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Blaney McMurtry
BARRISTERS & SOLICITORS LLP

Blaneys on Business

This newsletter is designed to bring news of changes to the law, new law, interesting deals and other matters of interest to our commercial clients and friends. We hope you will find it interesting, and welcome your comments.

Feel free to contact any of the lawyers who wrote or are quoted in these articles for more information, or call the head of our Corporate/Commercial Group, John C. Papadakis at 416.597.3998 or jpapadakis@blaney.com.

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Businesses evolve. Their products and processes change. Sometimes, where such change involves others, multiple legal issues can arise. The iconic Canadian franchisor, Tim Hortons, initiated some changes in its processes which raised questions of good faith and compliance with the Competition Act. Blaney McMurtry's Todd Greenbloom, an authority on these matters, writes about the issues as debated in the Ontario Superior Court of Justice and decided upon in March by Mr. Justice George R. Strathy.

COMPETITION LAW NOW GIVES MANUFACTURERS, DISTRIBUTORS LATITUDE WHEN IT COMES TO SETTING PRICES

H. Todd Greenbloom

Tim Hortons' desire to serve fresher donuts and Timbits gives us a fresh look at how manufacturers can establish pricing and stay within the bounds of the new Competition Act.

Before March 2009, the Competition Act provided rules to keep manufacturers and distributors, whether alone or together with others, from increasing prices to the public artificially. In March 2009, the Competition Act was changed to give manufacturers and distributors more flexibility in setting prices while still maintaining restrictions on a manufacturer acting alone or with others.

Under the old version of the Competition Act, there were two restrictions:

(i) section 61, which prohibited persons engaged in producing or supplying a product from attempting to influence upward, or discouraging reductions in, the price at which another person could offer products for sale, whether the influencing was by agreement, threat or promise; and

(ii) conspiring with another person to enhance unreasonably the price of a product.

Under the new version of the Competition Act, the two restrictions are:

(i) a person cannot abuse a dominant position, and

(ii) a person cannot conspire with a competitor to fix, maintain, increase or control the price for the supply of a product.

In addition, under the current version of the Competition Act, an aggrieved person can apply to have the Competition Tribunal look into a person who has, by agreement, threat or promise, allegedly influenced upward, or discouraged the reduction of, a retail price. (This is similar to the Act's old price-maintenance provisions, but it decriminalizes the offence and requires that there be an adverse effect on competition in a market).

Fairview Donut Inc. v the TDL Group Corp. is a recent case which shows how these sections apply under the old and new versions of the Competition Act.

At one point in time, Tim Hortons' franchisees baked their donuts from scratch. Tim Hortons saw a number of difficulties with this methodology. There were concerns about having a sufficient number of trained bakers available, for example, and about the freshness of the product versus the amount of waste.

The solution Tim Hortons came up with was to

"It was made clear that the Competition Act is concerned with the impact on pricing to the public and not with the allocation of profits between the various parties in the supply chain."

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eliminate "scratch baking" and replace it with supplying partially-frozen baked goods that could be completed on the franchisee's premises. This new method, par baked goods, ensured product consistency across the system and allowed for fresher goods, as it would be easier to meet any store's particular demand requirements.

In order to implement this new method of baking, Tim Hortons entered into a joint venture with an Irish bakery with expertise in par baked goods. The par baked goods were then delivered to a joint venture between Tim Hortons and the Irish baker at a predetermined price for each donut. The joint venture then sold the donuts to the ultimate distributor, who added its own markup.

The franchisees complained and sought relief on the basis of the price-influencing and conspiracy sections of the old version of the Competition Act mentioned above and the conspiracy section of the new version of the Competition Act.(The events in question straddled both versions of the Act.)

Ultimately the franchisees lost on all arguments, but the case illustrates how the same set of circumstances will be viewed with the new version of the Competition Act.

First, it should be observed that the franchisees did not attempt to use the abuse-of-dominant- position provisions in the new version of the Competition Act. This was likely an acknowledgment of the inherent difficulties, which include having to establish that there is a significant anti-competitive effect.

In giving his reasons for rejecting the retail price maintenance claim, Mr. Justice George R. Strathy of the Ontario Superior Court of Justice made it clear that manufacturers and distributors are entitled to make profits. It was made clear that the Competition Act is concerned with the impact on pricing to the public and not with the allocation of profits between the various parties in the supply chain. The amendments to the Competition Act, such as the removal of the offences related to price maintenance, were enacted to promote innovative pricing programs and increase certainty for Canadian businesses.

The conspiracy sections of the older version of the Competition Act required the following:

(i) a conspiracy with another person,

(ii) an unreasonable enhancement of the price,

(iii) a subjective intent to put the agreement into effect, and

(iv) an objective intent to lessen competition unduly.

The franchisees argued that they met these tests on the basis that the agreement with the Irish baker [test (i)] imposed an unreasonably high price on the sale of the products to the distributor; that this resulted in unreasonably high prices to the franchisees that were above market prices [test (ii)], and that the agreement was put in place with the intent of enhancing the price and making the franchisees less profitable [tests (iii) and (iv)].

Mr. Justice Strathy rejected the franchisees' claim on the basis that the mark-up did not enhance the price, but reallocated profit. He concluded that it is not reasonable that a higher price for inputs would reduce competition, especially when the franchisees could sell donuts to the public at whatever price they wanted and, given that the quick service restaurant business is highly competitive, there was no lessening of competition.

The new version of the Competition Act could arguably make it easier for the franchisees to estab-

"A duty of good faith often exists, however, where there is an imbalance of power between the contracting parties."

lish their case. Under the new version, the test is not just enhancing unreasonably the price, but fixing, maintaining and controlling the price, as well as increasing the price. Furthermore, the price does not necessarily have to be enhanced unreasonably.

That being said, the new version of the Competition Act requires that the "conspiracy" must be not just between any two people but between competitors, where a competitor is a person who it is reasonable to believe would be likely to compete with respect to the product in the absence of a conspiracy. Furthermore under the new version, there is no conspiracy if it can be established that the agreement was part of a broader or separate agreement, where the broader or separate agreement, when considered alone, does not breach the section.

Mr. Justice Strathy determined that if not for the arrangement with Tim Hortons, the Irish baker would not have come to Canada. For that reason alone, the Irish baker was not a competitor and so the conspiracy sections would not apply. As added commentary, he noted that the agreement with the Irish baker was part of a broader arrangement for a legitimate business purpose, and on that basis the conspiracy sections also would not apply.

The Tim Horton's case illustrates the flexibility that might be accorded to manufacturers and distributors in setting prices. Caution must still be exercised in setting prices, but there is now more room for creativity, so long as the pricing structure is not an agreement with a competitor, especially if the agreement carves up a market or controls the price of supply. ■

THE FRANCHISEES TRIED TO ROLL UP THE RIM AND TIM HORTON'S WON

H. Todd Greenbloom

Unlike other jurisdictions, there is no general duty of good faith in Ontario contract law – no automatic blanket requirement that one party to a contract perform under the contract in a way that has regard for the legitimate interests of the other party.

A duty of good faith *often* exists, however, where there is an imbalance of power between the contracting parties. Franchises and employment are two examples of situations where such a duty of good faith applies.

A recent case involving Tim Hortons provides a useful summary of the manner in which the duty of good faith applies in Ontario.

The Tim Hortons franchisees complained that changes imposed by Tim Hortons reduced their profitability and, as such, were contrary to the duty of good faith. The changes arose from decisions relating to lunch menu items, and the manner in which donuts should be baked.

Some of the specific allegations made by the franchisees were:

- Tim Hortons decisions had the effect of shifting profits from the franchisees to Tim Horton's
- requiring the franchisees to use partially-baked goods, instead of goods made totally in-house, was an inappropriate change
- Tim Hortons misrepresented the costs of implementing the changes.

Some of the factors that the judge used in coming to his decision were:

"A franchisor is not required to prefer the franchisees' interest over the franchise owners. So long as a franchisor takes into account the interests of the franchisees, the franchisor is allowed to act self-interestedly."

- the franchise agreements contemplated the kinds of changes that Tim Hortons required
- nothing in the franchise agreements assured the franchisees of any kind of profit
- nothing in the franchise agreements denied Tim Hortons the right to earn a profit.

Tim Hortons was completely successful.

In delivering his decision, Mr. Justice George R. Strathy of the Ontario Superior Court of Justice gave a useful summary of the factors to be considered in determining whether or not a duty of good faith has been reached. The following is a summary of those factors:

1. Changes can be made to methods of operation, even where the changes may have an adverse effect on the franchisee, where the type of change is contemplated in the franchise agreement and the decisions are not motivated by improper or extraneous considerations.

   In this case, it was determined that the change did represent an improved method of operations and that this improvement should pertain, even if it did not improve profitability. An influencing factor in reaching the conclusion was that the particular change was contemplated by, and permitted by, the express provisions of the franchise agreements.

2. The duty of good faith is imposed in order to secure the performance of the contract that the parties made. The decisions of the franchisor should not eviscerate the objectives of the agreement or substantially nullify the bargained-for objective or benefit.

   Since most franchisees continued to make a reasonable level of profit, it was determined that the decisions made by Tim Hortons could not be said to deprive the franchisees of the benefits of their agreement, or to defeat the purpose of the franchise agreement. In part, it was recognized that a lower profit margin, or absolute loss, on a small group of products, could still have an overall benefit to the franchisees (e.g. the loss encourages customer loyalty and may attract customers who would otherwise patronize a competitor).

3. "The party's conduct must be considered in the context of, and in conjunction with, the contract the party made. It is not a stand-alone duty that trumps all other contractual provisions."

   Given that there was a determination that the changes were permitted by the franchise agreements, there should not be another overarching obligation that would defeat the contract itself.

4. Decisions made by a franchisor must take into account the interests of the franchisees. Discretions cannot be made arbitrarily or capriciously.

   Justice Strathy concluded that, in the end, even though there may have been a diversion of revenue from the franchisees to the franchisor, the end product was better and the actual cost was lower than the alternative. Given the sound business reasons for the decisions, they could not be said to be arbitrary or capricious.

   Justice Strathy determined that the decisions made by Tim Hortons did not eviscerate the objectives of the agreement but were part of a reasonable evolution of the system and had benefits for both parties.It could not be said that Tim Horton's acted in an arbitrary or capricious manner in light of its having consulted with the franchisees throughout the process.

5. A franchisor is not required to prefer the franchisees' interest over the franchise owners. So long as a franchisor takes into account the interests of the franchisees, the franchisor is

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"...some non-residents will now have to pay the Government of Canada new or increased taxes on income that they earn from [their Canadian] operations."

allowed to act self-interestedly. Essentially, the duty of good faith does not prevent a franchisor from diverting revenue from the franchisee to itself. This presumably is reinforced by the franchise agreement contemplating the franchisor earning profits from different aspects of the operations.

The lessons learned from this case include:

(01) To the extent possible, it is appropriate for a contract to anticipate future needs and incorporate rights that will enable those needs to be addressed.

(02) Furthermore when a change is being implemented, there should be a sound business reason for making the change and the other party should be consulted throughout. ■

BUDGET INCREASES TAXES ON INCOME EARNED HERE BY NON-RESIDENTS; RAISES QUESTIONS ABOUT POSSIBLE IMPACTS ON FOREIGN INVESTMENT

Paul L. Schnier

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While the Spring federal budget has been advertised as one of "belt-tightening," it is not only Canadians who are sharing in the pain. One budget proposal will have a significant impact on non-residents who own and finance Canadian operations.

In a nutshell, some non-residents will now have to pay the Government of Canada new or increased taxes on income that they earn from these operations.

What that may mean for the continuation of the businesses, the production of goods and services of Canadian companies that they create, and the Canadian jobs that go along with them, remains to be seen.

All that can be certain for the moment is that because income that has escaped Canadian tax will now be assessed, the cost to non-residents of operating a business in Canada will rise and the number of after-tax dollars with which they will be left will fall.

If a non-resident entity wishes to carry on business in Canada through a Canadian corporation, it will often choose to finance this venture through debt in order to minimize its Canadian tax burden. (As interest payments on this debt generally will be deductible to the Canadian corporation, the Canadian profit will be minimized). Furthermore, at present, Canadian withholding tax does not apply to interest payments on most arm's length debt and is reduced under Canada's tax treaties (in some cases to zero) on non-arm's length debt. Some foreign entities can thus extract their Canadian profits with no Canadian tax whatsoever.

"Thin capitalization" rules exist under the *Income Tax Act* to moderate this "leakage." These rules prohibit the deduction of interest payments when taxes are calculated if the Canadian corporation's debt-equity ratio is greater than 2:1. Specifically, if the debt owing to "specified non-residents" (those owning 25 per cent or more of the shares of the Canadian company) exceeds twice the equity invested in the corporation, interest on the excess debt is not deductible.

The budget proposes that this rule be amended in three significant ways:

1. The debt-equity ratio is reduced from 2:1 to 1.5:1. (It is interesting to note that until the year 2000 this ratio was 3:1. So, this is not the first time that we have seen a reduction.),

Blaneys Welcomes New Partner, Dan Rothberg

Blaney McMurtry LLP is pleased to announce that Daniel Rothberg has joined the firm, where he will continue his practice in corporate finance and securities, mergers and acquisitions, and general corporate commercial law. Dan's experience includes initial public offerings, CPC qualifying transactions, private placement transactions and stock exchange listings with a particular focus on resource and technology companies listed or seeking listing on the TSX Venture Exchange. He also counsels companies on shareholder meetings, reverse takeovers, stock option plans, reorganizations, corporate governance issues, continuous disclosure obligations and investigations by securities regulatory authorities.

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2. the rule will now apply to partnerships, and
3. disallowed interest will be characterized as dividend income.

The change in the debt-equity ratio from 2:1 to 1.5:1 is a straightforward reduction by 25 per cent of the amount of profit that a Canadian corporation can pay to its non-resident shareholders tax-free. While interest rates are currently at record lows, this change may not seem material. If rates were to rise again to levels in the teens, however, this could amount to a significant cost.

Second, the thin capitalization rules have not applied to partnerships until now. Therefore, in the past, it has been possible for a foreign entity to structure its Canadian operations through a partnership of corporations and to lend unlimited funds to this partnership. All of the Canadian partnership's profits, therefore, have been extractable through interest payments to the foreign entity. Under the budget proposals, partnership debt will now be attributed to the corporate partners based on their respective profit sharing ratios in the partnership. This debt will therefore become subject to the thin capitalization rules. Rather than disallowing the deduction of the interest payment at the partnership level, however, it will be added back to the income of the corporate partner.

Finally, as stated, Canadian withholding tax on interest payments to non-arm's length parties is reduced under many of Canada's international tax treaties, in some cases to zero (as is the case under the Canada-U.S. Tax Treaty). There is therefore a strong preference to pay profits out of Canada by way of interest. The third thin capitalization proposal converts any disallowed (or added back) interest to dividends, which are subject to withholding tax at rates as high as 25 per cent. This rate may be reduced under a tax treaty as well but, in no case, is the rate reduced to zero.

The proposal lowering the debt-equity ratio will apply to taxation years that begin after 2012. The other proposals began to apply on March 29, 2012, the date that Finance Minister James Flaherty presented the budget to Parliament.

Although the budget documents talk about aligning the Canadian rules with other jurisdictions, the government's intent, clearly, is to reduce tax revenue leakage by limiting the ability of foreign entities to avoid tax on their Canadian operations.

Whether it discourages investment in Canadian operations by foreign-based multinational corporations and other non-resident entities remains to be seen. ■

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