To Market, to Market:
Alternative Methods of Distribution in a World of E-Commerce
(Canadian Perspective)

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1. Introduction[1]

Electronic commerce or "e-commerce" retailers are increasing their share of the market and impairing traditional methods of distribution. In Canada, six percent of retail spending occurred online in 2014.[2] This is projected to rise to ten percent (CAD$39.9 billion) by 2019.[3] Canada, like other parts of the world, is gradually developing a legal system to support the effective use of electronic commerce and distribution methods alongside traditional forms of commerce. This paper describes certain aspects of the general legal framework within which e-commerce participants must operate in Canada, focusing on issues related to competition, consumer protection, taxation, and franchising.

2. Defining E-Commerce

A formal legal definition of e-commerce does not currently exist in Canada. Over time, across a variety of contexts and authors, e-commerce has been defined as:

[1] The author would like to acknowledge and thank Veronica Meffe, Articling Student, McMillan LLP for her assistance.
[2] "E-Commerce in Canada" (2016), online: *Jones Lang LaSalle IP Inc.* < http://www.jll.ca/canada/en-ca/research/514/e-commerce-in-canada-2016-jll >.
[3] *Ibid*.

- "the exchange of goods or services ... using electronic tools and techniques";[4]
- "the use of computer networks to facilitate transactions involving the production, distribution, sale and delivery of goods and services in the marketplace";[5]
- "the delivery of information, products, services, or payments by telephone, computer, or other automated media."[6]
- The "sale and delivery of intangible products and services through the use of computer networks"[7]; and
- "the sale of tangible goods and services [...] through digital mechanisms"[8].

For the purposes of this paper, e-commerce generally refers to the buying and selling of goods and services via the internet.

E-commerce co-exists with traditional commerce;[9] however, e-commerce does not share the same restrictions as imposed on traditional commerce, including those with respect to national boundaries or distance.[10] E-commerce generally does not require a physical presence, and tends to rely on only a few traditional intermediaries such as distributors, sales representatives, brokers or lawyers.[11] E-commerce is frequently categorized according to the participants involved, as either a business-to-consumer ("**B2C**") transaction or a business-to-business ("**B2B**") transaction.[12]

Canada's legal system is evolving to accommodate e-commerce as the prevalent form of commerce.[13] Canada actively participates in international efforts to develop e-commerce best practices and standards, and promotes (but does not always achieve) harmonization of rules

[4] J Li, "Consumption Taxation of Electronic Commerce: Problems, Policy Implications and Proposals for Reform" (2003) 38 Can Bus LJ 425 at s I(1), citing *Selected Tax Policy Implications of Global Electronic Commerce* (Washington, DC: Department of the Treasury, 1996), online: < https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Global-Electronic-Commerce-1996.pdf>.
[5] *Ibid.* citing Howard E Abrams & Richard Doemberg, "How Electronic Commerce Works" (1997) 4 Tax Notes Intl 1573.
[6] *Supra* note 4 citing Canada, Minister's Advisory Committee on Electronic Commerce, *Electronic Commerce and Canada's Tax Administration: A Report to the Minister of National Revenue from the Minister's Advisory Committee on Electronic Commerce* (Ottawa: Revenue Canada, 1998).
[7] A Gahtan et al., eds, Electronic Commerce: A Practitioner's Guide, vol 2 (Toronto: Thomson Reuters Canada Limited, 2009), ch 16 at 2.
[8] *Ibid*.
[9] S*upra* note 2 at s I(2).
[10] *Ibid.*
[11] *Supra* note 2 at s I(2).
[12] *Ibid.* at s I(1). See Gahtan, *supra* note 7, ch 16 at 2. See also *The Canadian Electronic Commerce Strategy*, (Ottawa: Industry Canada, 1998) at 4.
[13] J Gregory, "Canadian Electronic Commerce Legislation" (2002) 17 BFLR 277 at 282.

within in its own borders.[14] Legislation has been adopted and amended at the federal, provincial and territorial levels to support the growth of e-commerce, and similarly, the common law has developed to accommodate challenges brought about by the proliferation of e-commerce.[15]

In the late 1990's, the Uniform Law Conference of Canada adopted the *Uniform Electronic Commerce Act*[16] ("***UECA***") as a model for provincial e-commerce legislation.[17] The UECA incorporates principles of the *Model Law of Electronic Commerce*[18] ("***UN Model Law***"), adopted by the United Nations Commission on International Trade Law.[19] Thereafter, most provinces and territories in Canada enacted legislation governing electronic transactions and e-commerce.[20] With the exception of Québec, such provincial and territorial laws are heavily modelled on the *UECA*.[21] Provincial and territorial electronic commerce legislation recognizes the validity of electronic communications, and acknowledges electronic communications, documents, contracts and signatures as functionally equivalent to their written or printed counterparts.[22]

3. Competition

Amendments to Canada's competition laws within the last decade have also contributed to a more favourable environment for e-commerce participants. In 2009, Canada's price maintenance rule underwent significant changes as the result of amendments to the federal *Competition Act*[23]. Prior to these changes, it was a criminal offence in Canada to attempt to influence a sale price downstream in Canada, whether by way of agreement, promise, threat, refusal to supply or other like means. Following the 2009 amendments, the criminal offence of price maintenance was replaced by a civil regime that allows suppliers increased freedom in setting resale prices for

[14] *Supra* note 13.
[15] *Ibid.* at 338.
[16] Uniform Law Conference of Canada, *Uniform Electronic Commerce Act*, (Winnipeg: 1999).
[17] *Consolidated E-Commerce Statutes*, (Toronto: Thomson Reuters, 2017), ch 1 at 1.
[18] United Nations, UNCITRAL, *Model Law of Electronic Commerce*, (adopted 12 June 1996).
[19] S*upra* note 13 at 282.
[20] S*upra* note 13 at 283. See also generally Alberta, *Electronic Transactions Act*, SA 2001, c E-5.5; British Columbia, *Electronic Transactions Act*, SBC 2001, c 10; Manitoba, *The Electronic Commerce and Information Act*, SM 2000, c 32; New Brunswick, *Electronic Transactions Act*, RSNB 2011, c 145; Newfoundland and Labrador, *Electronic Commerce Act*, SN 2001, c E-5.2, s 1; Nova Scotia, *Electronic Commerce Act*, SNS 2000, c 26, 1; Ontario, *Electronic Commerce Act, 2000,* SO 2000, c 17; Prince Edward Island, *Electronic Commerce Act,* SPEI 2000, c 31; Saskatchewan, *The Electronic Information and Documents Act, 2000,* SS 2000, c E-7.22, s 1; and Yukon, *Electronic Commerce Act,* RSY 2002, c 66.
[21] S*upra* note 13 at 283.
[22] S*upra* note 17 ch 1 at 3.
[23] RSC 1985, c C-34.

their products, provided their conduct does not lead to an adverse effect on competition.[24] While resellers remain free to set their own resale prices, a supplier can refuse to deal with a reseller that does not observe the supplier's unilaterally set minimum resale prices. The new price maintenance rule also permits unilateral minimum advertised price (**"MAP"**) policies.[25]

Canada's price maintenance rules only apply where the supplier and dealer compete with one another.[26] Moreover, price maintenance may now only be the subject of an order of the Competition Tribunal[27] if it "has had, is having, or is likely to have an adverse effect on competition in a market." The adverse effect requirement is easier to prove than the existence of a "substantial lessening or prevention of competition," as must be proven in relation to the other civil reviewable practices in the *Competition Act*.

If the Competition Tribunal determines that the respondent has engaged in price maintenance, it may order the respondent to stop engaging in the practice by issuing a cease and desist order, or accept the other person as a customer on usual trade terms. However, it has no authority to fine or award other monetary damages. The regime also provides for a private right of action. Both the Commissioner of Competition[28] and private parties may now initiate Competition Tribunal proceedings in respect of price maintenance, although a private party must first obtain leave of the Competition Tribunal.

There is, as yet, no jurisprudence concerning Canada's price maintenance rule. However, the new approach provides a safe harbour for e-commerce suppliers, permitting them greater flexibility in making pricing decisions.

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[24] *Supra* note 23 at s 76 ((1) [o]n application by the Commissioner or a person granted leave under section 103.1, the Tribunal may make an order under subsection (2) if the Tribunal finds that (a) a person referred to in subsection (3) directly or indirectly (i) by agreement, threat, promise or any like means, has influenced upward, or has discouraged the reduction of, the price at which the person's customer or any other person to whom the product comes for resale supplies or offers to supply or advertises a product within Canada, or (ii) has refused to supply a product to or has otherwise discriminated against any person or class of persons engaged in business in Canada because of the low pricing policy of that other person or class of persons; and (b) the conduct has had, is having or is likely to have an adverse effect on competition in a market).

[25] *Ibid.* at s 76 ((1) [f]or the purposes of this section, the publication by a producer or supplier of a product, other than a retailer, of an advertisement that mentions a resale price for the product is proof that the producer or supplier is influencing upward the selling price of any person to whom the product comes for resale, unless the price is expressed in a way that makes it clear to any person whose attention the advertisement comes to that the product may be sold at a lower price).

[26] *Ibid* at s 45 ((1) [e]very person commits an offence who, with a competitor of that person with respect to a product, conspires agrees or arranges (a) to fix, maintain, increase or control the price for the supply of the product; (b) to allocate sales, territories, customers or markets for the production or supply of the product; or (c) to fix, maintain, control, prevent, lessen or eliminate the production or supply of the product).

[27] The Competition Tribunal is a specialized federal adjudicative body for non-criminal competition matters arising in Canada.

[28] The Commissioner of Competition serves as Canada's chief antitrust enforcement official.

4. Consumer Protection

In Canada, businesses engaged in e-commerce must abide by federal legislation, including the *Competition Act*[29] discussed above, as well as provincial legislation and common law principles related to the sale of goods, unfair business practices, credit disclosure, and consumer protection.[30]

(a) Studies and Reports

Canadian authorities have released several studies concerning the adaptation of consumer protection laws in the context of e-commerce transactions. Generally, the studies have recommended developing consumers protections that are substantially the same as those afforded in traditional commerce transactions.

In the late 1990's, Industry Canada (now Innovation, Science and Economic Development Canada) commissioned a study of key legal issues concerning consumer protection in e-commerce transactions. The study, *Consumer Protection Rights in Canada in the Context of Electronic Commerce*[31], concluded that consumer protection statutes were generally outdated and did not allow for adequate application to e-commerce.[32] In an effort to update Canadian consumer protection laws, the federal government subsequently published the *Principles of Consumer Protection for Electronic Commerce: A Canadian Framework*[33] ("**Canadian Framework**") in 1999. Drafted by a working group of representatives from Canadian businesses and consumers, the Canadian Framework provided guiding principles for the development of a consumer protection regulatory framework.[34] The Canadian Framework sought to provide consumers with protection equivalent to those recognized amongst traditional forms of commerce, to harmonize approaches across provinces and territories, and to maintain consistent standards with those advocated in the international arena.[35] In 2004, the Consumer Measures Committee and the Working Group on Electronic Commerce and Consumers released

[29] *Supra* note 23.
[30] B Sookman, *Computer, Internet and Electronic Commerce Law* (Toronto: Thomson Reuters, 1988) (loose-leaf updated 2017), ch 10 at 1.
[31] Office of Consumer Affairs, *Consumer Protection Rights in Canada in the Context of Electronic Commerce*, (Ottawa: Industry Canada, 1999).
[32] *Supra* note 30, ch 10 at 2.
[33] Working Group on Electronic Commerce and Consumers, *Principles of Consumer Protection for Electronic Commerce: A Canadian Framework*, (Ottawa: Industry Canada, 1999).
[34] S*upra* note 30, ch 10 at 2. See also Gregory, *supra* note 13 at 284.
[35] *Supra* note 30.

the *Canadian Code of Practice for Consumer Protection in Electronic Commerce* ("**Code**").[36] The purpose of the Code was to establish benchmarks "for good business practices for merchants conducting commercial activities with consumers online."[37] Taken together, these publications provide a number of key principles that underlie the legal framework for transacting with consumers in the e-commerce context in Canada.

(b) Key Principles

According to the Canadian Framework, "consumers should be provided with clear and sufficient information to make an informed choice about whether and how to make a purchase."[38] This means that market participants engaged in e-commerce must provide consumers with accurate, clear and accessible information about their company, the goods or services, and the transaction.[39] Companies should also take reasonable steps to ensure that consumers are aware of their rights and obligations before an agreement is finalized.[40]

The issue of consumer redress is challenging in the context of e-commerce because it can be unclear, for example, whether the transaction should be governed by the laws of the jurisdiction where the consumer resides, or whether the consumer can bring proceedings against an online supplier in the supplier's local venue.[41] Generally, the choice of law provision in the agreement or, if there is none, then conflict of laws principles govern consumer redress. However, many Canadian provinces have laws designed to give consumers jurisdictional advantages in contracts.[42] In Québec, for example, the *Consumer Protection Act*[43] requires that a consumer contract with a resident of Québec be governed by Québec law.[44]

In May 2001, federal and provincial authorities responsible for consumer affairs adopted the *Internet Sales Contract Harmonization Template*[45] (the "**Internet Template**").[46] The focus of

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[36] Consumer Measures Committee, *Canadian Code of Practice for Consumer Protection in Electronic Commerce*, (Ottawa: Office of Consumer Affairs, Industry Canada, 2004). See Sookman, *supra* note 31, ch 10 at 2.
[37] S*upra* note 30, ch 10 at 3.
[38] *Ibid*.
[39] S*upra* note 30.
[40] *Ibid*.
[41] *Ibid*, ch 10 at 10.
[42] *Ibid*.
[43] CQLR, c P-40.1.
[44] S*upra* note 30, ch 10 at 10.
[45] Canada, Office of Consumer Affairs, *Internet Sales Contract Harmonization Template* (2001).
[46] S*upra* note 30, ch 10 at 12.

the Internet Template was to ensure that consumers are offered protection through on-the-face disclosure at the beginning of the transaction between the supplier and the consumer. The Internet Template applies to any consumer transaction formed by text-based Internet communications[47] and covers contract formation, cancellation rights, credit card charge-backs and information disclosures.[48]

Several provinces enacted legislation modelled on the Internet Template.[49] In 2002, Ontario amended its *Consumer Protection Act*[50] to extend consumer protections in the context of e-commerce.[51] Pursuant to the *Consumer Protection Act, 2002*, a supplier is required to disclose prescribed information to the consumer before entering into an Internet agreement.[52]

5. Taxation

Canada's current value-added taxation rules generally favour out-of-jurisdiction suppliers over local suppliers. The intangible nature of e-commerce can pose challenges for traditional tax

[47] S*upra* note 45. See also, *Consumer Protection Act, 2002*, SO 2002, c 30, schedule A, s 20 ("internet agreement means any consumer agreement formed by text-based internet communications").
[48] S*upra* note 30, ch 10 at 12.
[49] Manitoba and Alberta were the first provinces to enact such legislation. In 2001, Manitoba adopted the *Internet Agreements Regulation*, Man Reg 176/2000 and Alberta adopted the *Internet Sales Contract Regulation*, Alta Reg 81/2001.
[50] RSO 1990, c C-31, as repealed by *Consumer Protection Act, 2002*, SO 2002, c 30, schedule A.
[51] *Ontario Consumer Protection Act, supra* note 47 at s 2(1) ("[s]ubject to this section, this Act applies in respect of all consumer transactions if the consumer or the person engaging in the transaction with the consumer is located in Ontario when the transaction takes place").
[52] *Consumer Protection Act, 2002*, O Reg 17/05, s 32 ("the information that the supplier shall disclose to the consumer before the consumer enters into an internet agreement is: (1) The name of the supplier and, if different, the name under which the supplier carries on business. (2) The telephone number of the supplier, the address of the premises from which the supplier conducts business, and information respecting other ways, if any, in which the supplier can be contacted by the consumer, such as the fax number and e-mail address of the supplier. (3) A fair and accurate description of the goods and services proposed to be supplied to the consumer, including the technical requirements, if any, related to the use of the goods or services. (4) An itemized list of the prices at which the goods and services are proposed to be supplied to the consumer, including taxes and shipping charges. (5) A description of each additional charge that applies or may apply, such as customs duties or brokerage fees, and the amount of the charge if the supplier can reasonably determine it. (6) The total amount that the supplier knows would be payable by the consumer under the agreement, including amounts that are required to be disclosed under paragraph 5, or, if the goods and services are proposed to be supplied during an indefinite period, the amount and frequency of periodic payments. (7) The terms and methods of payment. (8) As applicable, the date or dates on which delivery, commencement of performance, ongoing performance and completion of performance would occur. (9) For goods and services that would be delivered, (i) the place to which they would be delivered, and (ii) if the supplier holds out a specific manner of delivery and intends to charge the consumer for delivery, the manner in which the goods and services would be delivered, including the name of the carrier, if any, and including the method of transportation that would be used. (10) For services that would be performed, the place where they would be performed, the person for whom they would be performed, the supplier's method of performing them and, if the supplier holds out that a specific person other than the supplier would perform any of the services on the supplier's behalf, the name of that person. (11) The rights, if any, that the supplier agrees the consumer will have in addition to the rights under the Act and the obligations, if any, by which the supplier agrees to be bound in addition to the obligations under the Act, in relation to cancellations, returns, exchanges and refunds. (12) If the agreement is to include a trade-in arrangement, a description of the trade-in arrangement and the amount of the trade-in allowance. (13) The currency in which amounts are expressed, if it is not Canadian currency. (14) Any other restrictions, limitations and conditions that would be imposed by the supplier").

administration rules.[53] For example, online transactions can blur national boarders making it difficult to define the physical location of the supplier, service provider or buyer.[54] Canadian authorities have made a concerted effort to develop tax administration rules that better reflect the prevalence of e-commerce. Both the Minister's Advisory Committee on Electronic Commerce and the Canada Customs and Revenue Agency published reports on tax administration in the context of e-commerce, which has informed the current rules for sales tax collection.[55]

(a) Collection of the Goods and Services Tax ("GST")

Generally, anyone who provides a taxable supply of property (goods) and/or services in Canada is required to register for GST[56], unless they are a small supplier.[57] Registration is not required for non-residents unless they are deemed to be a resident in Canada or are carrying on business in Canada.[58] GST collection also depends on the proper characterization of the taxable supply of goods or services.

(i) Permanent Establishment

A non-resident with a "permanent establishment" in Canada is deemed to be a resident of Canada, and is subject to the same GST obligations as a Canadian resident supplier for the activities carried on through that permanent establishment.[59] For GST purposes, "permanent establishment" is defined to "include a fixed place of business of a person, including a place of management, branch, office, factory or workshop, and a mine, oil or gas well, and other places of extraction of natural resources through which the non-resident person makes supplies."[60] The determination is made on a case-by-cases basis, but generally requires "certain physical space

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[53] Gahtan, *supra* note 7, ch 16 at 1. See also Li, *supra* note 3 at s III(3).
[54] *Ibid.* ch 16 at 3.
[55] See Canada, Minister's Advisory Committee on Electronic Commerce, *Electronic Commerce and Canada's Tax Administration: A Report to the Minister of National Revenue from the Minister's Advisory Committee on Electronic Commerce*, (Ottawa: Revenue Canada, 1998); Canada, Excise and GST/HST Rulings, *GST/HST and Electronic Commerce*, (Ottawa: Canada Customs and Revenue Agency, 2001).
[56] In 1997, the federal government introduced the harmonized sales tax ("HST"), pursuant to which certain participating provinces have harmonized their provincial sales tax with the GST. HST is collected by the Canada Revenue Agency, which then remits the appropriate amounts to the participating provinces.
[57] "GSH/HST and E-Commerce" (last modified 16 January 2018), online: *Government of Canada* <https://www.canada.ca/en/revenue-agency/services/tax/businesses/topics/e-commerce/gst-hst-e-commerce.html>.
[58] Li, *supra* note 4 at s II(2)(c).
[59] D Begun, "GST/HST and Electronic Commerce" (2002) 6:2 Mann's Technology Newsletters. See also Li, *supra* note 4 at s 2(c).
[60] Li, *supra* note 4 at s II(3), citing *Excise Tax Act (GST/HST Portions)*, RSC 1985,c E-15, s 123(1).

and that the functions carried on through the place of business must be an essential and significant part of the business activity of the non-resident person as a whole."[61]

(ii) Carrying on Business in Canada

A non-resident is also required to register for GST if it is "carrying on business in Canada." This determination is made on a case-by-case basis according to a number of factors, including: place where non-resident's agents or employees are located, place of delivery, place of payment, place of purchase, place of solicitation, location of inventory, place where business contracts are made, location of bank account, place where the name of the non-resident and the business are listed in a directory, location of branch office, place of service, and place of manufacture/production.[62] This approach recognizes that certain factors used with respect to traditional commerce are less applicable to those engaged in e-commerce, while other factors are of greater importance.[63]

(iii) Characterization of Supply

GST applies to taxable supplies of property or services made in Canada, with a few exemptions. The proper characterization of the taxable supply is necessary to determine the application of GST.[64] E-commerce presents a challenge to traditional characterization of taxable supplies because it "allows for electronic delivery of products which previously may have only been deliverable as tangible personal property."[65]

Digital transactions are characterized as either a supply of intangible personal property, services, or telecommunication services, the determination of which is made according to several factors.[66] For example, factors that generally indicate that a taxable supply is intangible personal property include: the supply is a right in a product or right to use a product for commercial or personal purposes; the product has already been created or developed; the product is created or developed for a specific customer, but the supplier retains ownership of the product; or the

[61] *Ibid.*
[62] "GSH/HST and E-Commerce", *supra* note 57. See also Begun, *supra* note 59; Gahtan, *supra* note 7, ch 16 at 5 (see *Gurd's Products Co v R*, [1985] 2 CTC 85, 85 DTC 5314, 60 NR 184 (Fed CA) (the court recognized that tax authorities must take into account a "multitude of incidents" together); *GLS Leasco Inc v Minister of National Revenue*, [1986] 2 CTC 2034, 86 DTC 1484 (TCC) (the company was deemed to be carrying on business in Canada where it had "an office, bank account, and access to personnel in Canada"); *Geigy (Canada) Ltd v British Columbia (Minister of Finance)*, [1969] CTC 79, 1 DLR (3d) 354, 66 WWR 689 (BSC) (the court concluded that the location of contract was an important factor in making the determination)).
[63] Begun, *supra* note 59.
[64] *Ibid.*
[65] *Ibid.*
[66] Li, *supra* note 4 at s IV(1). See also "GSH/HST and E-Commerce", *supra* note 57.

supply consists of a right to made a copy of a digitized product.[67] Factors that generally indicate that a taxable supply is a service include: the supply does not include the provision of rights, or if there is a provision of rights, the rights are incidental to the supply; the supply involves specific work performed for a specific customer; or human involvement in required to make the supply.[68]

6. Franchise

This portion of the paper briefly examines three multi-unit expansion options as vehicles for distribution: territorial development arrangements, master franchising, and joint venture franchising[69], as well as key components of the agreements underlying each of these options.

(a) Territorial Development Agreements

Territorial development agreements are contracts in which a franchisor grants to a franchisee the right to develop and operate multiple franchise units within a given territory, generally pursuant to separate franchise agreements for each unit. The franchisee agrees to a development schedule requiring at least a specified number of units be developed by specified deadlines. The franchisee is typically not allowed to sub-franchise, but must develop all of the units independently. Generally, territorial development agreements require the franchisee to pay a fee for the right to develop the territory. The franchisee will also pay a continuing royalty or license fee often calculated as a percentage of sales. The franchisee often pays additional development fees to the franchisor with each franchise unit established. The smaller the upfront fee, the larger the per unit development fee.

(b) Master Franchising

The term master franchising describes arrangements where a franchisor enters into an agreement with a master franchisee, frequently for a given territory and frequently providing for development or quota requirements, but also authorizes the master franchisee to grant sub-

[67] *Ibid*. See also "GSH/HST and E-Commerce", *supra* note 57.
[68] *Ibid*. See also "GSH/HST and E-Commerce", *supra* note 57.
[69] For purposes of this discussion, territorial development arrangements are those in which a new or existing franchisee receives rights to develop multiple units in a specific area. Master franchise arrangements involve the grant to a franchisee of rights to sub-franchise, and a joint venture franchise exists when franchisor invests with a third party to create an entity that becomes the franchisee. Please note, however, that the terms 'joint venture franchising', 'territorial development arrangement" and 'master franchising' are not precisely defined terms and there are many variations of each. "Multi-unit franchising" is used here to refer to all of the multi-unit franchising concepts including master franchising, territorial development agreements and joint venture franchising.

franchises to third parties. This section considers three variations on master franchising, although different variations or combinations are also possible.

One approach to master franchising involves a second tier of franchise relationships between the master franchisee and the unit franchisees. Under this arrangement, the master franchisee acquires from the franchisor the right to develop and operate its own units, but also to grant sub-franchises to third party franchisees. The master franchisee thus assumes the role of franchisor to its sub-franchisees and these franchisees have only an indirect relationship with the master franchisor.

An additional variation again permits the master franchisee to recruit additional sub-franchisees. The sub-franchisee would enter into a unit franchise agreement to which both the franchisor and the master franchisee would be parties. The sub franchisee would pay royalties to the master franchisee, but receive support and supervision from both the master franchisor and master franchisee, but primarily from the master franchisee.[70] The franchisor would have direct privity of contract with the sub-franchisee.

Another approach sometimes described as master franchising involves a more limited role for the master franchisee. Under this arrangement, the master franchisee is essentially an area representative or selling agent for the franchisor. The unit franchise agreement is between the franchisor and the ultimate franchisee and the master franchisee receives some form of commission for facilitating the transaction. Under this scenario, the area representative may retain obligations to provide service or support to franchisees or alternatively may have no further contact with the unit franchisee once the franchise agreement is in place. This arrangement is more typically thought of as an area representative or brokerage arrangement rather than master franchising.

These different arrangements can be seen as a continuum within the concept of master franchising. All three involve the franchisor contracting out degrees of responsibility for expanding the franchise system. The differences between the arrangements reflect varying

[70] V.S. Roh & W.P. Andrew, "Sub Franchising: A Multi-unit Alternative to Traditional Restaurant Franchising" Cornell, Hotel and Restaurant Administration Quarterly (December 1997) 39 at 40.; H.B. Lowell, "Multiple Unit Franchising: The Key to Rapid System Growth" (Washington: Brownstein, Zeidman and Schomer, 1991 area representation at 40.

degrees of control being given to the master franchisee. At one extreme, the master franchisee essentially takes over operation of an independent portion of the franchise system. At the other, a broker is essentially a commissioned salesperson.

(c) Joint Venture Franchising

In joint venture franchising, the franchisor takes on a partnership role or an equity position in the franchisee entity. This may arise because the franchisor is making a significant capital contribution. The franchisee entity then enters into either a territorial development agreement or master franchise agreement with the franchisor. Each unit developed would be governed by a standard unit franchise agreement with the franchisor. This type of relationship requires two distinct contracts. The franchisor and franchisee will enter into the franchisor's typical territorial development agreement or master franchise agreement. In respect of the entity that becomes the franchisee there will be also an agreement to govern the relationship of the two parties that have an equity interest in the franchisee. Depending on how this is structured, it may be a shareholder agreement, partnership agreement or co-ownership agreement. Aside from the franchisor's need to maintain control of the franchise system, these would be fairly typical agreements.

A joint venture franchise arrangement permits a franchisor greater control or influence over the franchise entity and higher participation in the anticipated return from development. If there are difficulties at the franchisee level, the franchisor will identify them sooner and will likely have greater contractual rights to step in and assume full control.

(d) Key Elements of Territorial Development Contracts

There are a number of key provisions typically found in territorial development agreements. These provisions can be grouped into those relating to the grant of the territory and the extent of any exclusivity granted; rights, obligations and remedies with respect to the development of that territory; and other provisions of importance given the increased responsibility taken on by the area developer as compared to a unit franchisee.

Defining the territory involves setting out the boundaries of the territory and defining the nature of the rights within that territory.[71] Defining the nature of the rights within the territory requires clarification of the extent of the exclusivity granted within the territory, the term of the agreement and any renewal rights and preconditions to rights of renewal. Any rights the franchisor wishes to reserve to itself within the territory will need to be set out. As with unit franchises, if the franchisor will be selling directly in the territory through national accounts, competitive products or services, or alternate channels of distribution, a right should be reserved to the franchisor for that purpose. Competitive channels may include the internet or other direct sales, or acquisition of competing systems or units formerly part of other systems. The term of the development agreement may be fixed in advance or may be for a limited number of development years. There may be rights of development renewal or rights of first refusal where the developer meets its specified development criteria.

Provisions spelling out the franchisee rights and obligations with respect to the development of the territory, advertising requirements (including obligations to participate in co-ordinated system wide advertising funds or programs), and franchisor remedies if the franchisee fails to meet its obligations, are critical elements of any territorial development contract. The development agreement typically contemplates separate unit franchise agreements for each unit franchise opened by the developer. The form of unit franchise agreement may be fixed at the time of the development contract. Alternatively, the development agreement may provide for use of the most current franchisor unit franchise agreement as of the date each unit franchise is opened.

Provisions typically control the actual ownership of each individual unit franchise. If any outside investors are to be permitted that will need to be specifically addressed (including consideration of disclosure obligations and the developer remaining liable). The procedures to be followed for development of single units, including any site selection criteria, approval

[71] See A. Frith et al., Canadian Franchise Guide, looseleaf (Toronto: Thompson Carswell, 2015) [hereinafter "Canadian Franchise Guide"] suggests that "[t]he territory can be defined by either fixed boundaries, on a geographic basis, or by boundaries which may be subject to change, depending upon factors such as population, advertising reach or other criteria." At 5B.1.

processes, and requirements that the franchisees open an administrative office must also be specified.[72]

The most critical provisions relate to the development schedule, setting out the detailed obligations of the developer with specified time lines. Provision must be made to address the consequences under the contract in the event the developer fails to comply with development requirements, or defaults under one or more unit franchise agreements. The franchisor will seek cross termination provisions or other remedies to protect itself in the event the franchisee defaults under one of its many contracts. A default might lead to the loss of all existing units or just development rights or, perhaps only a portion of the development rights (if the development obligations are subdivided within the territory). Specifying multiple alternative remedies will provide flexibility for the franchisor. Typically, as long as the unit franchise agreements are in good standing the developer would be permitted to retain them but would lose some or all of the development rights.

Other important provisions in territorial development agreements specify fees payable under the contract, business standards to which the developer must adhere and trade mark control provisions. Fees provided for in a territorial development contract may include the fee for the grant of the development contract, development or franchise fees for development of additional units, unit royalty or licence fees based on revenue, and renewal fees.

Territorial development contracts may also impose obligations on the developer to comply with financial covenants and to develop and maintain operational and management standards. The provisions addressing the franchisor's control over the developer's use of the franchisor's trade mark will generally follow the trade mark provisions contained in the single unit franchise agreement since the relationship with the developer is a direct contractual relationship. Non-competition and non-disclosure obligations to address the developer's use of the franchisor's confidential information and proprietary system will also be required. Territorial development contracts also contain many typical commercial provisions common to unit franchise agreements and other commercial contracts, including dispute resolution clauses, and termination provisions.

[72] *Ibid.* at 5B.12.

(e) Key Elements OF Master Franchise Agreements

The key provisions of territorial development agreements discussed above are a useful starting point for master franchise agreements and most will be applicable to master franchise agreements. A master franchise agreement is essentially an expanded form of territorial development contract that includes provisions to reflect the master franchisee's additional role in selling franchises to sub franchisees.

A master franchise agreement will need to address the manner in which the master franchisee may sub-franchise. As discussed above, the sub-franchise agreements could be two party contracts (master franchisee and sub-franchisee) or three party contracts with the franchisor also being a party.

Master franchise agreements will contain additional control mechanisms in view of the extent of responsibility for the franchise system and its development which is allocated to the master franchisee. The franchisor will generally include provisions obligating the master franchisee to establish and operate a minimum number of individual units before becoming entitled to grant sub-franchises and to maintain them on an ongoing basis. These units serve as models for location based systems and ensure that the master franchisee has operating experience in order to better pass knowledge on to sub-franchisees. The master franchisee will typically be required to use the franchisor's prescribed form of franchise agreement or a pre-approved form (since the master franchisor may need to assume these agreements in the event of default). Provisions will also need to be included if the franchisor will have rights to approve or reject sub-franchisees, locations, and rights to inspect or audit at the unit franchise level. Corresponding rights would need to be in the sub-franchise agreement. The master franchise agreement will require the master franchisee to enforce system standards with sub-franchisees and to include those rights in the sub-franchise agreements.

Provisions in master franchise agreements addressing the termination or expiry of the master franchise relationship will be of great importance. Particularly if the master franchisee contracts directly with sub-franchisees, the master franchise agreement will need to include clauses providing for assignment of the master franchisee's rights as against sub-franchisees on termination or expiry of the master franchise contract either to the franchisor or a designated

party. These provisions are critical to protecting the franchisor's interest in the franchise system once the relationship with a master franchisee comes to an end.

Many franchisors are reluctant to sign tripartite agreements with sub-franchisees. They feel the sub-franchisees should be supervised by the master franchisee and that the franchisor should contract only with the master franchisee. If a franchisor faces an event of non performance by a master franchisee the franchisor should also expect the master franchisee will not be fulfilling its obligations under the sub-franchise agreements. When the franchisor steps in, terminates the master franchisee and assumes control of the sub-franchise agreements, the sub-franchisees may allege their agreements have been breached and claim damages. Tripartite agreements, with clauses providing that the franchisor has liability only for matters arising following termination or expiry of the master franchise agreement could provide significant protection for the franchisor.

Other additional provisions required in master franchise agreements relate to the financial complexities and trade mark protection issues inherent in master franchise relationships. At the level of finances, provisions must be included to apportion between the franchisor and the master franchisee the franchise fees, continuing royalties, and any other consideration payable by unit franchisees. Provisions need to be included to ensure that the franchisor (or the trade mark owner if it is a separate entity) has appropriate controls over system trade marks including the right to inspect and approve advertising and trade mark usage. Failure to control use of the trade marks by the master franchisee or its sub-franchisees could lead to loss of trade mark rights.[73]

(f) **Disclosure Obligations**

(i) Territorial Development Agreements

In Ontario, a franchisor will need to provide a disclosure document to a territory developer at least 14 days prior to the agreement being signed. The disclosure document would include the development agreement and the unit franchise agreement. As territory development agreements are typically negotiated agreements, the negotiation would generally be completed

[73] Canadian Franchise Guide contains a useful, more detailed description of typical master franchise agreement provisions.

first to finalize the agreement, the disclosure document distributed and then signing would happen 14 days later. Provided there is no intervening "material change" as defined in the Ontario franchise legislation, in Ontario no new disclosure would be required prior to entering into an additional unit franchise agreement. If the development agreement, however, requires signing of the then current unit franchise agreement and there has been a material change in the terms of the unit franchise agreement or another material change, disclosure would have to be provided at least 14 days prior to signing a new agreement. Failure to provide disclosure would give the developer a right to rescind and to recover damages as specified in the Ontario franchise legislation.

(ii) Master Franchise Agreements

The grant by the franchisor of a master franchise agreement would also give rise to disclosure obligations in favour of the master franchisee. The disclosure provided should cover both the master franchise agreement and the form of unit franchise agreements applicable to the sites developed by the master franchisee. As referenced above, additional disclosure may be needed for additional unit franchises developed by the master franchisee if there has been a "material change" (in the terms of the unit franchise agreement or another material change) since the most recent disclosure.

For sub-franchises granted in Ontario by the master franchisee, disclosure would also be required. This disclosure would need to cover the master franchisee but also to some extent matters relating to the franchisor (such as trade mark matters). It will be necessary for the franchisor and franchisee to co-ordinate preparation of the disclosure document. At issue will be whether the franchisor and the master franchisee have joint and several liability to the extent there is any misrepresentation or omission in the disclosure document. The franchisor will want

to draft the portion of the disclosure document that relates to it and have the master franchisee complete the balance. As the franchisor will be exposed to potential liability if there are misrepresentations that relate to it, it should insist on the document being submitted to it for approval prior to distribution.