

Leveraging AI in franchising: opportunities and legal considerations

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Artificial intelligence (AI) has been a driving force in reshaping and transforming business operations across various industries. In the context of franchising, AI technologies may be leveraged to streamline business operations, improve decision-making processes, and enhance consumer experiences in a competitive market. While AI presents franchisors with unprecedented opportunities, the integration of AI poses several legal and ethical risks for franchisors to consider and proactively mitigate. This Update discusses the opportunities, challenges and legal considerations for franchisors when adopting and integrating AI in a franchise system.

What is AI?

AI refers to computer systems capable of performing cognitive functions associated with human behaviour, such as learning, reasoning, recognizing patterns, decision-making and problem solving. It is a broad umbrella term that encompasses many different technologies, including machine learning and deep learning. In the last couple years, generative AI has taken centre stage. Generative AI employs AI technology that learns patterns from existing data and uses this knowledge to create novel and complex content. This content mimics human creativity and can include images, videos, audio, text and 3D models. Well-known examples of generative AI technology include OpenAI's ChatGPT, Cohere's Command R, and Google's Bard or Stable Diffusion.

Current regulatory landscape

In June 2022, the federal government tabled Bill C-27 which introduced updates to the federal private sector privacy regime and the new *Artificial Intelligence and Data Act (AIDA)*. AIDA successfully passed second reading on April 24, 2023, and is currently being considered by the Standing Committee on Industry and Technology (INDU). AIDA applies to persons that design, develop or make available for use AI systems in the course of international or interprovincial trade and commerce, an area of regulation within the federal government's legislative authority.

Innovation, Science and Economic Development Canada (ISED) announced the *AI Voluntary Code of Conduct* (the Code) in September 2023, which is intended by the federal government to act as a "critical bridge" between now and when AIDA comes into force. The Code is

intended to apply to advanced generative systems and prescribes measures that fall within the following six key areas: accountability, safety, fairness and equity, transparency, human oversight, and validity and robustness.

The Minister of Innovation, Science and Industry, François-Philippe Champagne, subsequently proposed substantial amendments to INDU in November 2023. The proposed amendments represented a significant overhaul to the initial statutory framework and addressed some of the concerns arising from the first iteration of AIDA.

While AIDA is currently subject to parliamentary review and has not yet been officially adopted, there is uncertainty about the future of AIDA. It is currently unclear when AIDA will become law, though is not expected before 2025 at the earliest. Additionally, various provinces are also working on developing AI-related laws to supplement AIDA, adding to the regulatory landscape's complexity.

Current and anticipated use of AI in franchising

In the context of franchising, AI presents opportunities to streamline operations, automate tasks and promote data-driven decision-making. The following are examples of several current and potential use cases of AI in franchising:

- Automation — Franchise systems can integrate AI to automate repetitive tasks such as inventory management, scheduling and financial reporting to mitigate the risk of human error and reduce time-consuming tasks. AI also presents an opportunity for franchise systems to automate their user knowledge base and customer support process by leveraging insights from customer feedback and behaviour to provide personalized responses to feedback and inquiries.
- Supply chain — AI's advanced data analytics and predictive modeling capabilities enable franchisors to identify patterns, forecast trends, and derive valuable insights that may inform the franchise systems' decisions on ordering, pricing, marketing and inventory management. Predictive maintenance (PdM) solutions powered by AI provide franchise systems with the opportunity to monitor equipment performance to predict and preemptively address potential failures, thereby avoiding downtime costs and ensuring continuous system operations.
- Customer support — Use of AI-powered chatbots and virtual assistants equipped with natural language processing capabilities provide an opportunity for instantaneous, consistent and personalized customer service in franchising. Common use cases of AI-powered chatbots and virtual assistants include assisting with room bookings, and generating personalized recommendations, such as in-app recommendations.
- Personalized marketing — Franchisees are increasingly leveraging AI to tailor marketing strategies, optimize product assortments and create targeted promotions that would improve consumer conversion rates and bolster the bottom-line profitability of the franchise system. Leveraging generative AI in franchising enables franchise systems to provide personalized recommendations based on identified trends in consumer preferences, purchase patterns and browsing behaviours. AI also has been leveraged to automate the process of crafting personalized email campaigns tailored to individual

customer preferences and behaviours to further enhance customer engagement and brand loyalty.

Legal considerations for franchise systems

Franchisors should review existing franchise agreements and applicable franchise laws to ensure they have the contractual and legal right to integrate AI into their franchise systems. The right to introduce new technology into a franchise system is often set out in the “systems modification” or “system change” provision contained in the franchise agreement.

In addition to determining whether the franchisor has the contract right to introduce a new technology into the franchise system, the franchisor will need to ensure it is complying with its duty of good faith and fair dealing. In Canada, provincial franchise legislation imposes a statutory duty of good faith and fair dealing on both the franchisor and franchisee in the performance and enforcement of the franchise agreement. Canadian courts have confirmed the statutory duty of good faith and fair dealing is a codification of the common law duty of good faith. Accordingly, a franchisor’s discretion to integrate AI into the franchise system must be exercised in accordance with such duty. Canadian courts have clarified that the duty of good faith and fair dealing is not akin to a fiduciary or a standalone duty that alters the express terms of the agreement between parties, and it does not prevent a party from acting in its own interest, so long as the parties deal honestly, reasonably and fairly with one another. When considering the franchisor’s exercise of discretion in the performance of the franchise agreement, Canadian courts will show deference when such discretion is based on a rational exercise of business judgment by the franchisor.

Other legal and ethical considerations

At a high level, franchisors should consider the following legal risks and ethical implications of adopting and integrating AI in their franchise system:

- Data security and privacy — AI systems are trained on vast amounts of data to improve the accuracy and ability to make informed decisions. Some of this data may include proprietary information, trade secrets and competitively sensitive information, as well as personal information of customers, employees and franchisees. Accordingly, the nature of the data used to train an AI system may raise concerns around data breaches and unauthorized access to sensitive information. Franchisors must consider whether they have the legal authority to input personal information into AI systems, which may involve reviewing existing third-party agreements, privacy notices, and the obtaining and managing of individual consents.
- Intellectual property (IP) — Franchisors should carefully consider the IP-related risks arising from the use of AI, including the risk of using their own IP to train third-party models and using AI-generated outputs that may infringe third-party IP rights. AI blurs the line of authorship and challenges the notion of IP as a human creation. Currently, under Canadian laws, AI is not capable of being an author or inventor under Canadian copyright or patent laws in Canada. Courts in Canada have affirmed that the authors must be a natural person who exercises human “skill and judgement.” For a more fulsome discussion on the role of AI as an inventor or author of copyrighted work, please refer [this article](#).
- Bias and discrimination — Franchisors should consider the ethical implications of using AI,

such as the potential bias and discrimination in AI-driven decision-making processes. Bias in AI refers to the systematic error introduced into machine learning models which occurs when the training data used to teach the AI system reflects discriminatory or unfair societal biases, but also when the AI algorithm itself contains bias. AI systems that are trained on a dataset containing racial, gender or socioeconomic biases may inadvertently learn and perpetuate these biases, leading to unfair and discriminatory outcomes. Franchisors should regularly review and update algorithms, diversify training data to reduce bias, and implement measures to ensure transparency and accountability.

AI supply agreement considerations

Given the data-driven nature of AI, franchisors must be cognizant of the downstream risks of integrating AI into their franchise system when contracting with an AI provider.

In particular, franchisors should ensure that data ownership and use provisions accurately reflect their understanding of the business deal. In addition, franchisors should consider whether they have the rights to disclose inputs to the AI supplier. Various laws or third-party contracts may expressly prohibit disclosure of data for the purposes of training AI models or the use of AI generally.

Franchisors will likely want to retain ownership over their AI system inputs or, at the very least, make it clear that the AI supplier is not obtaining ownership of the franchisor's inputs into the AI system. Franchisors should also consider whether they want to expressly restrict the supplier's use of inputs for any purpose other than to provide the AI system to the franchise, such that these inputs are not disclosed to third parties or used in training the AI system. The franchisor should assess whether ownership of the outputs or a broad and perpetual license for use of the output aligns best with their operational needs. This would effectively grant the franchisor with the right to control the reproduction, distribution, display and modification of the output.

The standard terms and conditions of AI suppliers typically contains broad boilerplate disclaimers providing that the supplier makes no representations or warranties regarding sourcing training data, training the model, or the output. These disclaimers typically cover performance, accuracy, infringement and compliance with applicable laws. When using an AI suppliers' standard terms and conditions, the franchisor should pay careful attention to ensure it is obtaining the necessary representations, warranties and protections that it requires. For example, ensuring that the AI provider is committing to comply with all applicable laws, including privacy laws. Particular attention also should be given to the risk allocation provisions to ensure risk is appropriately allocated between the parties.

As the legal and regulatory environment continues to develop, franchisors should be vigilant and cognizant of the associated legal risks, including those discussed above.

Franchisee and employee AI use policy

Establishing a comprehensive AI use policy is a proactive and effective way for franchise systems to mitigate against the risks associated with biased decision-making. A robust AI use policy establishes a governance framework for the responsible use of AI that considers issues of accuracy, reliability, safety, fairness, bias and transparency. As a best practice, franchisors should implement a robust AI use policy for their employees and franchisees that best meets their operational needs and that considers the following

- the permissible scope of use
- risks and limitations of disclosure and creation of intellectual property
- risks and limitations of reliance and use of outputs
- disclaimers and required compliance with applicable laws, including AI and privacy laws

Implementing risk-based guidelines that highlight applicable use cases can further empower franchisees and employees to understand the risks and the parameters of use when using AI in the franchise system. An AI use policy may also effectively strengthen partnerships with third-party vendors by providing established guidelines and expectations.

Conclusion

As the regulatory landscape of AI continues to rapidly evolve, franchisors should ensure they are leveraging the benefits of AI technologies while proactively and responsibly addressing the legal and ethical challenges associated with its integration.