U.S. Laws.** U.S. franchise agreements will often make reference to certain U.S. legislation, either of a general application such as the *Patriot Act* or of a more specific statute relevant to the franchised business being offered. Such references should be amended by identifying the applicable Canadian legislation, if any, that is equivalent to the U.S. legislation.

(i) **Employment Related Issues.** Any employment-related references should be Canadianized to ensure compliance with Canadian law. For example, any reference to an employer's right to terminate an employment relationship at will should be removed and modified in accordance with Canada's wrongful dismissal laws.

(j) **Guarantees in Alberta**. Is important to note that personal guarantees sought in the province of Alberta require special attention to ensure enforceability. In particular, a franchisor should ensure that any personal guarantee signed by a guarantor in Alberta is executed in accordance with the *Alberta Guarantees Acknowledgment Act*.[88]

(k) **Canadian Spelling of Words.** Though more of a marketing issue than a legal one, U.S. franchisors should adapt their U.S. franchise agreements to accommodate the differences as between the U.S. and Canadian spelling of words. Canadian prospective franchisees will find a U.S. franchise agreement (and disclosure document) much friendlier if prepared with the sensitivity in mind.

(l) **Operation Manual.** In addition to amending the U.S. form of franchise agreement to accommodate Canadian laws and customs, U.S. franchisors should also Canadianize their operation manuals to ensure that their contents similarly comply with all applicable Canadian laws. Inconsistencies as between the obligations imposed by each of the franchise agreement and the operation manual will only cause confusion as among the Canadian franchisees, and possibly expose a franchisor to liability as a result.

1. Restrictive Covenants

The principal purpose of restrictive covenants in the franchising context is, as is the case in the U.S., to protect a franchisor's trade secrets and proprietary information. Generally speaking, non-solicitation and non-disclosure covenants are more readily enforceable in Canada than are non-competition covenants, which are viewed negatively as a restraint of trade. Restrictive covenants are prima facie unenforceable in Canada, unless they are deemed to be reasonable and they meet certain criteria. The Supreme Court of Canada in *Elsley v. J.G. Collins Insurance Agencies Ltd.*[89] is the leading Canadian case which established a three-part test in determining whether a restrictive covenant is enforceable.[90]

First, the covenant must protect a proprietary interest that it is entitled to protect, for example, the franchisor's trade secrets and reputation and goodwill. Second, the covenant must not be overly broad with respect to time or space, i.e., the term of the covenant and the territory

[88] Guarantees Acknowledgment Act, R.S.A. 2000, ch. G-11. Under this statute, no guarantee has any effect unless the person entering into the obligation appears before a notary public, acknowledges to the notary public that he or she executed the guarantee, and in the presence of the notary public signs a statement in the prescribed form.

[89] [1978] 2 S.C.R. 916 (Can.).

[90] *Id.* ¶ 19.

to which it applies, and the nature and extent of the business being restrained. Third, it must not be against competition generally, but should be a reasonable restraint of trade under the circumstances. Given the above, to be enforceable, restrictive covenants should be drafted more narrowly, unambiguously and with greater specificity than covenants typically found in U.S. franchise agreements. If a Canadian court finds that a restrictive covenant has ambiguous terms, it is more likely to strike out the covenant in its entirety than to sever or rewrite the ambiguous terms.[91]

As noted above, a party seeking to enforce a restrictive covenant must show that it is reasonable.[92] A court will determine the reasonableness of a restrictive covenant with reference to the context of the relationship between the parties and all of the circumstances surrounding the agreement between them.[93] For example, since an employer is presumed to have much more bargaining power relative to its employee, courts scrutinize covenants in favor of employers very carefully. Similarly, given the power imbalance between franchisors and franchisees, Canadian courts are much more reluctant to enforce a restrictive covenant in favor of a franchisor. This would not be the case however in a more balanced commercial relationship, such as that between a purchaser and a vendor, where a vendor seeks to enforce a non-competition covenant against the purchaser in the course of a purchase and sale transaction.

2. Anti-terror legislation and other examples of attempts at extraterritorial application of U.S. laws

Canada has various federal anti-terror statutes which regulate certain activities by individuals and corporations. The *Proceeds of Crime* (*Money Laundering*) *and Terrorist Financing Act*[94] applies primarily to financial institutions. It imposes various requirements on these institutions in respect of record keeping, client identification, and reporting of financial transactions and cross-border movements of currency and monetary instruments. In addition, the federal *Anti-Terrorism Act*[95] (*ATA*) created various anti-terror provisions in several other statutes, including the *Criminal Code*.[96] The *ATA* provides similar measures to those of the *Patriot Act* in the U.S., though there are significant differences and franchisors that might be subject to these measures should retain Canadian counsel with expertise in this area.

The *Foreign Extra-Territorial Measures Act*[97] (*FEMA*) empowers the Attorney General of Canada to make orders relating to the measures of foreign states and courts affecting international trade and commerce. *FEMA* thereby allows the Canadian government to protect Canadian interests against foreign courts and governments who seek to apply their laws extraterritorially to Canada. At present, the Attorney General has issued only one order pursuant to *FEMA*: the *Foreign Extraterritorial Measures* (*United States*) *Order, 1992*. This Order prohibits a Canadian corporation, including its officers, directors, managers, and employees

[91] *Veolia ES Industrial Services Inc v. Brule*, 2012 ONCA 173 (Can.).

[92] *Id*. ¶ 18.

[93] *Elsley v. J.G. Collins Ins. Agencies*, *supra* note 89.

[94] S.C. 2000, ch. 17 (Can.).

[95] S.C. 2001, ch. 41 (Can.).

[96] R.S.C. 1985, ch. C-46 (Can.).

[97] R.S.C. 1985, ch. F-29 (Can.).

from complying with (i) an extraterritorial measure of the U.S., or (ii) any communication relating to such measure from a person who is in a position to influence the Canadian corporation, in respect of trade between Canada and Cuba. The Order prohibits Canadian corporations from complying specifically with the U.S. Cuban Asset Control Regulations, but also applies to any other measures with a similar purpose.

Beyond the above, U.S. anti-terror legislation could be applied extra-territorially in Canada, however any such measure would be subject to the above Canadian legislation and the Canadian *Charter of Rights and Freedoms*,[98] which may impose constitutional limits on the extra-territorial application of U.S. measures.

G. <u>Relationship Laws</u>

Each of the franchise disclosure statutes mandates a couple of relationship-based obligations upon each of the franchisor and franchisee. Specifically, a duty of fair dealing and good faith is imposed on both parties to the franchise relationship and franchisees are as well granted the right to associate. Non-compliance with these statutory obligations provides the maligned party with certain statutory remedies.

1. <u>Duty of Good Faith and Fair Dealing</u>

Each of the Canadian Disclosure Laws imposes a duty of good faith and fair dealing on the parties to a franchise agreement, that is, both the franchisor and the franchisee.[99] The leading case on the meaning of “good faith” in franchising is the Ontario Court of Appeal’s decision in *Shelanu Inc v. Print Three Franchising Corp*.[100] In *Shelanu*, the court confirmed that the duty of good faith is imposed by statute but also arises at common law[101] and that the duty of good faith, though not a fiduciary standard, requires the parties to a franchise agreement to consider each other’s legitimate interests before exercising their powers arising out of the relationship.[102] In other words, though they are permitted to act self-interestedly, they must conduct themselves honestly, fairly, and reasonably with one another. A party could still breach its duty of good faith even though that party has complied with all of the terms of the franchise agreement.[103] Not every breach of contract is a breach of the duty of good faith.[104] A franchisor is also required to enforce the franchise agreement and to exercise its discretion without malice or ulterior motive and in a manner that is honest, fair and reasonable. A franchisor’s scope of discretionary power may therefore be restricted if its exercise would impact a franchisee negatively and unfairly. To comply with the duty of good faith, franchisors should be transparent when engaging in matters involving their franchisees, promptly respond to their requests and

[98] The Constitution Act, 1982, *being* Schedule B to the Canada Act, 1982, ch. 11 (U.K.), Part I.

[99] § 3(1) of each of the *Ontario, PEI, NB* and *Manitoba Acts* and § 7 of the *Alberta Act*.

[100] (2003) 172 OAC 78.

[101] *Id.* ¶¶ 65-66.

[102] Query as to how a franchisor could possibly take into account the interests of each and every of its franchisees, when it is required to protect the franchise system as a whole.

[103] *Shelanu Inc v. Print Three Franchising Corp*., *supra* note 100, ¶ 71.

[104] *Id*. ¶ 76.

convey important information to them at all times, particularly when failing to do so would impact them adversely.[105]

2. Franchisee Right of Association

Each of the Canadian Disclosure Laws provides franchisees with a legal right to associate with one another.[106] Under these laws, a franchisor and its associates are prohibited from interfering with, prohibiting or restricting, by contract or otherwise, a franchisee from forming or joining an organization of franchisees or from associating with other franchisees and indirectly, penalizing and attempting or threatening to penalize a franchisee for exercising any such right. Any provision in a franchise agreement or other agreement relating to a franchise which purports to interfere with, prohibit or restrict a franchisee from exercising any right under this section will be deemed void and if a franchisor or any of its associates contravenes the foregoing statutory rights, the franchisee will have a right of action for damages against the franchisor or franchisor's associate, as the case may be. The Ontario Court of Appeal in the *Midas* case[107] held that the right of association under the Ontario Act encompasses the right of franchisees to participate in a class action for the purpose of enforcing their rights against the franchisor. The franchisor's requirement that the franchisees sign a release as a condition of the renewal of their franchise agreements, therefore, was deemed to be a breach of their right to associate, as the demand for a release in *Midas* was distinguished from the "voluntarily negotiated settlement of existing claims" in *Tutor Time*.[108]

H. Other Regulatory Concerns

1. Investment Canada Act

The *Investment Canada Act*[109] ("ICA") is a federal statute which regulates investment in Canada by non-Canadians. Specifically, the ICA regulates the acquisition of control of Canadian businesses by non-Canadians through a government-administered investment review process. Direct acquisitions are reviewable where they meet certain financial thresholds set by Industry Canada, a department of the Government of Canada. For 2012, the threshold for a reviewable direct acquisition by a non-Canadian from a WTO member country is $330 million.

2. Competition Laws

The *Competition Act*[110] regulates business activity in order to promote competition in the Canadian marketplace. The *Competition Act* applies to virtually everyone carrying on business in Canada, including franchisors, franchisees, and suppliers. The *Competition Act* is federal legislation, and contains both civil and criminal sanctions for anti-competitive behavior. There are no provincial competition laws in Canada, however many provinces have enacted various consumer protection and trade laws.

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[105] *Salah v. Timothy's Coffees of the World Inc.*, *supra* note 52.

[106] § 8 of the *Alberta Act* and § 4 of the *Ontario, NB, PEI* and *Manitoba Acts*.

[107] *405341 Ontario Limited v. Midas Canada Inc.*, *supra* note 50.

[108] *Id*. ¶ 38.

[109] R.S.C. 1985, ch. 28 (Can.).

[110] R.S.C. 1985 ch. C-34 (Can.).

The *Competition Act* is enforced by the Commissioner of Competition, who investigates potential infringements of the Act through its staff at the Competition Bureau. The Commissioner may recommend criminal prosecution by the Attorney General of Canada, where the criminal provisions of the *Competition Act* are engaged, or seek administrative remedies at the Competition Tribunal for civil infringements. The Commissioner has broad powers to investigate potential infringements of the *Competition Act*, and may apply for court orders compelling full documentary disclosure or examinations under oath of anyone named in a formal inquiry by the Bureau. Amendments to the *Competition Act* which came into force on March 12, 2009 significantly changed the *Competition Act* with the intention of "harmonizing" it with U.S. law.[111] Specifically, "price maintenance" is no longer a *per se* criminal offence under the *Competition Act* and a new section on price maintenance (Section 76) was created that imposes no criminal penalties. This new "vertical arrangements" section is of particular interest to franchisors because it applies to arrangements between suppliers and distributors.[112]

Under Section 76, the Competition Tribunal may impose orders or fines on any person who has adversely affected competition in the market by directly or indirectly influencing upward the resale price of its supplies, or by discriminating against anyone who has a low pricing policy for those supplies[113] if that person[114] is engaged in the business of producing or supplying a product, extends credit by way of credit cards or is otherwise engaged in a business that relates to credit cards or has the exclusive rights and privileges conferred by a trademark or certain other intellectual property.

The Tribunal may impose fines, which the *Competition Act* refers to as "administrative monetary penalties," of up to $10,000,000 CDN for a first occurrence and $15,000,000 CDN for subsequent occurrences.[115] Some commentators have observed that "[g]iven these magnitudes, 'administrative monetary penalties' are an inappropriate euphemism for potentially large fines."[116]

For the purposes of Section 76, setting a "suggested retail price" is proof that a producer or supplier is engaged in price maintenance, unless that producer or supplier makes it clear to the person to whom the suggestion was made that they are "under no obligation to accept the suggestion and would in no way suffer in their business relations with the producer or supplier or with any other person if they failed to accept the suggestion."[117] In general, the price

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[111] Competition Policy Review Panel, Compete to Win: Final Report (Wilson Report) (June 2008) at 58, available at: http://www.ic.gc.ca/eic/site/cprp-gepmc.nsf/vwapj/Compete_to_Win.pdf/$FILE/Compete_to_Win.pdf (last visited on July 18, 2012). *See also* Senate, Standing Committee on Banking, Trade and Commerce, Recent Competition Act Changes: A Work in Progress (June 2009) at 8, available at: http://www.parl.gc.ca/Content/SEN/Committee/402/bank/rep/rep02Jun09-e.pdf (last visited on July 18, 2012).

[112] § 76 of the Competition Act deals with vertical agreements and arrangements, such as those between suppliers and retail distributors. Horizontal "price maintenance" is called "price-fixing" and occurs among competitors. Price-fixing is a *per se* criminal offence under § 45 and is not subject to § 76 of the Competition Act.

[113] Competition Act, *supra* note 110, § 76(1).

[114] *Id.* § 76(3).

[115] *Id.* §§ 79(2) and (3.3).

[116] Neil Campbell & Sorcha O'Carroll, *The Americanization of Canada's Competition Act*, 48 CAN. BUS. L.J. 446, 454 (2009).

[117] Competition Act, *supra* note 110, § 76(5).

maintenance restrictions will not prohibit a franchisor from imposing the maximum prices at which a product or service may be sold, unless it also attempts to prohibit discounting.

The Competition Bureau will only examine franchise agreements that allocate markets or customers (i.e., sales territories) where the agreements might have an anti-competitive effect on the market. In most cases, such agreements will be examined only under the civil and not criminal provisions of the *Competition Act*, since the Competition Bureau does not consider such agreements to be "agreements between competitors" for the purposes of the criminal provisions of the *Competition Act*. However, agreements among franchisees to restrain competition among themselves, by allocating markets or fixing prices, may still attract the criminal conspiracy provisions under Section 45 of the *Competition Act*.

The above amendments will be mainly of concern to franchisors that have more than one franchisee competing in the same territory. Such franchisors should ensure that their franchisees are aware of the criminal prohibitions against price fixing, market allocation and output restriction. Also, franchisors should be aware of the Competitor Collaboration Guidelines and the examples which they provide of potential anti-competitive activities arising from the territorial restrictions or minimum price requirements imposed by certain franchise agreements.[118]

In a relatively recent but important case involving several issues,[119] the Ontario Superior Court dismissed the claims of certain Tim Hortons franchisees against their franchisor that the franchisor had contravened the price maintenance and conspiracy provisions of the *Competition Act* by selling certain products to the franchisees at a profit. The franchisor had introduced a new method for baking donuts and other baked goods, and introduced new menu items that the franchisees were required to offer. The franchisees objected to these changes on the bases that: (i) the franchisor was able to sell the new products to the franchisees at a profit; (ii) the franchisees were forced to resell the products at a loss or break-even prices; and (iii) the franchisor profited off of the franchisees' increased sales through rent, royalties and advertising payments. The court:

(a) held that the franchisor had not contravened the price maintenance provisions of the *Competition Act* because its pricing did not impair the franchisees' ability to sell the products at any price they chose;[120]

(b) rejected the price fixing/conspiracy claims advanced against the franchisor, finding that there was no evidence of anti-competitive intent or undue lessening of competition on the part of the franchisor;[121] and

(c) found that there was no evidence that the franchisor was a "competitor" with its joint venture partner, with whom the franchisor produced and sold the baked goods and other supplies to franchisees.

Accordingly, the court held that the joint venture was not reviewable at all under the criminal provisions contained in Section 45 of the Act, but under the civil provisions of Section

[118] Competition Bureau, Competitor Collaboration Guidelines (May 2009), available at: http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/02987.html (last updated on November 1, 2011).

[119] *Fairview Donut Inc. v. TDL Group Corp., supra* note 33.

[120] *Id*. ¶ 584.

[121] *Id*. ¶ 624.

90.1 instead.[122] In any event, the court held that had Section 45 applied in this case, the franchisor would have met the "ancillary agreement" defense under Section 45(4).[123]

In summary, the 2009 amendments have harmonized Canadian competition law with U.S. laws somewhat, which should be a welcome development for U.S. franchisors. Pricing and distribution arrangements (vertical arrangements) between franchisors and their franchisees are now less likely to attract the criminal provisions of the *Competition Act*. Franchisors are permitted to make a profit on the goods that they sell to their franchisees, so long as they do not penalize franchisees who offer lower resale prices or otherwise attempt to influence upwards the resale price of the goods. Franchisors should be aware that if they provide "suggested pricing" guidelines to their franchisees, in order to avoid penalties for anti-competitive behaviour under the *Competition Act*, they must also make it clear that franchisees are "under no obligation to accept the suggestion and would in no way suffer in their business relations with the producer or supplier or with any other person if they failed to accept the suggestion."[124]

3. <u>Advertising, Packaging and Labeling</u>

When importing and distributing goods into and throughout Canada, U.S. franchisors should consider and ensure compliance with the various packaging and labelling requirements imposed by the *Consumer Packaging and Labelling Act*,[125] *Food and Drugs Act*,[126] *Canadian Agricultural Products Act*,[127] and other similar legislation and related regulations. These kinds of regulations apply to many different types of goods in addition to food products. For example, specific rules apply to the packaging, labelling and marketing of textile goods under the *Textile Labelling Act*.[128] U.S. franchisors seeking to import goods into the province of Québec should also consider the specific French-language rules that apply to the packaging, marketing and labelling of imported goods pursuant to the *Québec Charter of the French Language* (the "Charter").[129]

4. <u>Franchising in the Province of Québec</u>

Of the 10 Canadian provinces and 2 territories, the province of Québec is certainly the most unique from both a legal and a cultural perspective. As noted earlier, Québec is a civil law jurisdiction, while the rest of Canada employs a common law legal system. U.S. franchisors should not minimize the fact that the Québécois do have different cultural tastes and proclivities than other Canadians, and that these differences are not solely a question of language.

One of the most significant considerations when franchising in Québec is the critical issue of language. Apart from the island of Montreal, which is largely bilingual (i.e., English and

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[122] *Id*. ¶ 631.

[123] *Id*. ¶ 633: "the establishment of the price at which donuts would be sold by the joint venture was ancillary to the broader agreement for the construction of the Maidstone bakeries and the production of par baked donuts."

[124] Competition Act, *supra* note 110, § 76(5).

[125] R.S.C. 1985, ch. C-38 (Can.).

[126] R.S.C. 1985, ch. F-27 (Can.).

[127] R.S.C. 1985, ch. 20 (4th Supp) (Can.).

[128] R.S.C. 1985, ch. T-10 (Can.).

[129] R.S.Q., ch. C-11 (Can.).

French speaking), the balance of the province is predominantly French speaking. Linguistically, it is important to consider the Charter, as it imposes certain obligations regarding the use of the French language in dealings with the Government, legal authorities or private corporations. French is mandated to be the language of business with consumers in Québec. In particular, Section 2 of the Charter states that "Every person has a right to have the civil administration, the health services and social services, the public utility enterprises, the professional orders, the associations of employees and all enterprises doing business in Québec communicate with him in French." Other sections of the Charter address language issues of importance to franchisors conducting business in Québec.[130]

Most notably, catalogues, brochures, folders, commercial directories and any similar publications must be drawn up in French.[131] U.S. franchisors looking to franchise in Québec, therefore, need not only to Canadianize their operations manuals so that they conform with all applicable Canadian law, but also to translate their manuals into the French language to comply with the Charter and otherwise to make them comprehensible to their target audiences.

In addition, contracts pre-determined by one party, contracts containing printed standard clauses and related documents, must be drawn up in French.[132] They may be drawn up in another language as well provided both parties agree in writing. Franchise agreements prepared for franchisees in Québec, therefore, should include an English rider provision which expressly stipulates that the agreements and related documents be drafted in the English language. Furthermore, a product inscription, product wrapper, or menu, for example, may be drafted in the English language provided that the English wording is not given greater prominence than its French counterpart.

The *Regulation Respecting Language of Commerce and Business*[133] (the "French Charter Regulation") must be considered in this regard. Under the French Charter Regulation, a "recognized trade mark within the meaning of the Trade Marks Act" that is inscribed on products, public signs and posters and in commercial advertising, or in catalogues, brochures, folders, commercial directories and any similar publications, need not be translated in French, unless a French version has been registered.[134] To date, retailers in Québec have relied on this exception when employing English signage only on their stores. Unfortunately however, the Office Québécois de La Langue Française (the "Office"),[135] the government agency charged

[130] *Id.* § 5, which provides that "Consumers of goods and services have a right to be informed and served in French," while § 6 provides that "Every person eligible for instruction in Québec has a right to receive that instruction in French." Chapter 7 contains provisions on the mandatory use of French in commerce and as a business language and § 51 in particular establishes a general rule requiring the use of French for packaging and labeling. § 51: "Every inscription on a product, on its container or on its wrapping, or on a document or object supplied with it, including the directions for use and the warranty certificates, must be drafted in French. This rule applies also to menus and wine lists. The French inscription may be accompanied by a translation or translations, but no inscription in another language may be given greater prominence than that in French."

[131] *Id.* § 52.

[132] *Id.* § 55.

[133] Regulation respecting the language of commerce and business, R.R.Q., ch. C-11, r. 9 (Can.).

[134] *Id*. § 7(4). Note that although the Trade-marks Act*, supra* note 10, defines "recognized trade-marks" as both registered and unregistered marks, the Office regards only registered marks as "recognized" within the meaning of the French Charter Regulation. It is therefore advisable to utilize only registered marks in Quebec in order to avoid potentially infringing the French Charter Regulation.

with the responsibility of enforcing French language rights and obligations in Québec, has recently adopted a new and troubling interpretation of the applicable Charter obligations. The Office is now of the view that trademarks used on store signage are not being used as trademarks and therefore retailers can no longer rely on this exception and are required to use French translations.

Apart from the legal obligations surrounding the use of the French language in Québec, there are practical, business related reasons for conducting business in that language in Québec. While U.S. franchisors may not need to translate their franchise, master, area development and/or area representative agreements when contracting with a Québec-based entity, provided that they include in their agreements an English rider provision as noted above, it is far more difficult to conduct business in Québec using only the English language. Communication and marketing considerations will inevitably require the use of the French language in Québec, as the vast majority of consumers, suppliers and prospective and existing franchisees in Québec will speak French almost exclusively. U.S. franchisors should, therefore, be aware of the associated costs of translation, as well as the cost of retaining local French-speaking consultants, brokers and professionals, when expanding into that province.

As discussed previously, it is important to consider the Civil Code and its impact on franchising in Québec.[136] Franchise agreements are often, though not always, deemed to be "contracts of adhesion" under Article 1379 of the Civil Code. If so deemed, a franchisor will be required to abide by certain provisions of the Civil Code, one of which is a pre-contractual disclosure obligation, which would require a franchisor to bring certain information regarding the agreement to the attention of its prospective franchisees. Furthermore, though an "external clause" referenced in an agreement will typically bind the parties to an agreement,[137] an external clause in a contract deemed to be a consumer contract or an adhesion contract may be "null" if, at the time of formation of the contract, it was not expressly brought to the attention of the consumer or adhering party.[138] An example of an "external clause" is a document such as a franchisor's operations manual which is not included in the franchise agreement, though it is

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[135] It ensures that businesses comply with the Charter through the work of inspectors, but most complaints under the Charter are initiated by consumers. The inquiry process is twofold. At the first level, the Office will contact the party who has allegedly contravened the Charter and try to mediate the complaint or try to obtain voluntary compliance. At this stage, a company may be fined and/or asked to take steps to comply with the Charter. A party can be held liable to pay significant fines for non-compliance with any provision of the Charter (Charter, § 205.1). Fines for each offence can range between $600 to $6,000 CDN "in the case of a natural person," and $1,500 to $20,000 CDN "in the case of a legal person" and may be doubled for any subsequent conviction (Charter, § 205). § 205 also provides, in part, that "if a person is convicted of an offence under this Act, a judge may, on an application made by the prosecutor and submitted with the statement of offence, impose on the offender, in addition to any other penalty, a further fine equal to the financial gain the offender realized or derived from the offence, even if the maximum fine has also been imposed." The Office dealt with well over 3,000 complaints in 2011, of which about 70 were referred for penal prosecution. Office québécois de la langue française Québec,Statistiques 2010-2011, available at: http://www.oqlf.gouv.qc.ca/francisation/respect/statistiques/stat20102011.html (last visited July 19, 2012).

[136] *See* Pascale Cloutier & Fadi Amine, *Consequences of a Franchise Contract Being Called a Contract of Adhesion in Quebec Civil Law*, XVI Franchise and Distribution Journal 1307 (2010), for a detailed analysis of the Civil Code in this regard.

[137] Civil Code of Québec, *supra* note 9, Article 1435.

[138] "Unless the other party proves that the consumer or adhering party otherwise knew of it" (Civil Code of Québec, *supra* note 9, Article 1435). *See also* Civil Code of Québec, *supra* note 9, Article 1436, which invalidates provisions that are "illegible or incomprehensible to a reasonable person" if the consumer or the adhering party suffers an injury as a result, "unless the other party proves that an adequate explanation of the nature and scope of the clause was given to the consumer or adhering party", and Article 1437, which invalidates abusive clauses as well.

typically referenced in the agreement. Finally, the Civil Code also imposes an obligation upon parties to a franchise agreement to act in good faith, and not only in the performance and enforcement of franchise agreements, but also in their negotiation. This would arguably also oblige a franchisor to make reasonable pre-contractual disclosure of information to its prospective franchisees. As a result of the foregoing, a franchisor is encouraged to provide some form of disclosure to its prospective franchisees in Québec, even if not providing its standard form of disclosure document prepared for the Franchise Disclosure Jurisdictions.

Finally, a recent Superior Court of Québec case[139] is worthy of some attention given the substantial and unusually high level of damages awarded to the franchisees ($16.4 million CDN) and the relatively strident language used by the court in referencing the prominent U.S. franchisor, Dunkin Donuts. Twenty-one Dunkin Donuts franchisees that had operated over 32 stores throughout Québec brought the claim for the termination of their leases and franchise agreements along with a claim for damages. The language of the franchise agreement under consideration by the Québec court was rather atypical in its lengthy and detailed elaboration of the franchisor's duties to the franchisees. Two of the duties assumed by the franchisor were to "increase demand for the products" and "to protect and enhance both its reputation and the demand for the products of the Dunkin Donuts System," both highly unusual obligations to be imposed upon the franchisor. The court considered these obligations as being by "far and away the most important explicit obligations" under the franchise agreements and held that the franchisor fundamentally breached the agreements by failing to protect and enhance its brand in Québec. Given that this decision turned on some very specific and unusual contractual language and the fact that it was decided in a civil law jurisdiction, it is yet to be determined as to how it will impact franchising generally in Canada, even if the franchisor is unsuccessful on appeal.

5. <u>Import Restrictions and Tariffs</u>

U.S. franchisors seeking to export their goods to Canada should be aware that different import restrictions and tariffs will apply depending on the types of goods to be imported, their national origin, and their end use. In general, import restrictions and tariffs are enforced by the Canada Border Services Agency (CBSA), a federal agency empowered by the *Canada Customs Act*[140] to determine tariff classifications and values for goods to be imported into Canada.

In most cases, U.S. franchisors will be able to take advantage of preferential Canadian tariff treatment under the *North American Free Trade Agreement*[141] (NAFTA), depending on the origin of the goods to be imported and whether they are being shipped directly from the U.S. or through another country. The CBSA issues advance rulings on tariff classification of different goods for the benefit of importers.[142] Canadian customs tariffs are based on the World Customs

[139] *Bertico Inc. v. Dunkin' Brands Canada Ltd*. (Can. Québec Superior Court), 2012 QCCS 2809, EYB 2012-208263, J.E. 2012-1303.

[140] R.S.C. 1985 ch. 1 (2nd Supp) (Can.).

[141] North American Free Trade Agreement, U.S.-Can.-Mex., Dec. 17, 1992, 32 I.L.M. 289 (1993), implemented in Canada under the North American Free Trade Agreement Implementation Act, S.C. 1993, ch. 44.

[142] Canada Border Services Agency, *Advance Rulings for Tariff Classification*, available at: http://www.cbsa-asfc.gc.ca/import/ar-da/recent-eng.html (last updated November 18, 2011).

Organization's Harmonized Commodity Description and Coding System, so there is a degree of standardization of tariff classification rules internationally.

Despite the above, the process of classifying goods for the purpose of determining the applicable tariffs under the *Customs Tariff Act*[143] is a complex determination, with thousands of different tariffs for different types of goods. For example, different classifications apply to cheese sticks, chicken burgers, chicken nuggets, cookies and cucumbers. NAFTA also imposes various "rules of origin" to determine the national origin of goods for tariff classification purposes. It is therefore important to consider how Canadian import restrictions and tariffs may apply to the specific goods in question, before deciding whether to import those goods into Canada or to source them locally.

Aside from tariffs, other federal restrictions may apply to imported goods. All agricultural and food products are subject to inspection by the Canadian Food Inspection Agency (CFIA), which monitors the quality, labelling and packaging of all such goods. Specific regulations are imposed on the following goods, among others: dairy products, eggs, fresh fruit and vegetables, honey, organic products, maple products, fish and meat.[144] With respect to certain food and agricultural products, the Canadian Department of Agriculture and Agri-Food Canada may impose restrictions in addition to those outlined above.

6. <u>Provincial Marketing Boards</u>

Although Canada's provincial governments have no authority to impose import tariffs, they often regulate different types of goods after importation. For example, the Ontario *Milk Act*[145] regulates the production, marketing and distribution of all milk products within Ontario, and each province has similar legislation applicable to milk and other food products. Interprovincial restrictions may also apply, so U.S. franchisors that import their goods into Canada with a view to moving those goods across provincial borders should ensure that when doing so, they comply with the laws of each province as well as any applicable rules on the interprovincial transportation of goods. The federal and provincial governments have also signed the *Agreement on Internal Trade*, which seeks to regulate internal trade within Canada, and some provinces have signed similar interprovincial agreements amongst themselves.

7. <u>Other - Industry Specific Legislation</u>

In addition to franchise-specific legislation and the other regulatory matters addressed above, U.S. franchisors need to be alert to other Canadian laws, regulations and regulatory issues which may be directed at their particular industries or business activities. Examples include liquor licensing, consumer protection and regulatory and licensing bodies which have

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[143] S.C. 1997, ch. 36 (Can.).

[144] For example, the Dairy Products Regulations, S.O.R./79-840 (Can.), requires that an import permit be obtained by the party seeking to import certain dairy products in order to qualify for a lower tariff rate. These products include, but are not limited to: cheese of all types including fresh, grated, powdered, and processed; milk and cream (liquid or powder) with or without sweetener; milk, cream, or butter substitutes with more than 15% milk fat; buttermilk, curdled milk and cream, kephir and other fermented or acidified milk and cream; ice cream mixes and ice milk mixes; and ice cream, edible ice, and ice sherbets. For further information, see the CFIA's website: http://www.inspection.gc.ca/food/dairy-products/imports-exports/eng/1300214060169/1300214161699 (last visited July 19, 2012).

[145] R.S.O. 1990, ch. M12 (Can. Ont.).

established requirements imposing certain professional and ethical standards on their respective members. Laws and regulations can be enacted and enforced at the federal, provincial and local levels and, as such, franchisees should be encouraged to retain their own professional advisors who are familiar with all applicable laws and standards to ensure compliance.

I. Governing Law and Dispute Resolution

Choice of Law/Forum. Choice of law and forum provisions will generally be respected by Canadian courts, subject to notable exceptions in the context of franchise law. One such exception arises if the choice of law purports to restrict the application of any of the Canadian Disclosure Laws, which laws invalidate any provision that purports to do so.[146] A situation can therefore result where some elements of a dispute are governed by local provincial law (pursuant to the applicable Canadian Disclosure Law) and others by foreign law (matters not covered by the Canadian Disclosure Law) if the choice of law is from a jurisdiction outside the province.

Another possible exception may arise if the choice of forum clause purports to restrict venue contrary to any of the Canadian Disclosure Laws, which preclude any provision that mandates exclusive venue to a foreign jurisdiction.[147] Again, the statute only applies to the extent of matters governed by the statute, so there can be a situation where the exclusive venue in a foreign jurisdiction applies to some elements of a dispute and not to others. The provision, while invalidating an exclusive foreign venue, does not invalidate concurrent venues. Where both venues are named as appropriate fora, it is possible that the Ontario court will defer to the foreign court on a standard test for *forum non-conveniens*. An unusual and undesirable, but not impossible, outcome in this scenario is that concurrent proceedings take place in the venues as neither court is prepared to defer to the other.

The decisions of foreign courts, particularly those with recognizably Western-based legal systems, will generally be enforced by Canadian courts, subject to certain exceptions. For example, a foreign court order might not be enforceable in Canada if some basis upon which the order is made is found to violate public policy in Canada - as it likely would if the foreign court did not respect the provisions of local franchising statutes. Finally, choosing the law of a particular province to apply to a franchise located within Canada, but in a different province, may result in importing statutory requirements that otherwise would not apply in the province where the franchise is located.[148]

To avoid confusion arising out of all of the foregoing, consideration should be given to selecting the law of the province (and applicable laws of Canada therein) where the franchise is located as the law of the contract, and to selecting the venue for dispute resolution as the province where the franchise is located. This will avoid confusion and make it more likely that any court or arbitral decision can be enforced against the franchisee.

Class Action Proceedings. Class actions are relatively new in Canada, and the law in this area is developing rapidly. Although Canada has a Federal Court, its jurisdiction over

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[146] § 10 of each of the *Ontario* and *Manitoba Acts*, § 11 of each of the *NB* and *PEI Acts*, and § 17 of the *Alberta Act*.

[147] *Id.*

[148] *Ontario Limited v. Midas Canada Inc.*, *supra* note 50.

commercial matters is limited to proceedings against the Federal Crown, admiralty law, and intellectual property law.[149] Therefore, class actions are typically brought in the superior courts of the provinces. All provinces except Prince Edward Island have comprehensive class action legislation.[150] In Prince Edward Island, even though there is no comprehensive legislation, class actions may be brought using local rules of court.[151]

In addition, the superior courts of some provinces, such as Ontario, have asserted their jurisdiction to certify class action proceedings nationally (i.e., where the claimants are in different provinces). As such cases may precipitate class proceedings in multiple provinces, issues relating to procedure and enforceability may ensue. The Canadian Bar Association has adopted the Canadian Judicial Protocol for the Management of Multijurisdictional Class Actions.[152]

In order for a court to certify a class action in Canada, the plaintiff must satisfy the court that:[153] (i) the pleadings disclose a legal cause of action; (ii) there is an identifiable class of two or more persons; (iii) the claims or defenses of the class members raise common issues; (iv) the class proceedings are the preferable procedure for resolving the common issues; and (v) there is a representative plaintiff or defendant who: (A) would fairly and adequately represent the interest of the class, (B) has produced a plan for the proceeding that presents a workable method of advancing the proceeding on behalf of the class and of notifying class members of the proceedings, and (C) does not have an interest that might conflict with the interests of other class members. The above test differs from the U.S. test for certification under Rule 23 of the *Federal Rules of Civil Procedure*.[154] The U.S. test requires that the common issues in a class proceeding "predominate" over the issues affecting the individual members of the class. There is no such express requirement for certifying a class action in Canada, and as such, it is easier to certify a class action in Canada than in the U.S. with respect to the common issues criterion.[155]

Franchise relationships are increasingly the subject of class proceedings in Canada. In *Fairview Donut Inc. v. TDL Group Corp*,[156] a recent and important decision of the Ontario Superior Court of Justice, the court dismissed a class action proceeding by franchisees of Tim Hortons against the franchisor. However, while the court dismissed each of the franchisees' claims on its merits, the court stated that it would have certified the class action had the claims been allowed. The court explained that franchise disputes are often suitable for certification

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[149] Federal Courts Rules, S.O.R. 98-106, Part 5.1 (Can.); Federal Courts Act, R.S.C. 1985 ch. F-7(Can.). Class actions may be brought in Federal Court for matters in these areas of jurisdiction.

[150] The federal territories of the Yukon, Northwest Territories and Nunavut do not have legislation. Michael Eizenga *et al*., Class Actions Law and Practice (LexisNexis Canada Inc., 2008) at 3.2. In Ontario, the applicable provincial statute is the Class Proceedings Act, 1992, S.O. 1992 ch. 6.

[151] Permitted pursuant to the S.C.C.'s decision in *Western Canadian Shopping Centres Inc. v. Dutton*, [2001] 2 S.C.R. 534 (Can.).

[152] Applied by Superior Court of Quebec in *Sophie St. Marseille v. Procter & Gamble Inc*., 2012 QCCS 1527 (Can.).

[153] As articulated pursuant to the Ontario statute. *See*, *e.g.*, *1250264 Ontario Inc. v. Pet Valu Canada Inc*., 2011 ONSC 287, ¶ 63 (Can.).

[154] Federal Rules of Civil Procedure, Class Actions, Rule 23.

[155] *See Hollick v. Toronto (City)*, 2001 SCC 68, ¶ 30 (Can.).

[156] 2012 ONSC 1252 (Can.).

because of "[t]he existence of a clearly identifiable class, a common standard form contract and a common business system, coupled with conduct of the franchisor that treats every franchisee in the same way."[157] Given this statement, franchisors should be aware of the potential for franchisee class actions, even though the Tim Hortons decision is favourable to franchisors, and, as a practical matter, not every franchise dispute will be suitable for a class action.[158]

Arbitration. Arbitration provisions are *prima facie* enforceable, even in the face of a rescission claim.[159] However, an arbitration provision will not defeat a class or multi-party action in a jurisdiction which has a legislative regime that includes the right to associate.[160] Furthermore, franchisors should be wary of employing arbitration clauses in their franchise agreements for several reasons. First, the case law on the enforceability of arbitration clauses as they might apply in the franchising context continues to develop and is, therefore, not entirely predictable. Second, the subject matter of an arbitration is necessarily limited to what is agreed to in the franchise agreement. Therefore, unlike in a court proceeding, it is not always possible or easy to expand the scope of the proceeding to accommodate unforeseen circumstances. Finally, if the arbitration procedure in the franchise agreement, or as may be adopted and incorporated by reference in the franchise agreement, is insufficiently developed, the parties may become bogged down and would be forced to proceed to court in any event to resolve the procedural issues – for example, the parties might disagree over the choice of arbitrators. For the above reasons, arbitration provisions, if adopted at all, should incorporate the arbitration rules of a recognized service such as the ADR Institute of Canada and its provincial counterparts or ADR Chambers. In addition, arbitration provisions should carve out exceptions for court proceedings (e.g., to protect the franchisor's intellectual property) in order to ensure that the franchisor has access to urgent and enforceable injunctive relief, should this be required.

III. MEXICO

A. Introduction

1. The Mexican Landscape

The United Mexican States (Mexico) is among the twenty largest countries in the world in terms of territorial surface and has a population of over 112,000,000 persons.[161] Mexico offers a great diversity of natural resources and, together with its geographical location, constitutes a strategic destination for foreign investors. As part of North America, and sharing a large border with the U.S., Mexico serves as an economic and social bridge to Central and South America. During 2011, 55% of the direct foreign investment received in Mexico came from the U.S.[162]

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[157] *Id.* ¶ 351.

[158] *Id.* ¶ 352: "[t]his is not to say that a class action will be the preferable procedure for the resolution of every franchise case."

[159] *See*, *for example*, *MDG Kingston Inc. v. MDG Computers Canada Inc.*, *supra* note 50, ¶¶ 32-33.

[160] *405341 Ontario Limited v. Midas Canada Inc.*, *supra* note 50, ¶¶ 32-39.

[161] Anuario Estadístico de los Estados Unidos Mexicanos 2011, Instituto Nacional de Estadística y Geografía ("INEGI").

[162] Informe Estadístico Sobre el Comportamiento de la Inversión Extranjera Directa en México (enero-diciembre 2011), Comisión Nacional de Inversiones Extranjeras.

Mexico has entered into more than 10 international free trade agreements with more than 40 countries around the world, and is a party to 28 international agreements related to the reciprocal promotion and protection of investments (*Acuerdos para la Promoción y Protección Recíproca de las Inversiones*). Mexico, together with the U.S. and Canada, is a party to NAFTA, which came into force on January 1, 1994. Pursuant to Article 102 of NAFTA, the objectives of the agreement, as elaborated more specifically through its principles and rules, including national treatment, most-favored nation treatment and transparency, are to: a) eliminate barriers to trade in, and facilitate the cross border movement of goods and services between, the territory of the three countries; b) promote conditions of fair competition in the free trade area; c) increase substantially investment opportunities in the territories of the three countries; d) provide adequate and effective protection and enforcement of intellectual property rights in each country's territory; e) create effective procedures for the implementation and application of the agreement, for its joint administration and for the resolution of disputes; and f) establish a framework for further trilateral, regional and multilateral cooperation to expand and enhance the benefits of the agreement.

Mexico is also an active participant in several international organizations, including the World Trade Organization, the Organization for Economic Co-operation and Development, Asia-Pacific Economic Cooperation and the *Asociación Latinoamericana de Integración*.

2. Franchising in Mexico

The franchise model was originally introduced into Mexico in the late 1980's by foreign franchisors, and has become a more common model of doing business in Mexico throughout the years.

One of the key issues and main concerns of U.S. franchisors expanding their business into Mexico is finding the right local partner or franchisee. Although the particular concerns may be dependent upon the type of business involving the franchise, such concerns are generally focused on issues such as the franchisee's business experience and financial condition. Foreign franchisors should take into consideration that one of the problems that local potential franchisees commonly encounter when exploring a franchise is the difficulty in obtaining local financing (especially with respect to medium and small-sized potential franchisees).

According to the Mexican Franchise Association, (i) there are over 1000 franchise systems in Mexico from which it is estimated that 500 are effectively operating; (ii) the franchise systems in Mexico generate approximately 85 billion Mexican Pesos annually (approximately 6 billion U.S. Dollars at an exchange rate of 13.90 Pesos per one Dollar); (iii) the franchise systems in Mexico generate about 500,000 direct jobs; and (iv) the franchise industry grew by 13% in 2011.[163]

The franchise industry in Mexico has significant potential to continue growing, as more people are becoming familiar with this business model. Lately, more Mexican companies have started to explore this model to expand their businesses locally and internationally. Examples of such Mexican companies internationally expanding their business include El Fogoncito (a Mexican food restaurant with activities in the U.S., Brazil and Costa Rica), Sushi Itto (a

[163] Asociación Mexicana de Franquicias, Section on Acerca de la AMF, *Estadísticas, available at* http://www.franquiciasdemexico.org/index.php?idsec=22 (last visited June 14, 2012).

Japanese food restaurant with activities in Central America) and Prendamex (a pawn shop business with activities in the U.S.).

Although the concept of franchising in Mexico has been present for several years now, the specific legal framework regulating this type of business has not evolved much. The latest efforts to codify the concept resulted in certain amendments to the Mexican Industrial Property Law (IPL) that went into effect in 2006.

The IPL provides that a franchise exists when, in conjunction with a written license to use a trademark, know-how or technical assistance is transferred, so that the transferee may manufacture or sell goods or provide services in a uniform manner, using the operative, commercial and administrative methods established by the holder of the trademark, for purposes of maintaining the quality, prestige and image of the products or services under the respective trademark. The IPL definition of “franchise” contains no fee element.

Franchise agreements require no registration in order to be enforceable between the franchisor and franchisee; nevertheless, the same must be registered with the Mexican Industrial Property Institute (IMPI), in order for such agreements to have legal effect against third parties. The IPL’s Regulation provides that when registering franchise agreements sensitive information, including royalties, confidential and technical information may be omitted. As a result of the foregoing, it is a common practice to prepare summary versions of franchise agreements for purposes of the IMPI registration. The registration application for franchise agreements must include the registration or application number of the trademarks under the franchise, the name, nationality and address of the franchisor and the franchisee, the products or services offered under the franchise, the term of the franchise agreement and if the franchise agreement reserves for the franchisor the right to initiate legal actions to protect the intellectual property rights under the franchise agreement. Typically, in the case of U.S. franchisors, English and Spanish versions of such summary agreements are attached as exhibits to the respective franchise agreements, and revisions are made to the forms of franchise agreements in order to make reference to the summary franchise agreements and the correspondent registration.

Another key issue that U.S. franchisors must take into consideration when expanding their business into Mexico is trademarks. As mentioned above, the license of a trademark is an essential part of a franchise agreement. The IPL provides that trademark licenses may be granted only with respect to registered trademarks or pending trademark registration applications. The U.S. franchisor must accordingly be sure to have the trademarks that will be subject to its franchise system in Mexico registered with the IMPI. Because the registration of the trademarks with the IMPI may, as further explained below, take some months, it is important for the U.S. franchisor to plan ahead for this requirement. Although the IPL permits the grant of trademark licenses with respect to pending trademark registration applications, due to the nature of a franchise, in most cases and situations it is advisable to grant the respective franchise with respect to registered trademarks in order to avoid potential problems.

3. The Mexican Franchise Association

The Mexican Franchise Association was created in 1989 by a group of companies with the objective of improving the conditions in which the franchise industry was developing.

The Mexican Franchise Association is a private association that encompasses more than 240 affiliated franchise companies. The objectives of the Association include, among others, to develop and promote actions to improve the conditions of the franchise sector in

Mexico, organize training programs for its members and the public, establish rules that promote the professionalism of franchisors and professionals participating in the franchise sector in Mexico, and represent franchise companies before the government in order to promote actions and laws that could result in improving the franchise sector in Mexico.[164]

Affiliation with the Mexican Franchise Association is voluntary. There are no mandatory affiliation obligations for franchisors to join the Mexican Franchise Association.

4. Civil Code System

Mexico has a civil law system as opposed to a common law system as in the U.S. Unlike the common law system, the civil law system is a legal system in which, generally, its core principles are codified in statutes that constitute the primary source of law. In Mexico, the highest source of law is the Constitution of the United Mexican States, from which federal laws are derived. Although federal laws, together with international treaties adopted by Mexico, govern throughout Mexico, there are local laws (including local constitutions) that govern in each of the states of Mexico. Jurisprudence or judicial precedents are also a source of law in Mexico but in a more limited way than in common law systems.

In Mexico, there are two main federal laws on intellectual property that derive from Article 28 of the Constitution of the United Mexican States--the IPL and the Copyrights Law.

In addition, Mexico is a party to several international treaties on intellectual property, including:

(a) The Paris Convention, [165] the main objective of which is to provide uniformity with respect to the registration of industrial property rights. The main benefit of this treaty is the right of priority for the registration of worldwide patents.

(b) The Patent Cooperation Treaty, [166] the main objective of which is the patent protection for an invention simultaneously in each of a large group of countries by filing an “international” patent application.

(c) The Nice Agreement,[167] which establishes a uniform international classification of goods and services for the purposes of registering trademarks and service marks.

(d) The Berne Convention,[168] the main objective of which is the protection of literary and artistic works, establishing three basic principals that the contracting parties must observe: (i) national treatment; (ii) automatic protection and (iii) independence of protection.

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[164] Asociación Mexicana de Franquicias, Section on ¿Qué es la AMF?, *Entrevista Jorge Alba, available at* http://www.franquiciasdemexico.org (last visited June 14, 2012).

[165] Paris Convention for the Protection of Industrial Property, 1 B.D.I.E.L. 681, *available at* http://www.wipo.int/treaties/en/ip/paris/ trtdocs_wo020.html (last visited Aug. 4, 2012).

[166] Patent Cooperation Treaty, 1 B.D.I.E.L. 833, *available at* http://www.wipo.int/pct/en/texts/articles/atoc.htm (last visited Aug. 4, 2012).

[167] Nice Agreement Concerning the International Classification of Goods and Services for the Purposes of the Registration of Marks*, supra* note 11.

[168] Berne Convention for the Protection of Literary and Artistic Works, 1 B.D.I.E.L. 715*, available at* http://www.wipo.int/treaties/en/ip/ berne/trtdocs_wo001.html (last visited Aug. 4, 2012).

In this context, franchise agreements fall under the scope of federal law in Mexico; their legal framework includes the IPL, the Commercial Code and the Federal Civil Code.

U.S. franchisors should consider that in the civil law system they will most likely be facing in Mexico a less flexible and more formal legal system than in the U.S. This could result in, for example, limited injunctive relief, no self-help measures, the need to comply with certain formalities to create security interests or liens, the need to conduct due diligence on the standing and corporate authority of the prospective franchisee, and the authority vested in the officers executing the franchise-related documents.

B. Intellectual Property Protection and Licensing Considerations

1. The Mexican Institute of Industrial Property

The IMPI is a federal governmental agency of the executive branch whose purpose includes the administrative oversight of the IPL. It is the federal agency in charge of the protection of intellectual property rights, from the registration of utility models, industrial designs and trademarks, through the granting of exclusive rights over invention patents, including the registration of renewals, transfers or licenses thereon, for purposes of recognizing and maintaining intellectual property rights.

The IMPI is also the agency in charge of conducting administrative procedures in connection with alleged administrative infringements related to intellectual property. The IMPI has the authority to, among other things, perform audits, request information, order the enforcement of injunctive relief and preventive measures, and impose administrative sanctions. The administrative sanctions include fines and temporary or definitive closures. In addition, the IMPI has material jurisdictional authority to conduct different types of administrative procedures to declare intellectual property rights as null and void, cancelled or expired.

The administrative internal bodies of the IMPI are the Governing Body and the General Director. The Governing Body is comprised of 10 federal government officers, and the General Director is, ultimately, appointed by the President of Mexico through the Governing Body.

A U.S. franchisor expanding its business into Mexico will generally have two points of contact with the IMPI: (i) upon the registration of its trademarks, and (ii) when registering the respective summary franchise agreements.

2. Trademarks, Patents and Copyrights

Trademarks and patents are governed by the IPL and its Regulations. Copyrights are governed by the Federal Copyrights Law (FCL) and its Regulations.

A trademark is any visible sign that distinguishes products or services from others of the same class or kind in the market. There are four types of trademarks that can be registered with IMPI:

(a) Nominative: a combination of words, letters or numbers;
(b) Unnamed: drawings and/or designs;
(c) Mixed: contemplates both nominative and unnamed trademarks; and
(d) Tri-dimensional: shape and packaging of goods.

As in the U.S., trademarks must be registered in connection with specific products or services pursuant to a certain classification as established by the Regulations to the IPL. In this respect, Mexico adopted the international classification of trademarks derived from the Nice Agreement.

U.S. franchisors should know that the registration of a trademark in Mexico has a term of 10 years and may be renewed for similar terms. Generally, the procedure for registering a trademark with the IMPI takes between six and eight months. As mentioned before, U.S. franchisors expanding their business into Mexico should plan ahead with respect to the registration of their trademarks in Mexico.

In April 2012, Mexico acceded to the Madrid Protocol, although the formal instrument of accession has not yet been deposited with the World Intellectual Property Organization (WIPO) as of the date of this paper. When fully effective, this accession will allow for, among others, the international registration of trademarks as provided in such Protocol. As a result of the foregoing, amendments to the IPL, its Regulations and the IMPI's internal regulations are required, but the precise timetable for these actions is unknown.

Patents are protected by the IPL and are defined as new inventions derived from inventive activities and susceptible to industrial use. The IPL provides for an exclusive right to exploit a patent for a non-renewable term of 20 years.

Copyrights are protected by the FCL and include, among other things, literary works, music, drama, dance, drawings and paintings, sculptures, architecture, films, audiovisual works, radio and television programs, software, photographic work, artwork, including graphic and textile design, databases, and similar works. Mexican law recognizes moral and patrimonial rights derived from copyrights. The author of a work is considered as the holder of the moral rights, which may not be subject to any waiver or transfer. The author is also the holder of the patrimonial rights; although these rights may be transferred or licensed to a third party, allowing the latter to exploit the same. Such transfer or license must be in writing, provide for economic compensation for the benefit of the author and only in extraordinary cases may have a term exceeding 15 years.

The FCL also contemplates the work-for-hire concept, providing that unless otherwise agreed, the individual or company that contracts or engages a person to create a work shall retain the patrimonial rights with respect to such work, and the rights related to the release, integrity and compilation of such work.

The foregoing general concepts and implications related to copyrights regulation in Mexico should be taken into consideration by U.S. franchisors expanding their business in Mexico.

3. Trademark License Agreements

As mentioned before, the license of a trademark is an essential part of the franchise agreement. The license may be granted with respect to registered trademarks or trademark applications that are pending registration. As to franchise agreements, it is more advisable to grant the franchise with respect to registered trademarks, in order to avoid potential problems that may grow out of challenges to trademark applications.

Unlike in the case of franchise agreements, the IPL does not provide that trademark license agreements must be executed in writing. Nevertheless, the IPL establishes that in order for trademark license agreements to have legal effect against third parties, the same must be registered with the IMPI (in written form). In addition, licensors should take particular care to register trademark license agreements with the IMPI, as the IPL provides that the use of the trademark by the licensee with respect to registered trademark license agreements shall be deemed as if such trademark is used by the licensor. This registration would prevent third parties from claiming that due to the lack of use of the trademark by its owner, the respective trademark registration must be cancelled. In many cases U.S. franchisors use their trademarks in Mexico only through their franchisees. Accordingly, U.S. franchisors should register the respective summary franchise agreements.

U.S. franchisors expanding their business into Mexico should have their upstream trademark license agreements structure reviewed. Sometimes the U.S. entity owner of the trademarks is different from the U.S. entity serving as franchisor in Mexico. In these cases, the trademark license agreements (summary versions) executed between the two U.S. entities should be registered with the IMPI, so that the IMPI can accept the registration of the respective summary franchise agreements. In order words, the complete chain of trademark license agreements, between the registered owner of the trademarks and the final licensee or franchisee, should be registered with the IMPI.

In accordance with the IPL Regulations, the registration of a trademark license or franchise agreement could be made by either the licensor/franchisor or the licensee/franchisee. Nevertheless, it is important to consider that the cancellation of a trademark license or franchise agreement before the IMPI will only be made under the following scenarios: (i) by the joint request of the licensor/franchisor and the licensee/franchisee; (ii) as a result of the cancellation or expiration of a trademark registration or when the same is declared as null and void, or when a registration is denied with respect to a licensed application; or (iii) by a court order.

Since the joint request of the licensor/franchisor and licensee/franchisee is necessary to have a trademark license or franchise agreement registration cancelled from the IMPI, it has been a common practice to request from the licensee or franchisee, upon the execution of the trademark license or franchise agreement, the grant of an irrevocable power of attorney in favor of the licensor or franchisor, in order for the latter to be able to request the cancellation of the registration of the agreement before the IMPI.

C. Structural Considerations

As mentioned above, one of the key issues for a U.S. franchisor expanding its business into Mexico is finding the right partner. There are many ways to expand a franchise system into Mexico.

Some U.S. franchisors prefer to expand their business in a more direct way by, for example, entering into individual franchise agreements with different Mexican franchisees covering different territories; or granting area development agreements so that a Mexican partner develops certain territories. Other U.S. franchisors prefer to rely on the knowledge and capabilities of the local market of Mexican partners by, for example, entering into master franchise structures with Mexican master franchisees, so that the latter develop certain territories with different subfranchisees.

As there could be many combinations of franchising relationships to expand a business, each U.S. franchisor should determine its own expansion strategy depending upon the particularities of its own franchise systems. Factors to consider are many and varied, including whether special knowledge and expertise of the local market is required, whether local expertise regarding the selling of franchises locally is required and the extent of penetration or knowledge of the trademarks in the local market.

Generally, it is not necessary for U.S. franchisors expanding their business into Mexico to set up a Mexican subsidiary company or other corporate presence. Typically, the master franchise or individual franchise agreements, including area development agreements, are executed directly by the U.S. company, serving as franchisor, and the Mexican company or companies, serving as master or unit franchisees. It is possible, however, for U.S. franchisors to partner with Mexican investors by setting up corporate structures in Mexico such as joint venture companies.[169]

D. <u>Tax Considerations</u>

The U.S. and Mexico have entered into the *Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (the Tax Treaty).Under the Tax Treaty, the withholding tax rate on royalties is reduced to 10%. Per the Tax Treaty, the term "royalties" means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work, including motion picture films and works on film or tapes or other means of reproduction for use in connection with television, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience as well as for the use of or the right to use industrial, commercial, or scientific equipment not constituting immovable property referred to in Article 6 of the Tax Treaty. Royalties also include gains derived from the alienation of any such right or property which are contingent on the productivity, use or disposition thereof.[170]

Also, under the Tax Treaty the withholding rate for technical assistance payments is generally 0%, assuming that the U.S. resident rendering the services does not have a "permanent establishment" in Mexico.[171] U.S. franchisors should consult with local tax counsel with respect to the tax treatment for the different types of fees or payments under the respective franchise agreements. For example, there could be situations where technical assistance could qualify under the concept of royalties and, therefore, the respective payments could be subject to a 10% withholding.

It is a common practice to include in franchise agreements tax gross-up provisions with respect to the payments by the franchisees to franchisors, for purposes of ensuring that

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[169] The Mexican Foreign Investment Law provides for certain activities to be restricted or limited to foreign investment. Although activities related to franchise systems are generally not restricted or limited to foreign investment, U.S. franchisors should verify that no foreign investment restriction or limitation is applicable to their franchise systems. Examples of restricted activities include oil, electricity and nuclear energy generation; limited activities include national air transportation services and printing and publication of local newspapers.

[170] Article 12 of the Tax Treaty.

[171] Article 7 of the Tax Treaty.

franchisors will be receiving the full amounts of fees agreed in the respective franchise agreements.

E. Regulation of Franchise Offers and Sales

1. Disclosure/Registration Laws

Mexican law requires that a disclosure document be provided to prospective franchisees in connection with the execution of franchise agreements. The IPL establishes that the franchisor must provide to the prospective franchisees information related to the franchise 30 days prior to the execution date of the franchise agreement.[172] Article 65 of the Regulations to the IPL specifies the technical, economic and financial information that the disclosure document must contain, as follows:

(a) Name, address and nationality of the franchisor;
(b) Description of the franchise;
(c) Experience of the franchisor and, if applicable, of the master franchisor, with respect to the franchise business;
(d) Intellectual property rights covering the franchise;
(e) Payment of fees and other amounts payable by the franchisee to the franchisor;
(f) Types of services and technical assistance that the franchisor must provide to the franchisee;
(g) Territory covered by the franchise;
(h) If the franchise allows the franchisee to grant subfranchises to third parties and, if so, the requirements to be met in order to be able to grant such subfranchises;
(i) Confidential obligations for the franchisee with respect to the information provided by the franchisor; and
(j) In general, the franchisee's rights and obligations arising from the execution of the franchise.

There is no obligation or requirement to have the disclosure document registered with the IMPI or with any other governmental agency.

2. Use of Adapted U.S. Disclosure Documents

It is a common practice to have disclosure documents used by U.S. franchisors in their domestic franchise operations adapted or tailored for their use in Mexico. Typically, U.S. disclosure documents contain more information than the Mexican mandatory information. Although Mexican law does not limit the information that may be contained in a franchise disclosure document, it is appropriate to evaluate, on a case by case basis, the convenience or not of including information in addition to the mandatory information required under Mexican law.

In many cases, such additional information contained in U.S. disclosure documents refers to investment, economic or financial information or, more specifically, to suppliers, products or services, for the specific market place in the U.S. for which the disclosure document and the trademark license was originally intended. The franchisor may be inadvertently

[172] Article 142 of the IPL.

misinforming a prospective franchisee by leaving such additional information in the disclosure document.

3. Issues Surrounding the Delivery of a Disclosure Document

The 2006 amendments to the IPL introduced certain protections for franchisees in connection with the disclosure document. In this respect, Article 142 of the IPL provides that the lack of veracity of the information provided by the franchisor to the franchisee in the disclosure document will entitle the franchisee to sue the franchisor for, in addition to having the franchise agreement declared as null and void, the payment of damages and losses incurred by the franchisee as a result of such breach. The action by the franchisee to recover damages and losses may be initiated within one year after the execution date of the franchise agreement. After the one-year term has elapsed, the franchisee may initiate a legal action only to have the franchise agreement declared as null and void. It is important to mention that Mexican law only recognizes direct damages and losses. These legal actions must be conducted before a civil judge and not before the IMPI.

In addition to the above-mentioned legal actions available to the franchisee, Article 213, Section XXV of the IPL, includes as an administrative violation the fact that the franchisor fails to provide the franchisee with the disclosure document, provided that the 30 days mandatory term has elapsed and the same was requested. The administrative violation action must be conducted before the IMPI and could result in administrative sanctions for the franchisor, including fines.

In connection with the delivery of the disclosure document, and in light of the judicial and administrative actions available to franchisees, it is a common practice to request from prospective franchisees an executed acknowledgment of receipt of the disclosure document. Typically, such acknowledgment contains the date of delivery of the disclosure document, a statement that the disclosure document contains all of the mandatory information as required by the IPL and its regulations, and, in the event that the disclosure document was provided in English, a statement by the franchisee confirming that he/she/it understands English and that he/she/it understood the contents of the disclosure document.

In addition to the above-mentioned acknowledgment of receipt, it is also customary to include in the respective franchise agreement a representation by the franchisee stating that the delivery of the disclosure document was made at least 30 days prior of the execution date of the franchise agreement, and that such document contained all of the mandatory information as provided by the IPL and its Regulations.

F. Other Mexican-Specific Amendments to the Franchise Agreement

As discussed above, the Mexican legal system is based on a civil law system as opposed to a common law system. U.S. franchisors expanding their business into Mexico commonly encounter differences not only with respect to culture and language, but also with the way attorneys approach different provisions contained in the U.S. forms of franchise agreements. Generally, Mexican law offers less flexibility and more formality with respect to various situations contemplated under the franchise agreements and the overall relationship between the U.S. franchisor and the Mexican franchisee.

As a result of the foregoing, it is necessary to adapt, tailor or "tropicalize" the U.S. forms of franchise agreements to be used in Mexico. The following is a non-exhaustive list of examples of common Mexican-specific amendments to U.S. forms of franchise agreements:

(a) Insert representations by franchisee. The representations generally include standing of the legal entity serving as franchisee, the authority of the attorney-in-fact executing the franchise agreement on behalf of the franchisee and acknowledgement of delivery of the disclosure document within the 30 day mandatory term.

(b) Adjust the information related to the licensed trademarks under the franchise agreement, including the registration or application information before the IMPI.

(c) Insert references to the execution of summary versions of the franchise agreement for registration purposes before the IMPI. Attach English and Spanish forms of the summary agreements.

(d) Insert obligations by the franchisee regarding cancellation of the registration of the summary franchise agreements before the IMPI upon the termination or expiration of the franchise agreement. In some cases, adding an obligation by the franchisee to grant an irrevocable power of attorney to the franchisor, in order for the latter to be able to cancel the IMPI registration.

(e) Adjust injunctive or equitable relief provisions and provide for the possibility of the franchisor to request injunctive relief or preventive measures from the IMPI and Mexican courts. Generally, in Mexico injunctive relief is limited.

(f) Insert liquidated damages provisions where self-help measures are contemplated under the franchise agreement, in particular with respect to post-termination obligations by the franchisee. Under Mexican law, self-help measures are generally not available.

(g) Adjust provisions where powers of attorney are granted. Under Mexican law, the granting of powers of attorney must generally comply with certain formalities, including in most cases the formalization of the same before Mexican notaries public.

(h) Adjust provisions where security interests or liens are created in favor of the franchisor. Under Mexican law, the creation of security interests or liens must generally comply with certain formalities, including in some cases the formalization of documents before Mexican notaries public and registration with public registries (i.e., the Public Registry of Property, the Public Registry of Commerce, the Movable Property Registry).

(i) Adjust termination provisions of the franchise agreements.

(j) Adjust guaranties provided under the franchise agreements.

(k) Add or adjust indemnity provisions in favor of the franchisor (i.e., labor indemnities).

(l) Address reporting requests by franchisors under U.S. GAAP.

In addition to the foregoing, the form of U.S. franchise agreement must be revised in order to incorporate the information provided by Article 142 BIS of the IPL, as explained in the following Section of this paper.

U.S. franchisors expanding their business into Mexico are strongly encouraged to conduct due diligence regarding prospective franchisees, due to the formalistic characteristics of Mexican law.

G. Other Regulatory Concerns

1. Mandatory Specific Provisions for Franchise Agreements

As a result of the 2006 amendments to the IPL, Article 142 BIS was added with the purpose of protecting franchisees, by establishing mandatory information that franchise agreements must contain.

In this respect, Article 142 BIS provides that franchise agreements must be executed in writing and must contain, at least, the following information:

(a) The geographical area in which the franchisee shall perform the activities under the contract;
(b) The location, minimum size and characteristics of infrastructure investments with respect to the establishment, in which the franchisee shall perform the activities under the contract;
(c) Inventory, marketing and advertising policies, including provisions related to merchandise supply and contracting with suppliers, if applicable;
(d) Policies, procedures and terms for reimbursement, financing and other considerations by the parties under the contract;
(e) The criteria and methods applicable for the determination of profit margins and/or commissions of the franchisees;
(f) The characteristics of the technical and operational training of the franchisee's personnel, as well as the method or manner in which the franchisor will provide technical assistance;
(g) The details, supervision, evaluation and rating of performance criteria, methods and procedures, as well as for the quality of services by the franchisor and the franchisee;
(h) The terms and conditions under which the franchisee may subfranchise, in the event that the parties have so agreed;
(i) The causes for termination of the franchise agreement;
(j) The situations under which the terms and conditions of the franchise agreement may be reviewed, and, in its case, modified by mutual agreement of the parties;
(k) Unless otherwise agreed by the parties, the franchisee shall have no obligation to sell its assets to the franchisor, or the person so appointed by the latter, upon the termination of the franchise agreement; and
(l) Unless otherwise agreed, the franchisee shall have no obligation to transfer or convey at any time to the franchisor, its shares or to have the franchisor become its shareholder.

Accordingly, U.S. forms of franchise agreement must be revised in order to incorporate the above-described requirements of Article 142 BIS.

2. Advertising, Packaging and Labeling

In many cases, U.S. franchisors undertake the obligation of advertising the franchise using advertising funds provided in whole or in part by the franchisees. Advertising is generally governed in Mexico by the Federal Consumers' Protection Law ("FCPL") and by the IPL. The Federal Consumers' Protection Bureau ("Profeco") is a governmental agency of the executive branch that periodically undertakes investigations regarding advertising.

The FCPL establishes a set of rules regarding advertising. Among such rules, advertising of products and services released in any way must be accurate, subject of verification and with no information that could mislead or induce confusion or error. The advertising must be in Spanish and using Pesos as the advertised currency. The Profeco has authority to order the suspension or correction of the advertising and to impose administrative sanctions, including fines.

As to packaging and labeling, there is a set of official Mexican regulations ("NOMS") that generally establishes the regulatory requirements for different types of products. Some of such requirements must be met upon the commercialization of the products within Mexico, but there are cases where such requirements must be met prior to the importation of the products into Mexico. There are different governmental agencies that supervise and verify compliance with the packaging and labeling regulatory requirements provided for in the NOMS. Such agencies include, among others, the Profeco (for general commercial products) and the Health Risks Federal Protection Bureau (*Comisión Federal para la Potección contra Riesgos Sanitarios - Cofepris*) (for health related products).

3. <u>Language Restrictions</u>

The disclosure document and the franchise agreement may be drafted and executed in English. As noted above, it is recommended that the franchise agreement include a statement establishing that the franchisee understands English and that the franchisee has fully understood the contents of the disclosure document. However, the summary version of the same to be registered with the IMPI must be executed in Spanish.

The U.S. franchisor expanding its business into Mexico should be aware that in the event that the franchise agreement is enforced in Mexico, a Spanish translation prepared by a court authorized expert will be required.

4. <u>Import Restrictions and Tariffs</u>

As mentioned above, Mexico, the U.S. and Canada are parties to NAFTA, which became effective in 1994. The provisions of NAFTA will apply to the importation of products that qualify under the treaty.

Generally, importation duties and taxes could be applicable upon the importation of products into Mexico. A search on a case by case basis should be conducted in order to determine the applicable importation duties and taxes for each specific product. An importer of record will be required for the importation of products into Mexico. The franchisee could serve as the importer of record. An authorized customs broker must also be retained in order to handle the importation procedures.

5. <u>Relationship Laws</u>

The Commercial Code and the Federal Civil Code contemplate a contract law principle under which the parties to a contract may assume, and bind themselves to, the rights and obligations that such parties freely agree upon (with the obvious exclusion of illegal terms and conditions).[173]

Based on the foregoing principle, the parties to a franchise contract may freely agree on the provisions to be included in such contract, including termination provisions. Nevertheless, it is important to bear in mind the following provisions established by the IPL, which governs the relationship between the franchisor and the franchisee:

(a) Pursuant to Article 142 BIS 1 of the IPL, the franchisor may only be involved in the organization and operation of the franchisee in order to ensure that the management and image standards established in the franchise agreement are met. Such Article further clarifies that the franchisor may be involved in matters related to the merger, spin-off, transformation, by-laws amendment, franchisees' corporate interests transfers or the creation of security interests thereon, when such matters affect the personal characteristics or qualities of the franchisee with which the franchisor entered into the franchise agreement.

(b) Article 142 BIS 2 of the IPL provides that the franchisee must maintain, during the term of the franchise agreement and thereafter, the confidentiality of the information of the franchisor as well as of the operations and activities conducted under the franchise agreement.

(c) Pursuant to Article 142 BIS 3, the franchisor and the franchisee may not unilaterally terminate or rescind the franchise agreement, unless the agreement contemplates no specific term, or either the franchisor or franchisee terminates or rescinds the agreement for good cause. In order for the franchisor or the franchisee to have the franchise agreement terminated in advance, either by mutual agreement or as a result of a unilateral rescission, each of the franchisor and the franchisee must observe the termination causes and the termination procedures established under the franchise agreement. Any breach by the franchisor or franchisee of the provisions of Article 142 BIS 3 could result in the payment by the defaulting party of the liquidated damages provision (if agreed) or the damages and losses incurred by the non-defaulting party.

6. Competition Laws

The Mexican Federal Antitrust Law ("FAL") sets forth the legal framework with respect to fair competition by preventing and penalizing antitrust practices. The Federal Antitrust Commission (*Comisión Federal de Competencia Económica*) is the governmental agency of the executive branch that investigates, supervises and sanctions antitrust practices.

The FAL generally contemplates and proscribes two different types of antitrust practices, absolute and relative. Absolute antitrust practices are generally referred to arrangements, contracts and agreements between competitors that result in (i) the manipulation of the purchase or sale prices of goods and services, (ii) the restriction of the supply or demand of goods or services, (iii) the division or allocation of actual or potential markets for goods or services and (iv) bid rigging. Relative antitrust practices generally refer to arrangements, contracts and agreements between economic agents, with substantial power in the respective market, that result in (i) the unlawful removal of other economic agents from the market, (ii) the

[173] Article 78 of the Commerce Code and Article 1832 of the Federal Civil Code.

impediment for an economic agent to access a certain market or (iii) the establishment of exclusive advantages in favor of certain persons.

As established by the IPL, the purpose of franchise agreements is for the franchisee to produce and sell products and services on a uniform basis and using the operative, commercial and administrative methods established by the holder of the respective trademarks, for purposes of maintaining the quality, prestige and image of the products or services under the licensed trademarks. In this respect, Section III of Article 142 BIS of the IPL provides that the franchise agreement must contain information related to inventory, marketing and advertising policies, as well as provisions related to supply of goods and contracting with suppliers. Generally, the provisions of franchise agreements related to suppliers of the franchisee, supply of goods to the franchisee, and fixing of price or products and services offered by the franchisee, should not fall under a relative antitrust practice as provided by the FAL. Nevertheless, a specific analysis should be conducted in the event the economic agents involved in the franchise have substantial power in the relevant market for the products or services.

Non-competition provisions are also typically included in franchise agreements. In Mexico there have been extensive discussions regarding the enforceability of the same. Some arguments against the enforceability of non-compete obligations are based on allegations that such type of obligations violate constitutional rights, limiting the ability for persons (in particular individuals, as opposed to commercial companies) to engage in any lawful activity.

Non-competition provisions are generally enforceable under Mexican law. In the event of the enforcement of a non-compete provision in Mexico or a dispute thereon, the judge will perform an analysis of the specific case, in order to ensure that no rights of the affected party are violated (as mentioned above). This analysis will be performed on a case by case basis. The Federal Antitrust Commission has issued criteria in connection with the evaluation of non-compete provisions. The Commission has mentioned that non-compete provisions may be valid provided that certain requirements are met: (i) the non-compete obligations are limited to a specific territory, (ii) the non-compete obligations deal with specific services or products and (iii) the non-compete obligations are limited to a certain period of time.[174]

H. Employment and Immigration Concerns

Mexican labor law strongly protects employees and contemplates rigid hiring alternatives, while providing for material severance payments for the benefit of employees. Employee-related issues and exposure generally lie with the franchisee as the operating party of the franchise in Mexico. Notwithstanding the foregoing, even when the U.S. franchisor has no presence in Mexico, and the form of franchise agreement contains typical provisions concerning the nature of the relationship as independent contractors, it is important to include in such forms strong labor-related indemnities protecting the franchisor.

Officers or employees of U.S. franchisors visiting Mexico may generally be able to enter the country showing their valid U.S. passport, and filing a migratory form FMM upon their entrance. Such business migratory form generally allows the visitor a stay in Mexico up to 6 months to conduct business activities. Such business activities may include the negotiation of

[174] There are no guidelines for the maximum period of time regarding non-compete obligations. Traditionally, a five-year term has been considered as a safe-harbor period.

franchise and related agreements, as well as supervision activities related to the franchise. In the event that an officer or employee of the U.S. franchisor needs to perform periodic visits to Mexico to conduct business activities, it may be convenient for such officer or employee to apply for an FM3 visa that will allow him or her several entries into Mexico. FM3 visas have a term of one year and may be renewed four times.

I. Foreign Exchange Controls

There are no foreign exchange controls in Mexico.

J. Governing Law and Dispute Resolutions

U.S. franchisors expanding their business into Mexico are generally reluctant to accept Mexican law to govern their franchise agreements. Pursuant to Mexican law, the franchisor and the franchisee may choose which law will govern the franchise agreement. This possibility provides a certain level of comfort to U.S. franchisors, as they are familiar with the law governing their U.S. franchise operations.

Under Mexican law, the franchisor and the franchisee may submit themselves to the jurisdiction of Mexican or foreign courts in connection with disputes arising from the franchise agreement. Also, the franchisor and the franchisee may agree on alternative mechanisms to resolve disputes, including arbitration.[175]

In accordance with the Commercial Code, a final judgment rendered abroad may be enforceable by Mexican courts without re-examination of the merits of the case, provided that: (i) formalities under international treaties with respect to letters rogatory are followed; (ii) the judgment is based on an action *in personam*; (iii) the court issuing the judgment had jurisdiction to resolve the dispute in accordance with international law rules that are consistent or compatible with the rules of the Commercial Code; (iv) the process in the action has been served personally on the defendant; (v) the judgment is a final judgment in accordance with the laws of the country where the judgment was issued; (vi) the legal action upon which the final judgment is issued is not pending between the same parties before Mexican courts; (vii) the obligation to be enforced in Mexico is not contrary to Mexican public policy; and (viii) the judgment complies with the requirement of authenticity. Pursuant to the Commercial Code, even if all of the above-mentioned requirements are met, the Mexican judge may deny the enforceability of the foreign judgment if the country where the judgment was issued would not enforce foreign judgments in similar cases (reciprocity).

The enforcement of foreign judgments in Mexico is carried out by means of a "homologation" procedure conducted before a Mexican judge.

U.S. franchisors seeking to initiate a legal action in the U.S. against a Mexican franchisee should retain Mexican counsel, to ensure that all the formalities are met in order to be able to have the respective judgment enforced in Mexico.

[175] Mexico is a party to the Convention on Recognition and Enforcement of Foreign Arbitral Awards, generally referred to the "New York Convention".

IV. CONCLUSION[176]

Canada and Mexico, while our closest neighbors on our own continent, represent markets, franchising environments and legal regimes that are in many respects quite different from the U.S. Franchisors based in the U.S. who decide to embark on expansion into one or both of our neighboring countries should not do so lightly but should be prepared for the challenges as well as the new opportunities they will likely find just across our borders.

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BIOGRAPHIES

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Joseph is a partner with the franchise law boutique firm of Hoffer Adler LLP, located in Toronto, Ontario, Canada. He is a senior corporate and commercial lawyer whose practice is focused on franchise law and is a registered trade-mark agent.

Joseph is the Secretary and General Counsel to the Canadian Franchise Association (CFA) and a director and executive member of the CFA's Board of Directors.

Joseph serves as legal counsel for Canadian and U.S. (and other foreign) franchisors doing business in Canada and Canadian franchisors doing business in the U.S. and internationally, and provides counsel to such franchisors on all aspects of Canadian franchise legal matters. He also acts and has acted for various multi-unit franchisees and franchisee associations.

Joseph has published and has been quoted in numerous articles and has spoken on various franchising topics at venues organized by the CFA, the Ontario Bar Association (Franchise Law Section) and the International Franchise Association (IFA). He has also written the following articles for the ABA Forum on Franchising: *Assessing Materiality in Franchise Disclosure Documents: A Canada-U.S. Analysis* (co-authored by Joseph Y. Adler and Michael R. Laidhold, Spring, 2011) and *The Ethics of Franchising: How Codes of Ethics Compare and What to Consider in Deciding Whether to Subscribe to Them* (Fall, 2009).

Recognized by his peers, Joseph is a member of the CFA's Legal and Legislative Affairs Committee, a contributing editor to the Franchise and Distribution Journal (Federated Press) and consistently listed as a leading practitioner in franchise law in the INTERNATIONAL WHO'S WHO OF FRANCHISE LAWYERS, LEGAL LEXPERT DIRECTORY, FRANCHISE TIMES LEGAL EAGLES and the National Post's BEST LAWYERS IN CANADA (FRANCHISING).

MICHAEL K. LINDSEY

Michael is a partner in the Los Angeles office of Paul Hastings LLP, an international law firm with more than 1,000 lawyers and 18 offices in major business centers across Asia, Europe and the U.S. He is a corporate and transactional lawyer, with a practice concentration in the areas of franchise, distribution and intellectual property law. Michael's practice includes the acquisition, development, protection and licensing of various forms of intellectual property; antitrust preventive counseling; merger analysis and structuring; franchise disclosure, registration and relationship matters; and advice concerning the sale, distribution and marketing of products and services through manufacturing, joint venture, distribution, dealership and agency relationships. He has spoken and written extensively in these fields. He serves as co-editor-in-chief of INTERNATIONAL FRANCHISE SALES LAWS (ABA 2006 and 2009 - 2011 supplements). He is also a co-author of ANTITRUST HANDBOOK FOR FRANCHISE AND DISTRIBUTION PRACTITIONERS (ABA 2008), THE INTELLECTUAL PROPERTY HANDBOOK: A PRACTICAL GUIDE FOR FRANCHISE, BUSINESS AND IP COUNSEL (ABA 2005), ANNUAL FRANCHISE AND DISTRIBUTION LAW DEVELOPMENTS 2003 (ABA 2003) and INTERNATIONAL SALES TRANSACTION CHECKLIST (IBA 2003). He also served as co-editor-in-chief of the treatise STATE ANTITRUST LAW AND STATUTES (ABA 2d ed. 1999); and as editor-in-chief of the monograph FRANCHISE PROTECTION: LAWS AGAINST TERMINATION AND ESTABLISHMENT OF ADDITIONAL FRANCHISES (ABA 1990).

Michael has been active for a number of years in various Bar organizations. He currently serves as a member of the Governing Committee of the ABA Forum on Franchising, as a past Director of that organization's International Franchise and Distribution Division, co-chair of the Committee Operations Task Force of the ABA Section of Antitrust Law, member of the Executive Committee of the USC Intellectual Property Law Institute, and member of the Board of Trustees of the Los Angeles County Bar Association. His recent past positions include chair of the Computer Industry & Internet Committee of the ABA Section of Antitrust Law, member of ABA Steering Committees on Continuing Legal Education and Technology and Information Systems, officer of the International Franchising Committee of the International Bar Association, and chair of the Franchise Law Committee of the California State Bar Business Law Section and of the Franchise and Dealership Committee of the ABA Antitrust Law Section. Michael received his B.S. degree, *summa cum laude*, from Texas A&M University and his J.D. degree from Stanford Law School. Michael is listed in THE BEST LAWYERS IN AMERICA, CHAMBERS GLOBAL, CHAMBERS USA, SUPER LAWYERS and in WHO'S WHO LEGAL.

RAMIRO RANGEL

Ramiro is a graduate of the Escuela Libre de Derecho, Mexico City, and became admitted to practice in 1996. From 1996 to 1999 he obtained postgraduate degrees and diplomas on Commercial Law and International Commercial Arbitration from the Escuela Libre de Derecho and the International Chamber of Commerce. In 1999, Ramiro obtained diplomas on Orientation in U.S.A Law and International Financial Transactions from the University of California at Berkeley and Davis.

From 2002 through 2004, Ramiro was a partner at Strasburger & Price, L.L.P. and from 2004 to 2012 he was a partner of Forastieri Abogados, S.C. In 2012, he became a founding partner of the law firm, Rangel & Rangel Asociados, S.C., in which he continues his practice.

Ramiro has substantial experience in advising local and international investors in matters related to corporate law, financial law, mergers & acquisitions, foreign investment law, real estate law, franchise and distribution law and cross-border transactions.

Ramiro has participated as co-author in publications by the ABA Forum on Franchising and is a member of the Mexican Bar Association.

Attachment A
CANADA EXPANSION CHECKLIST

U.S. franchisors should consider the following issues when expanding into Canada:

Protecting Intellectual Property.
- ✓ Register trademarks, .ca domain names and trade names and protect copyrights & patents.
- ✓ Consider registering French equivalent names for use in the province of Québec.
- ✓ Obtain confidentiality and employment agreements to protect trade secrets.

Preliminary Steps.
- ✓ Retain Canadian lawyers and accountants.
- ✓ Retain personnel for training & other tasks associated with expansion into Canada.
- ✓ Negotiate contracts with Canadian suppliers.
- ✓ Develop privacy policy and otherwise ensure compliance with Canadian privacy legislation.

Form of Doing Business.
- ✓ Consider alternatives to franchising such as licensing, distribution, use of Canadian subsidiaries, purchase of competing system etc.
- ✓ If franchising, consider whether to pursue unit franchising or the grant of master franchise, area representative or developer rights.
- ✓ Review cross border tax issues, including most appropriate vehicle for doing business and the application of the *Canada-United States Income Tax Convention*.
- ✓ Identify appropriate corporate structure: branch, subsidiary, joint venture or partnership.
- ✓ Consider need for extra-provincial registration.
- ✓ Consider incorporating separate entities for franchising, ownership of marks, leasing premises and distribution of goods.

Doing Business in Québec.
- ✓ Ensure compliance with *Civil Code of Québec*.
- ✓ Consider the French language issues raised by the *Charter of the French Language*, including translation of franchise documentation.
- ✓ Retain Québec consultant to provide advice on Québec-specific cultural/business issues.

Franchise Documentation.
- ✓ Prepare Canadianized disclosure document and consider issues surrounding disclosure to Canadian prospects not governed by Canadian disclosure laws if a member of the CFA.
- ✓ Prepare Canadianized versions of franchise agreement, master franchise agreement, area representative or area developer agreement and supporting documentation.
- ✓ Enter into trademark license agreement between trademark owner & Canadian subsidiary or affiliate, if applicable.
- ✓ Prepare and negotiate lease and sublease or lease assumption agreement, if applicable.
- ✓ Prepare Canadianized versions of the operations and training manuals.

Miscellaneous Issues.
- ✓ Retain Canadian broker and sales agents.
- ✓ Consider establishing a separate marketing fund for Canada.
- ✓ Address cross-border immigration issues for key personnel & any employment issues.
- ✓ Consider Canadian/provincial legislation relevant to the franchised business.
- ✓ Address any competition law (anti-trust) issues.