Best practices: Is it time for your franchise agreement to have a tune-up?

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Authors: Dominic Mochrie, Paul Kotschorek

Most Canadian franchisors are now following the practice of having their franchise disclosure documents reviewed and updated annually in order to comply with disclosure items that are based on fiscal year information.[1] However, they do not always follow a similar practice of having their franchise agreements (and ancillary documents) reviewed on an annual or other periodic basis to make changes necessitated by developments in franchise law, particularly court decisions, and other best practices necessitated by developments in commercial laws that apply to their franchise systems. By adopting a practice of regular franchise agreement review, franchisors can ensure that they are in compliance with relevant laws and operating their franchise systems in accordance with applicable commercial law requirements. This practice is of particular importance to U.S.-based franchisors whose local franchise documents and practices must be modified to conform to different laws and practices in Canada.

Osler franchise lawyers have seen a number of recent examples of franchise agreements which have not been amended or adapted to deal with recent or, in some cases, traditional areas of concern. Consider the following examples:

- **Term and renewal:** It has become clear from recent cases that if there is any suggestion in a franchise agreement that the term may be subject to a right or option of renewal or extension, regardless of the conditions or qualifications, the franchisor must act fairly, in good faith and in accordance with reasonable commercial standards in considering a request of a franchisee to renew or extend. For this reason we recommend that the franchise agreement contain an absolute and unconditional provision confirming that the agreement is not subject to any form of renewal or extension at the relevant time.
- **Reserved rights:** Most franchise grants are for the operation of a specific type of franchise under a designated brand name or trademark. Typically, grants have been restricted to a particular format, location or territory. For protective reasons, franchisors often reserve rights which may otherwise be alleged to be included within the grant. However, with the explosive expansion of typical franchise operations into other non-traditional channels, such as transportation facilities, universities, hospitals, kiosks, within other franchised systems, mobile units, web-based ordering, web-based delivery and through social media to name a few, it is highly recommended that franchisors revisit their agreements to be certain that a reserved rights clause is current and up-to-date.
- **Non-competition:** The courts are regularly passing judgment on the enforceability of non-

competition covenants in franchise agreements. Examples of non-competition covenants that may be declared unenforceable are those that: restrict activities in a "competing business"; do not carefully define the nature of the restricted activities; do not explicitly restrict competition at the actual franchised location; are too wide in terms of geographic restriction; are for too long a period of time; are uncertain in terms of location within a mall; or which contain a number of optional restrictions for a court to decide (the "blue pencil test"). Franchisors are not anxious to learn that non-competition covenants which they have in their agreements may not be enforceable at a time of crisis. The best preventative action is to review these clauses frequently to make appropriate adjustments resulting from changes in their own business systems or because of court decisions.

- **Pre-authorized deposit or automatic bank withdrawal covenants or agreements:** The form and content of these covenants or agreements must comply with the requirements of the Canadian Payments Association. Franchisors, especially those based in the U.S., should ensure that their covenants or agreements contain the new mandatory language.
- **Operations manuals:** We are regularly surprised to find that franchisors refer to operations manuals with a typical provision in their agreements that franchisees must comply with the standards of operation contained within those manuals. Sometimes the definition of a "manual" may be too limited to include bulletins, policies or other directions. In other cases, the franchisor may not even have a manual. Given the importance in almost every franchise system, those parts of the franchise agreement that refer to manuals must be updated with regularity.
- **Limitation of liability:** Some franchise agreements or ancillary supply contracts (e.g., software licenses) contain limitation of liability clauses in favour of the franchisor. These types of clauses must be reviewed and updated in accord with judicial pronouncements and new legislation. For example, some clauses may not distinguish between negligence and gross negligence. In Canada, negligence generally constitutes a failure to act with the level of care and skill that is reasonable in the circumstances, while gross negligence generally constitutes a "very marked departure" from a standard of reasonable care and skill. The "very marked departure" standard is a lower threshold for gross negligence than what we understand to be the threshold in the U.S.
- **Third-party beneficiaries:** Some franchise agreements, usually those used by U.S.-based franchisors, include "third-party beneficiary" language. Canadian law does not recognize an equivalent to the third-party beneficiary doctrine as it exists in the U.S. As a result, those entities who are to be given third-party beneficiary status (e.g., a third-party trademark owner, or affiliates of the franchisor), even if named in the agreement, may not have standing in Canadian courts to bring an action against a franchisee. It is necessary in Canada to use some rather complicated trust language to create the equivalent of a third-party beneficiary right in a franchise agreement or an ancillary document.
- **Governing law:** Apart from the issue as to governing law clauses adopting foreign law (a practice which we strongly recommend against), some franchise agreements refer to the laws of a particular named province (e.g., Ontario) for franchisees located or operating in another province (e.g., Saskatchewan). Setting aside enforcement difficulties, there is

caselaw from the Ontario Court of Appeal that if the governing law clause of a franchise agreement adopts the law of a province having franchise legislation, certain rights accorded to franchisees under the franchise legislation of that province will be extended to a franchisee in another province even if that other province does not have its own franchise law. Governing law clauses need to be carefully reviewed and amended in such cases.

- **Duty of fair dealing:** While certainly not a new issue, we still see franchise agreements reserving the right of a franchisor to act "arbitrarily," in an "unfettered" manner, or "solely" within its discretion, in certain instances. These clauses do little, if anything, to give franchisors enhanced rights beyond their statutory and common law obligations to deal fairly and to take their franchisees' interests into account and, in fact, can be interpreted by the courts to be excessive and unenforceable.
- **Interest rate:** Pursuant to federal legislation, if an interest rate is not expressed as an effective annual percentage, no more than 5% per annum may be charged. If an agreement expresses interest using a monthly percentage, for example, it will be necessary to revise these clauses in order not to default to the 5% rate.

As stated earlier, these are only some of the many examples of clauses in franchise agreements or ancillary documents that we often see as being in dire need of revision. Even a franchise agreement prepared yesterday may be subject to updating next week if there is an unexpected new development in the law or by reason of a court decision. However, in our experience there is no better way to ensure that a franchise agreement remains current than to have it reviewed regularly and updated at that time (we recommend annually at the same time as franchise disclosure documents are updated). The time, effort and costs involved will be relatively insignificant if a critical clause in a franchise agreement or an ancillary document cannot be enforced at a later date.

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[1] This is an updated version of an article written by Frank Zaid.