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Competition Law Considerations for the Franchise Industry in Canada

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INTRODUCTION

The Canadian franchise industry constitutes an important sector of the Canadian economy. The industry employs one in every 35 Canadian, generates approximately CDN$68 billion in revenues, and covers a wide variety of businesses (60% of franchisees are in non-food sectors and industries.)

Franchising in Canada is governed principally by provincial legislation, with six provinces having enacted specific statutes in this regard. However, in addition to provincial regulation, franchisors and franchisees operating in Canada must also comply with the federal Competition Act (the "Act"), which applies generally to all businesses and industries in Canada.

Given the potential sanctions involved, compliance with the requirements of Canadian competition law – as embodied in the Act – is a critical business imperative. In this article, we provide a primer on the aspects of Canadian competition law that are most relevant to the franchise industry in Canada, with a view to providing the foundation for such compliance.

OVERVIEW OF CANADIAN COMPETITION LAW

The Act is a federal statute of general application. Its objective is to "maintain and encourage competition in Canada". In contrast to the United States, where many states have their own antitrust laws, there are no provincial or territorial counterparts to the Act.

The Act is administered and enforced by the Commissioner of Competition ("Commissioner"), a federal official who heads the Competition Bureau ("Bureau"). The Bureau has a wide array of investigative tools at its disposal, including the power to obtain search warrants and wiretaps, and to compel production of documents and testimony under oath.

The prohibitions established by the Act are broadly divided into two categories: criminal offences and "reviewable matters" (also referred to as "reviewable practices").

The principal criminal offences under the Act are criminal agreements between competitors (conspiracies) and bid-rigging. Certain types of deceptive marketing practices (including pyramid schemes and multi-level marketing plans) are also criminal offences. All of these offences are prosecuted in the criminal courts by federal prosecutors and are subject to potential sanctions, including fines and/or imprisonment.

The principal reviewable matters under the Act include abuse of dominance (monopolization); various distribution practices (exclusive dealing/market restrictions/tied selling/refusal to deal); price maintenance; non-criminal agreements between competitors; mergers; and certain deceptive marketing practices (such as misleading "ordinary sales price" representations). The Act's "reviewable matters" are governed by a civil adjudication regime, with applications brought by the Bureau principally to the Competition Tribunal ("Tribunal"), a specialized administrative body. Potential remedies include injunctive-type relief and "administrative monetary penalties".

Private enforcement of the Act is also available. In the case of reviewable matters, private parties may seek leave from the Tribunal to apply for relief where the Bureau has declined to bring proceedings on its own part. This right of private application is only available for certain reviewable matters (e.g., it does not apply to allegations of abuse of dominance) and damages may not be claimed. In the case of the Act's criminal offences, however, private parties may sue for damages where they have allegedly suffered harm as a result of the conduct in question.

There have been very few successful private applications brought under the reviewable matters provisions; by contrast, civil claims for damages with respect to the Act's criminal offences are commonplace (usually in the form of class actions) and have resulted in substantial damage awards (typically negotiated settlements).

COMPETITION LAW IMPLICATIONS FOR FRANCHISING IN CANADA

1. Criminal Conspiracies

Section 45 of the Act makes it a criminal offence for competitors to agree to fix prices; allocate sales/territories/customers/markets; or restrict (including eliminate) the production or supply of a product. Section 45 is a per se offence, meaning that the prosecution is not required to prove harm to the marketplace; the offence is in the agreement itself. This is a relatively recent change, in that prior to amendments to the Act in 2009 (which came into force in 2010), the prosecution had to prove an "undue lessening of competition" resulting from the conduct.

Section 45 also contains a potential defence if the conduct in question is "ancillary and reasonably related to" an otherwise legal agreement. This defence has not been considered extensively by the courts but has been applied in at least one franchise related case to dismiss a class action for damages against a franchisee (see below).

According to its Competitor Collaboration Guidelines (the "Collaboration Guidelines"), the Bureau takes the view that since section 45 refers to agreements between competitors, it does not apply to vertical arrangements between suppliers and their customers. To the extent that competition issues arise, the Bureau would examine these under one of the Act's relevant reviewable practices provisions (e.g., the market restriction or price maintenance provisions discussed infra).

The Collaboration Guidelines specifically refer to agreements between franchisors and franchisees to illustrate this point. Thus, the Collaboration Guidelines state that even if a franchisor's agreements effectively allocate markets or customers (e.g., by creating limited authorized sales territories for franchisees), the Bureau will not consider such arrangements to fall under section 45 because they are vertical in nature and do not involve competitors.

That said, the Collaboration Guidelines caution that franchise-related conduct could be caught by section 45 if, for example, franchisors agreed with other franchisors (or franchisees agreed with other franchisees) to restrain competition between themselves, such as by allocating markets or fixing prices. Franchisors should also be aware that they could be subject to prosecution under the Canadian Criminal Code's "aiding and abetting" offences if they facilitated an anti-competitive agreement between their franchisees.

What of a situation in which a franchisor sells its products to franchisees for resale to customers but also competes with franchisees by selling directly to customers as well? This hybrid situation is usually referred to as "dual distribution" and is addressed in the Bureau's Competitor Guidelines. Although acknowledging that dual distribution agreements contain both vertical and horizontal elements, the Collaboration Guidelines state that the Bureau will not approach potentially anti-competitive arrangements in this context as per se offences under section 45. Rather, they will be assessed under one or more of the Act's reviewable practices provisions.

2. Price Maintenance

An important issue for franchisors is whether, and to what extent, they can control the prices at which products are resold by franchisees (known as "price maintenance"). Franchisors may have an interest in prices being lower (e.g., to drive demand) or higher (e.g., to ensure that franchisees earn sufficient margins or to protect a product's brand image).

Under Canadian law, there is no prohibition against a franchisor imposing a maximum resale price on a franchisee. However, pursuant to section 76 of the Act, there may be an issue if a franchisor attempts to impose a minimum resale price on a franchisee, or otherwise seeks to "directly or indirectly influence upward or discourage the reduction of a resale price", including by restricting the price at which a product is advertised.

Section 76 was enacted in 2009. It brought about very important changes to the Act's prior treatment of price maintenance. Whereas price maintenance had previously been a per se criminal offence, under section 76 price maintenance is now (i) a civil reviewable practice and (ii) only actionable if it has had, is having, or is likely to have an "adverse effect on competition in a market".

As such, rather than being potentially subject to criminal sanction, parties found to be engaged in price maintenance will only be subject to injunctive relief (not even damages). Moreover, and critically, a party will only be found to be engaged in price maintenance to begin with if its conduct has the requisite negative impact on competition in the relevant market.

What does having an "adverse effect on competition" mean? There is not much case law on point but, according to the Bureau's Price Maintenance Enforcement Guidelines (2014) , price maintenance conduct will only have this effect where it is likely to "create, preserve or enhance the market power" of the supplier, i.e., give the supplier the ability to behave relatively independently of the market.

The Bureau's general approach is that it will not be concerned about "market power" where a supplier has a less than 35% share of the relevant market. This is an important safe harbour. But even if a supplier's market share is above 35%, the Bureau (or a private applicant) would have to prove that the supplier’s conduct has harmed competition. This is not an easy task, as the virtual absence of price maintenance cases since 2009 demonstrates.

The repeal of the per se price maintenance offence in 2009, and the enactment of section 76, was intended to give suppliers more flexibility to impose resale pricing restrictions. In part, this was meant to conform Canadian law with prevailing economic and legal thought, which argued that price maintenance could be pro-competitive and thus should not be automatically proscribed. The change was also intended to more closely harmonize Canadian law with U.S. federal law after the U.S. Supreme Court’s decision in *Leegin*, which held that price maintenance agreements should be subject to a “rule of reason” analysis that takes into account market impact.

That said, two cautions should be noted. First, the retail industry in Canada has been very unhappy with the liberalization of Canada’s price maintenance law, and there continue to be suggestions made about re-introducing tougher restrictions. Second, even under the current law, franchisors and franchisees must be careful to avoid conduct that could create issues under other provisions of the Act, such as section 45. For example:

• Competing franchisors should not agree amongst themselves to use price maintenance policies to facilitate less vigorous price competition between themselves or to help police a price-fixing arrangement;

• Franchisees and their franchisor should not agree to engage in price maintenance with a view to limiting competition at the franchisee level (e.g. to help police a price-fixing arrangement between the franchisees).

3. Distribution Practices

(i) Exclusive Dealing/Market Restriction/Tied Selling

Franchise relationships may incorporate various types of restrictions on franchisees regarding the products they must buy or where or to whom they may sell. For example, a franchisee may be required to purchase certain products only from the franchisor or a supplier designated by the franchisor (including a required bundle of products); or to sell products only in a certain territory or to certain types of customers.

The Act contains several “reviewable practices” prohibiting when a franchisor may impose such restrictions on franchisees. By virtue of section 77 of the Act, a franchisor cannot engage in “exclusive dealing”, “market restrictions” or “tied selling” when:

(a) it is a “major supplier of a product in a market”; and

(b) the conduct is likely to lessen competition substantially by impeding entry or expansion of a firm or a product in a market, or otherwise have any exclusionary effect.

In short, similar to price maintenance, the prohibitions in section 77 only apply if the franchisor is (a) a major player in the market and (b) its conduct is proved to have a negative impact on competition in that market. As a practical matter, these limitations mean that there have not been many cases under section 77.

Moreover, to the extent that the Bureau brings such applications, they are typically rolled into “abuse of dominance” cases, rather than proceeded upon on a stand-alone basis.

(ii) Abuse of Dominance

“Abuse of a dominant position” is proscribed under section 79 of the Act. As noted, this is another reviewable practice that requires demonstrating a negative impact on competition (“substantial prevention or lessening competition in a market”), and applies when a dominant party in a market uses “anti-competitive acts” to harm competition.

The abuse of dominance provision was historically limited to conduct targeted at “competitors”. However, a recent decision has expanded the scope of this provision so it also can apply to a dominant supplier engaging in conduct that harms competition in a downstream market. As such, franchisors may now have to consider the potential impact of this provision if their planned business strategies could impact competition between their franchisees. One reason for potential concern – the Tribunal may order substantial “administrative monetary penalties” (i.e., fines) against parties found to have violated this provision.

(iii) Refusal to Deal

Although parties are generally permitted under Canadian law to do business with whom they choose, section 75 of the Act limits the ability of parties to terminate business relationships where:

(a) the refusal to deal will substantially affect a person in his business or preclude him from carrying on business; and

(b) will have an “adverse effect on competition in a market”.

Although as a practical matter there have been very few successful section 75 applications in recent years, franchisors planning to terminate franchisees should bear this provision in mind when doing a risk assessment of their intended course of action. As a practical matter, this is not much of an issue in the franchising context because the likelihood of the termination having an “adverse effect on competition” is quite minimal.

4. Tim Hortons

The Tims Hortons case is an important decision worth examining in the competition law context. In this case, the Tim Hortons franchisees brought a motion before the Ontario Superior Court of Justice to certify a proceeding as a class action as against their franchisor. As part of their claim, the franchisees claimed that the franchisor had engaged in price maintenance and price fixing in breach of the Act. All the competition claims were dismissed by the court.

First, the court examined the old criminal conspiracy provisions which pre-date the 2009 Act amendments which ultimately eliminated them. It dismissed the claim, but we need not examine it here as the decision only applies to those cases which involve acts of conspiracy that pre-date the amendments.

Second, the court considered the conduct of the franchisor in light of the current criminal conspiracy offence in section 45 of the Act. The court held that the franchisor was not a competitor with its joint venture partner nor was it likely that it would become one and as such, no offence occurred. In any event, the court held that the price-fixing arrangement would have been saved by the ancillary restraints defence in section 45.

Third, the court rejected the franchisees' allegation that the franchisor violated the section 61 price maintenance provisions on the grounds that the joint venture agreement did not limit the ability of downstream purchasers to sell at whatever prices they choose and because the franchisor was not in the business of producing or supplying a product, as only the joint venture was.

Though the Tim Hortons franchisees were ultimately unsuccessful in making their claims under the Act, this decision serves as a good primer for how a court will apply the Act in the franchising context.

5. Conclusion

Franchisors looking to expand their franchise systems into Canada and those that are already present in Canada need to ensure that they comply with the applicable provisions of the Act. Franchisors that fail to do so risk being subject to an array of criminal offences, fines and other sanctions.

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