

# Buying a Franchise – A Legal Overview

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One option you may wish to consider when looking for a business to start is purchasing a franchise. On the other hand, if you have an established business, expanding it into a franchise may be one way to expand.

From traditional quick service restaurants and fast food outlets, to motor vehicle repair centres, drug stores, home maintenance services, hotels, educational facilities, children's play stores, donut shops, hair salons, tax services and fitness centres, to name just a few examples, franchised business continue to expand in virtually every product and service industry.

The attraction in purchasing a franchise is the idea that you are able to go into business for yourself, but not by yourself. Franchising is a middle ground where you can achieve the independence and goal of owning and operating your own business, while having the safety net of the franchisor's name, know-how, training and "systems".

Franchising has been steadily growing over the last 20-30 years. It is now one of the most prevalent ways in which to set up as a retail, or service business.

While the success rate of franchises is generally higher than start-ups, as you are investing in a product with a proven track record one must always conduct proper due diligence before embarking in any business venture.

## **WHAT IS A FRANCHISE?**

Franchising is fundamentally a form of business investment and ownership governing the distribution and sale of goods or services. In a franchise, the franchisor typically develops a business system, in association with a trade-mark, and licences the use of that system to a franchise, for a period of five - usually 10, 15 or 20 years – with renewal options. The franchisee is required to conform to the standards of the system and to pay consideration to the franchisor, usually as a combination of an initial fee and ongoing payments in the nature of royalties based on gross sales of the products and services associated with the franchise system.

The basis of any franchise relationship is the franchise agreement. The franchise agreement governs the grant of the franchise and the operation of the franchise for the term of the grant. Franchise agreements have evolved from documents of a few pages to agreements now often exceeding one hundred pages in length. In addition, a variety of ancillary documents is often required to complement the basic franchise agreement. Typically, a modern franchise document package could include the following legal documents:

1. Application form;
2. Deposit and confidentiality agreement;
3. Franchise Agreement;
4. Lease, Sublease, and/or Conditional assignment of lease;
5. Individual shareholder non-competition and confidentiality agreements;
6. General security agreement;



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7. Shareholder guarantee / Indemnity agreement;

Typically, in a developed franchise system, a prospective franchisee will be able to adequately investigate the benefits expected, and such an opportunity will often be viewed as one with less risk attached. The most important method of investigating the franchisor is also sometimes the simplest; by talking to existing franchisees. More so than anyone else, they will be able to tell you whether the franchisor has “delivered” on its promises, by answering questions such as whether the training program was adequate, if there is a continuing benefit being obtained from the payment of royalties, whether the advertising programs are effective, and, perhaps most simply put, would they do it all over again.

A newer franchise system will, in contrast, be somewhat of an unknown commodity, less capable of being investigated through its prior actions. Of course, a prospective franchisee may very well be willing to bear the greater risk when the opportunity exists to obtain a franchise in the early stages of its development, presumably at a lower cost, at a better location and when it could turn out to be the next great success story.

The lawyer acting for the prospective franchisee must realise that most franchisors will present the franchise agreement as non-negotiable, even when this may not in fact be the case. In any event, the franchise agreement, and any related documents which are to be signed, will typically be fairly long and complicated, and must be read and understood in their entirety by anyone purchasing a franchise. The lawyers’ task is therefore to ensure that the client understand fully the commitment being made, and to assist in the negotiation of changes where possible and appropriate. A lawyer with knowledge in the field will know when such negotiation is possible and appropriate, as well as the scope of changes which can minimize the franchise’s overall risk.

There are essentially three forms of franchise arrangements:

1. **Business format franchises:** the franchisor, often a manufacturer of supplies, licences an entire business system to the franchisee. In addition to receiving a licence to use a trade-mark, the franchisee may be given the right to use a trade-mark, the franchisee may be given the right to use a specified building layout, furnishings, location, marketing techniques, and reporting systems. Typical examples include fast food outlets and hotels.
2. **Product distribution franchises:** The franchisee obtains a licence from the franchisor to market and sell products in a specific location area. Unlike business format franchises (which is commonly understood as a franchise by most people), product distribution arrangements often allow the franchisee some latitude to personalize business operations, with the franchisor generally exerting less control over the format of the franchise. Product distribution franchises are often large independent business operations, including automobile dealers and soft drink bottlers.
3. **Business opportunities:** the franchisee is provided the right to sell goods and services supplied by the franchisor as well as receiving location assistance in terms of retail outlets or accounts. Examples include vending machines, amusement games, and display racks.

The Ontario government, in introducing the [Arthur Wishart Act](#) (Franchise Disclosure) 2000, specifically



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defined the term “franchise” to include all three types of franchise models, thereby determining by way of legislation the broader scope of franchising in the Province of Ontario.

The one key element, however, common in all three models of franchising, is that the franchisor and the franchisee operate as independent contractors through a franchise or dealer agreement and other related documents.

Currently, the Provinces of Alberta, New Brunswick, Prince Edward Island, Manitoba and Ontario are the only ones in Canada which have laws dealing directly with the sale of franchises. They require that a franchisor provide any prospective franchisee with a copy of a “disclosure document” offering information on the franchisor, the people behind the franchise and the material terms of the franchise agreement. Other than the five provinces, no province in Canada currently regulates the sale of franchises, so it is left to the parties (the franchisor and the franchisee) to decide what goes into a franchise agreement.

In Ontario, the [Arthur Wishart Act](#) (Franchise Disclosure) 2000 (the “Act”) makes it necessary for franchisors operating in Ontario to provide a prospective franchisee with a disclosure document not less than 14 days before 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.

In general terms, the Ontario Act requires the disclosure document to contain the following:

- a) all material facts, including material facts as prescribed in the Regulation.
- b) financial statements as prescribed in the Regulations.
- 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 purpose of assisting the prospective franchisee in making informed investment decisions.

Buying a franchise business can be a complicated task, especially for those not used to long legal agreements being in business on their own. However, using professional advisors can assist in understanding the entire process of purchasing a franchise, thus ensuring the extent possible, that the purchase is also rewarding.

