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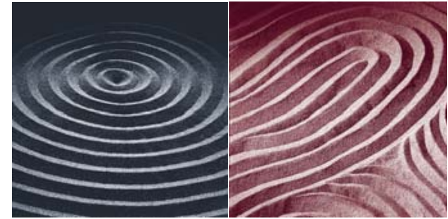

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Privacy Issues in Franchise Relationships: A Practical Guide

Richard D. Leblanc

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Editor's Note

IT IS WITH GREAT PLEASURE THAT the first 2006 issue of the *Canadian Franchise Review* has been launched through our new publisher, Irwin Law. As readers of the *Canadian Franchise Review* will recall, the journal was previously published by LexisNexis Canada.

I am also pleased to advise that the *Canadian Franchise Review* is continuing its commitment to providing members of the Canadian franchise profession with a journal focusing on the multi-disciplinary aspects of franchising. This makes the *Canadian Franchise Review* the only one of its kind in Canada.

The *Canadian Franchise Review* is unique in its breath of coverage of professional franchise issues that are not limited to the legal community, but rather transcend into the arena of franchisors' management and other professionals advising the franchise industry. In this issue, we bring to you the distinct perspectives of a franchisor's general counsel, a franchise consultant, and of course, franchise legal counsel.

I hope you find this issue of the *Canadian Franchise Review* of interest, and invite you to email or telephone me with respect to any comments or article submission ideas that you, as our reader, may have.

SINCERELY,

*Ben V. Hanuka**

EDITOR

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FRANCHISOR'S CORNER

It's a Small World After All

*Wayne A. Steinberg, General Counsel, WSI**

NO, THIS IS NOT AN ARTICLE about one of America's favourite amusement parks where the title of this article is repeated in song as one, in a few moments of fantasy, quite literally travels "around the world" through the magic of modern technology. Rather, this is an article about how a Canadian franchisor has tackled the franchise world, emerging from obscurity in a few short years to become a major player in the international franchising community. Like the amusement park, this company has also been making a name for itself with its cutting-edge technology. This company has risen like a phoenix in a short few years to challenge many of the long-established industry leaders around the world for recognition as a company that is likely to be one of the most significant franchisors of tomorrow in the worldwide franchise community. It is a company that may be thought of as a Canadian David coming out of obscurity to meet the challenges of the Goliaths of the highly competitive world we all know as the world of international franchising. That company is WSI, a company I serve as General Counsel, a position I have held since joining WSI in the spring of 2002.

Before you say just "who" is WSI, here is a little information about the company. WSI, headquartered in Toronto, Canada, stands for "We Simplify *the* Internet." We are the leading provider of Internet solutions to small- and medium-size businesses the world over. While providing a cutting-edge website is at the heart of our product and service, offering a complete Internet solution involves much more than just a website. We call our solutions the ABC's of the Internet: A for advanced technologies, B for being found and C for consulting. The client gets all three of these in every solution we deliver. WSI works with a network of independent production centres and authorized suppliers all over the world to provide the very best and latest technology to its franchisees and to their customers by offering them these solutions.

WSI's business is obviously directly related to the spectacular growth of the Internet, and to the growth of e-mail and websites, all vehicles that have revolutionized the way business is done in the twenty-first century. There has been so much progress in this now taken-for-granted technology in just a few short years. How many of us remember the not-so-distant past when all our letters and documents had to be generated by hand on a typewriter, and we relied mainly on the mail and on couriers to communicate with one another? Those days are consigned to the dustbin of history, since today computers have taken over many of these functions. How has the world changed as a result? Now we use computers with technology that surpasses anything we might have predicted just a few years ago and, of course, the Internet, e-mail and websites have totally revamped how we carry on business, learning new information from one another online and communicating in mere seconds. Naturally, new technology always creates new problems which need to be solved, and WSI is uniquely positioned in the global economy to meet that twenty-first-century challenge as well. This is not a franchisor that rests on past laurels, looking backward. Indeed, rapid growth, a focus on continued growth, sourcing and delivering leading-edge technology and tools to businesses economically, and keeping several steps ahead of the current business needs of small- and medium-size businesses have always been the goals of WSI.

WSI is indeed a real Canadian success story. The WSI network was founded in 1995 in Toronto, Canada. It has since gone through a period of stellar growth while very much out of the spotlight, preferring to quietly maintain its steady growth, and leaving to others the glare of the spotlight of attention. From its modest beginnings, WSI has grown into a formidable international force in international franchising. Each year we have gone from strength to new strength. It was quite a thrill a few years ago to crack the top 200 ratings, and then, shortly after, the top 100 in *Entrepreneur* magazine's annual franchisor rankings. In the latest 2006, ratings WSI cracked the top 50. This survey is well known among international franchisors, who anxiously await its results every year.

From its humble beginnings, and in its few short years of activity, WSI has grown to include over 2,000 franchises located in eighty-seven countries and it has left in its wake many would-be competitors. The prestigious *Entrepreneur* magazine, in its brand-new January 2006 "Franchise 500" listings, reviewed over 22,000 franchise systems worldwide and awarded WSI a number 46 out of 500 when ranking the world's franchisors overall. That is quite an achievement. It has also named WSI as the number one Technology Services franchise in the world, and furthermore WSI moved up a record 23 spots just this past year in the

survey, currently placing 6th among the top 10 global franchises. Each year, WSI has taken a quantum leap in the *Entrepreneur* rankings, in recognition of WSI's superlative growth seen again just over this past year with a triple-digit increase in franchises. It is truly a real Canadian success story and with WSI's new *Entrepreneur* rankings this company has now attained one of the highest industry ratings ever enjoyed by a Canadian franchisor. Indeed, I believe no other Canadian franchisor has come so far in such a short time!

Rapid growth and moving from the fairly narrow confines of franchising in the Canadian market to being a global player competing with the "big boys" internationally admittedly has its challenges. International waters can be choppy and it has not always been clear sailing. Like any other company, as it expands beyond its home base there can be a whole host of interesting challenges, some of which I will discuss later. The message though, for those companies that may be considering taking a similar plunge into the international marketplace, is that it really is a matter of understanding the challenges that lie ahead and determining how best to proceed. I think our own experience at WSI proves that challenges are simply that: they are merely obstacles to be overcome, not barriers that are impossible to ascend.

No country has a lock on the global franchising marketplace and any other Canadian company interested in taking a global approach should not hesitate to do so once it has done its homework. That is the real issue, I think: doing one's homework before going outside Canada's borders into the great world beyond. Or, as we lawyers refer to it, each business needs to do its "due diligence." No company should be afraid of moving outside its borders and competing with other world-class franchisors in their own markets. It is simply a matter of knowing what hurdles await you, whether they are business or legal or both, then ensuring that you prepare and adjust for them.

What are some of these hurdles to "going international?" The first thing to consider is whether the system fits the existing business model in every country into which you want to expand? It is important to recognize that business is not always conducted in the exact same way everywhere. In the food business, for example, the challenges of standardizing restaurant menus from one country to the next to respond to differing laws, cultures, religious requirements, ease of supply, etc. are intricate and expensive. But this is no less daunting a task than is the internationalizing of the service that goes into an Internet business in the eighty-seven countries where WSI currently operates. All franchisors will, to some extent, need to understand and design their model with a mind to understanding local circumstances in target markets that could impact on the success of their businesses abroad. WSI has a global reach and local presence via franchisees requiring the company to understand and address localization issues and opportunities such as the web-accessibility laws that are prevalent in the United Kingdom, Australia and Europe.

At WSI we have found, for example, that some countries are more technologically developed than others and that our franchisees in some countries enjoy greater competitive advantages over others when selling Internet solutions in that market, advantages that may not be as readily available to franchisees located in other countries with different market conditions. Although the Internet is a universal, international phenomenon, found to some degree everywhere, the business fit is not necessarily the same everywhere and we have had to recognize that reality in our own expansion plans. However, that is true of any franchise system. A honey-baked ham franchise, for example, would obviously choose to stay out of markets where pork products offend the majority of a country's religious sensitivities.

Our development team also looks at local conditions to determine if a WSI franchise makes sense and if there is a good fit with the business model. There are certain markets where, after close examination, we have concluded that the WSI business model just cannot operate competitively, or we have found other impediments to be overcome before we can consider entering that market. Therefore, it is a matter of carefully studying each new market before deciding to go forward with expansion.

Sometimes, after this due diligence has been completed, we do choose to stay out of a market where there is still too much uncertainty, even though the potential pay-off for generating franchise revenue may be huge. In WSI's case, for example, we are temporarily choosing to stay out of certain large markets like China until we are more comfortable with the local infrastructure and with some of the still-developing legal requirements in that country, both for franchising in general and for operating an Internet-solutions type of business specifically.

That said, it is definitely the exception rather than the rule that we close off a major country with significant market potential from the possibility of franchise sales, even temporarily as we have done with China. As stated above, overall WSI is experiencing high growth and, where we think the risks are worth taking, we will definitely proceed into a new market as soon as we are sufficiently comfortable with the challenges that may lie ahead.

Another hurdle for franchisors expanding abroad has to be language issues. For WSI, this continues to be a concern raised by new franchisees in countries where the dominant language is not English, and it will always be an issue whenever a franchisor expands internationally into such countries. However, in some businesses, in my experience, the need for local translation can be much more extensive than in others. A restau-

rant business, for example, will require localized menus and translations of all printed items, a substantial expense to be sure, whereas in the case of an Internet-based business we have found that most items we distribute as a franchisor do not, in fact, need to be translated for all franchisees. We offer guidance to our franchisees in translating their local marketing material and we require that our production centres build their websites to produce them in all of the world's main languages. Nevertheless, from the outset WSI is marketed as an English-only system and we make no representation to our franchisees that we have comprehensive translation of the entire system and all of its supporting materials available in all languages.

My personal recommendation, when seeking to expand outside of Canada, is to always seek to balance the need for local translations in any system with what actually makes good business sense for that system. Sometimes, for example, franchisees can look after or assist with translations of marketing and certain other materials themselves, especially in markets where business sense simply does not justify the franchisor itself making substantial expenditure on translations. When necessary, the franchisor can always work together with the franchisees to share this cost. These strategies have worked well overall for WSI.

Another common issue faced by franchisors going abroad is selecting the appropriate method for their expansion outside Canada. Some of the more common methods used by franchisors to expand are (i) by master franchising, where a master franchisee buys rights to a territory and re-sells rights to sub-franchisees; (ii) by entering into a joint venture with a local partner; (iii) by area representation, where an area representative agrees to find franchisees for the franchisor; (iv) by using local franchise brokers to sell their franchises; (v) by re-franchising, where the franchisor sells company-owned units to local franchisees; and (vi) by conversion franchising, where established local independents agree to re-brand into the franchisor's system.

While each of these methods has advantages and disadvantages and while the most common method of international expansion selected is probably by master franchising, it is important to assess what will likely work best for each individual system before settling on the method. There is no one-size-fits-all solution to international expansion.

For example, a franchise system seeking rapid expansion into a remote location with a different language and culture from that of the franchisor may find that the best person to guide this international expansion is someone who is a local in that market already, to whom the functions of the franchisor can then largely be delegated. That person knows the local market and is best positioned to meet local requirements. This minimizes the expense and direct involvement of the franchisor ("head franchisor"), but it does mean splitting revenues with the master, and it also entails a certain loss of control by the head franchisor because the franchise agreements are not entered into with the head franchisor directly, rather there are sub-franchise agreements entered into by sub-franchisees with the master franchisee. Other concerns of master franchising include how to deal with what happens to all sub-franchisees in the event that the master franchisee becomes insolvent, or what happens to them if the master franchise agreement is terminated by the head franchisor.

Although master franchising seems to be the most commonly chosen model for international expansion by franchisors, it is a method that WSI has itself tried and rejected. For our system, where most of the business activity is already online (including how we advertise our opportunities and from where we harvest our applicants), the need for masters is simply not there, and we find that direct franchising works best, selling our franchises internationally in the same way we sell franchises in Canada. Clearly, what may work for one system may be totally wrong for another.

Yet another issue one must address is the effect of the local law in the jurisdiction on the system and the franchisor's ability to operate there. Are there, for example, laws prohibiting the free flow of currency abroad? If so, the collection of franchise fees and royalties from a foreign franchisee, where the franchisor is based in Canada, is going to be a problem. Are there differences in treatment of employees when hiring or locating employees in foreign countries such that employment protection statutes may impose significantly more onerous requirements on employers than we are used to in Canada? Are certain products and services offered by the business prohibited or, if permitted, are they more heavily regulated than in Canada? Are there agency laws to consider wherein franchisees may seek to register themselves as commercial agents? These can be very problematic for franchisors and may well impact on the franchisor's rights of termination or non-renewal, notwithstanding what may said about these issues in the franchise agreement. Specific to franchising, are there laws governing any aspects of franchising in that country? A number of countries have passed pre-sale disclosure laws that require the franchisor to prepare and maintain a variety of disclosure documents and then to provide pre-sale disclosure to an applicant for a franchise in that territory. Some countries have also enacted franchisee relationship laws that govern various aspects of the ongoing franchise relationship. Naturally, the general laws of a country can certainly also impact on how a franchisor must operate in a country. To comply with all these legal requirements, a franchisor must find competent legal advice in the jurisdiction. At WSI, for example, we work with a network of well-qualified and recog-

nized franchise law experts all over the world. Such contacts are vital, given the number and variety of legal systems in which we do business.

A final hurdle to consider in international expansion is protection of your system's intellectual property abroad. There are many types of IP that may be worthy of taking formal steps to protect abroad, including trademarks, trade names, patents, copyrights, industrial design and trade secrets. This is a complex area of law, too detailed to try to review here, but an IP review with local counsel in the proposed territory where the system expansion is intended is to be recommended before the expansion gets underway. Once your system is established in the country, it may be too late!

I will confine my comments to a couple of trademarks considerations, noting that the bulk of the IP that we must protect at WSI is its trademarks when we look at expanding into new countries. It is important to understand that in most countries of the world trademark rights are only acquired through registration, and not through mere continued use of an unregistered mark. Thus, for companies with unregistered marks in Canada, using and protecting those marks in other countries can be problematic if the marks have not already been registered in those countries, or if there are no international treaty priority protections available based on some prior foreign registration elsewhere. The last thing a company wants is to plan an expansion into a country, only to find that someone else has already registered the trademark; that the mark is not registrable in that country for any other reason; or that the mark, although legally registrable, needs to be changed due to some other perceptual problem.

For example, the translation of anglicized word marks into a local foreign language sometimes presents problems. Translating English marks into a foreign language is not as simple as it sounds. There may be no comparative word for the English word in the other language at all, or worse still, the exact local translation may result in something that has very negative connotations locally.

These hurdles or considerations, when planning an international expansion, are of course not exhaustive. Others may apply to only certain types of franchises. However, for WSI, the issues noted have been the most common ones we have had to focus on when planning to expand the system into a new country. As stated in the beginning, while there are certainly challenges, it is indeed a small world out there. Our own experience has shown that foreign expansion is not to be feared. Do your homework before going down this path. I can only encourage other systems interested in expanding abroad that, with proper preparation, the risks can be well worth the rewards. WSI has proven that a Canadian franchisor can be a very successful player in the global marketplace.

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* Wayne A. Steinberg is General Counsel to WSI Internet Consulting & Education in Mississauga, Ontario.

Operating Lean in a Fat Economy: Ten Ways to Improve the Bottom Line … Without Increasing Sales

*Douglas P. Fisher, President, FGH International Inc.**

WHILE THIS ARTICLE FOCUSES ON THE foodservice sector, the concepts and ideas clearly are applicable to all retail franchises.

What a weird article to write. Why would anyone want to operate lean in a fat economy? We are all trying to increase our market share, take advantage of the booming economy, let loose of the controls and enjoy the wealth that comes with consumers eating out more, spending more and returning more often.

Franchisors are taking advantage of the boom by selling more franchises. Potential franchisees are lining up at the door with "cash and a heartbeat" and luckily, over the past ten years, franchisors have also been able to choose franchisees with the right character. However, while franchisors increase their sales and bottom line by increasing the number of units in the marketplace, they must not forget to think about the financial well-being of their franchisees as well.

As a franchisor you are responsible for providing the tools necessary for the franchisee to be successful. You need to provide the franchisee with support and services throughout the relationship. If you provide the right support in the good times, you will have a much stronger relationship in the leaner times.

Many of you may believe that you provide strong support as franchisors — and I think that many of you do — however, I know from my twenty-plus years as a foodservice franchise consultant that many franchisors do not assist their franchisees in the manner they should. Those franchises that have grown on hype (Krispy Kreme is a fine example) and those that have grown too fast have all learned that short-term money is not as "sweet" as the long-term success that others in our industry have enjoyed. While I could list the things franchisors should offer, such as better operation manuals, roll-out strategies and so forth, I want to take this opportunity to discuss a few things that may be really important to franchisees and their bottom line.

Before I begin, there are two things to note.

The first is that not all restaurants that enjoy huge sales are earning huge dollars. As the franchisor, your franchisees' gross sales are your main concern because you live on their royalty payments and product mark-up, but are your franchisees benefiting from these good times? For example, our recent work has taken us into the following franchisees:

- a steak house where sales were over $6 million ($30,000 per seat), but the operating profit was only 4.5 percent
- a diner where sales were over $1.2 million ($20,000 per seat), but there was no profit
- an Asian fusion concept where sales were over $600,000 ($15,000 per seat), but profit was non-existent

THESE EATING ESTABLISHMENTS WERE OPERATED BY effective, hard-working franchisees, who concentrated on increasing sales but simply did not have the tools to drive the bottom-line profits. In one case, the operator even opened a second unit to try to make the economies work more in his favour. However, unless franchisees know how to drive bottom-line profit, it is unlikely to materialize, no matter how high their sales.

The second thing to note (and I apologize for being the bearer of bad news) is that there is likely to be a recession around the corner and if your franchisees are not making "great" money now, there is no way they will make it then. Therefore, while you are marketing and driving sales, think about driving franchisee profits as well.

Here are some key aspects of your franchisees' business for you to focus upon, and ten tactics to improve their store-level profitability.

Tactic I — Menu costing, portions and pricing

ONE OF THE FIRST PLACES WE look when a foodservice operation has good sales but is not making an operating profit is at the menu and the food cost. First, we ensure that the restaurant's standard recipes (which should be developed for every item) are properly written and that everything is included from the side bread and butter to the garnishes. Each raw ingredient must be

measured and priced accordingly. Once a theoretical food cost is established for each item, we develop a sales mix by tracking each item sold as registered on the Point of Sales system. We then multiply each item cost against the number of items sold and add the results for each item, resulting in a theoretical food cost for a period of time (usually a day, week or month). When that theoretical food cost is divided by the food sales for the same period of time, a theoretical food cost percentage can be determined. That theoretical food cost should be compared to the actual food cost for the same period, and if the cost is out by more than 1.5 percent then you, as franchisor, should investigate the problem. At a minimum, give your franchisees the tools to investigate the problem on their own.

In the case of one of the above-noted restaurants, we found that the food cost was 41 percent against a theoretical food cost of 33 percent. Clearly, a difference of 8 percent on $1.2 million was worth about $100,000 in operating profit. We looked at the purchasing procedures, food handling, waste and portion controls. When we reviewed the portion controls, we found that 11-oz. hamburgers, rather than the specified 8-oz. burgers, were being made. We found larger 5-oz. crabcakes rather than the 3-oz. ones specified, and so on. When we asked the cook what was going on he told us that the 8-oz. and 3-oz. portions were not "fair" in his opinion, so he made them bigger. By returning to the "specified portion" the restaurant reduced food cost by 8 percent, or about $100,000 in just a few weeks, and customers were just as happy. The benefit to the franchisor was a successful franchisee, and all it took was a little operations support and direction — something a franchisor is supposed to supply anyway.

Tactic II — Manage your labour costs

Labour costs can be a killer. They are ones we watch closely in bad times but which we are more lax about in the good times. Don't forget: it's your franchisee's bottom line!

There are three things franchisors should try to do.

The first is to ensure that your franchisee's staff members do not sign in too early or sign out too late. In one restaurant where we were recently engaged, we found that staff had "figured out" the time clock. Employees could sign in up to seven minutes early and get paid from 4:45 instead of 5:00, or the full first quarter hour, and sign out eight minutes after their shift ended and get the last quarter hour. What they did was stop working at 5:00, go for a smoke and sign out at 5:08. It would look like they signed out on time but in fact, due to time-clock program rounding, each got an extra 15 minutes before and after a shift at $7 per hour or $3.50 per shift. With fifteen server shifts per day the loss amounted to over $19,000 per year, just for the servers alone.

To avoid this problem, we recommend that all hourly staff punch in and punch out on a time clock or via your Point of Sales machine, and have each bring his or her card to the manager to verify and sign off on at the beginning and end of each shift. The manager can make the adjustments to the time sheets in front of the employee, saving your franchisee money and eliminating any possible disputes later. Further, as management is already in place, likely on a fixed salary and supposed to control costs anyway, this is not a stretch and is really not extra work as the staff member will be hunting down management and not the other way around.

The second recommendation for managing labour costs is to develop a staffing-to-sales criterion or ratio where your franchisee can staff according to sales levels and customer counts and eliminate all excess staff. In order to find the right balance, teach your franchisee how to track sales and customer counts on an hourly basis, as well as to staff to satisfy this demand level only.

Third, there are ways to reduce your normal staff requirements, for example, by modifying your menu to include items where product preparation is reduced. A perfect illustration of this is the offering of a roasted beef, baked ham, lasagna, ribs or other batch-type of items that can be served with a simple slice and are not cooked to order. This greatly reduces time spent in preparation and, therefore, reduces labour costs. Reducing labour costs does not increase sales so there is no direct benefit to the franchisor, however, if you teach your franchisees how to do this they should be forever indebted to you.

Tactic III — Sell high-profit items

Interestingly, every franchisor is pushing for the "up-sell," to get the customer to buy more and buy bigger portions. Sales go up, average cheque goes up, server's tips go up, franchisor's revenue goes up … it sounds great, but it is not necessarily great.

I have learned a few things over the years. The first was not to focus on profit percentages but rather focus on what is going into your franchisee's pocket. The franchisee cannot bank percentages, only dollars. If you only had one customer would you prefer to sell the $45 steak with a 50 percent cost ($22.50) and $22.50 profit, or sell the $35 steak with a 25 percent cost ($8.75) and $26.25 profit? The server wants to sell the $45 steak — the manager's bonus may be based on the higher cheque average and increased sales; obviously the franchisor's royalty is larger on the more expensive items — but clearly the franchisee can make more on the lower priced item. We always recommend selling the higher profit items.

Look at your costs for wine, entrées, side dishes, desserts, etc., and have your franchisee's staff sell the most profitable items, not the highest priced ones. Overall, customers may appreciate your selling lower priced items irrespective of whether or not you make the best royalty on them.

Tactic IV — Utility management

We are now in a modern age. Utilities can manage themselves, and in the end, reduce franchisee operating costs. Find a utility management-consulting firm to assess your operations on an overall basis and determine where you can reduce your franchisee's costs. Basics would include such changes as moving from electric heat and cooking elements to gas-driven equipment. Additionally, innovations such as automatic water for washroom sinks, automatic flush systems and even motion sensitive lighting can reduce costs greatly. Other cost-saving opportunities include turning down the heat or air-conditioning when the restaurant is not in use and reducing the utility usage in rooms that are not in use. Further, windows can be covered with coatings that assist in keeping heat or air conditioning in, and the natural elements out.

There have been so many advances in utility management over the past few years that you should look into them and adopt those that make economical and environmental sense in your franchisee program.

Tactic V — Assess your kitchen and restaurant design

In one of the restaurants noted above, the operator was using a pre-existing kitchen. As such, it inherited a dishwasher area in one corner of the kitchen and a pot-washer area in the diagonally opposite corner. We recommended moving the pot-washer next to the dishwasher space at the time of construction, but the operator could not see the benefit of the $25,000 expense. Five years later, he is paying for a pot-washer at a rate of $15,000 or more per year — a job that could have been eliminated. Quite frankly, the operator should still make the change and save the ongoing costs.

In another restaurant, the operator would not put in a fourth Point of Sales terminal, saving about $2,500. As a result, it has created a situation where servers must walk from tables in the front of the dining room to the back (about fifty paces), causing them to waste time in travel for each order and make them leave their sections for long periods of time, thus sacrificing service and forcing an extra busboy onto the staff in order to properly service customers. Had a server station been placed near the seating area, the franchisee could have reduced one staff member while increasing service — again, it is never too late to fix mistakes — but maybe it is better for the franchisor to sacrifice one or two tables in design in order to develop a system that minimizes labour and thus labour costs.

Tactic VI — Control your marketing expense

While we usually struggle to get our clients to spend the 3 to 5 percent they should spend on advertising, we have run into a few operators who spend from 6 to 10 percent on advertising. Over-promoting a restaurant is also an error that should be avoided. A restaurant should spend a sufficient amount of money on advertising but not succumb to the idea that it must overdo it. If your advertising budget is over 5 percent (perhaps 3 percent advertising fund and 2 percent local store marketing), sit back and take a careful look at what it is generating for the business and make adjustments to focus it more directly and to control its high costs.

Tactic VII — Reduce your breakage, theft and tableware waste

One key aspect to reducing costs is to reduce your franchisee's breakage, theft and tableware waste. There is a lot of breakage within the restaurant business — much of which can be reduced. First, if you are using bus bins, have your franchisee's staff separate them into a bin for plates and cutlery, and a second one for glassware. The glassware one should ideally be partitioned for each glass. This will reduce glass breakage significantly. If dishes are brought straight to the dish area, have the bussers separate dishes from glasses when they put the dishes on the catch-all.

Add metal catchers to the top of the garbage bins to catch knives and forks that may drop in or be discarded accidentally, or buy a metal detector and examine the garbage on the way out the door. While I am usually amazed by the number of glasses that break in a restaurant (mostly due to poor handling by staff), I find the amount of cutlery that is inadvertently thrown away incomprehensible. Both losses are easy to prevent. Give your franchisees the advice they need to save the cost. Do not let their staff throw away their hard-earned profit.

In terms of linen usage, try not to overuse your linen. Linen napkins should not be used to clean up a mess, nor are they a substitute for a kitchen towel. They are for customer usage, not staff usage, and should not be going home with the staff. Have your franchisees take a daily inventory of what is coming in and what is going out. Your franchisees' employees likely have the balance. If you take inventory of the linen, it will minimize your loss from theft.

Tactic VIII — Inventory Control

Another aspect of our business in which we become somewhat lax is the maintenance of a strong inventory control system. You need to have your franchisees take weekly and monthly inventory of all products within their restaurants. You also need to have franchisees maintain variance reports on all expensive items such as chicken, steaks, seafood and so forth. In many restaurants there are usage standards for items such as butter. Depending on your franchisees' sales, your usage of a particular product will fluctuate as a percentage of sales. Set up inventory procedures on everything (food, liquor, cash, linen) and everyone (servers, bussers, kitchen staff, hosts, management).

In one restaurant, we set up inventory controls on cigars on a daily basis and still found missing items everyday. In another, we found missing wine and beer bottles on a very consistent basis. In the first example, the bar manager was giving away expensive cigars to customers for the large tip he would get in return and, in the other, employees were having nightly parties after management went home. In both cases, the inventory control procedures ferreted out the culprits and created more profits once they were removed.

Again, franchisors derive no benefit from inventory control other than assisting their franchisees to be more profitable. It is well worth the effort!

Tactic IX — Purchasing controls

Purchasing controls are also paramount in maximizing profits for franchisees. You need to develop a system of checks and balances for many of your franchisees' purchases. For example, on almost all products you will find competitive prices and service. Once every few months you should do some price shopping to see who is the least expensive in the market and to assess whether or not your supplier is artificially raising prices slowly over a period of time. You, as a franchisor, have a responsibility to your franchisees under the doctrine of "good faith" to assist them in obtaining the lowest price for your product specifications.

For each item you use, create a standard purchase specification that includes the grade, quantity, quality and other features you are looking for. Offer those specifications to three or four suppliers in each category and ask them for their prices. You will quickly be offered price reductions and discounts. Drop the poorest offer next time you go to tender on the prices and find a new potential supplier, thus keeping the field open. We recommend that you go for tender every three months in order to keep your suppliers aware of your business and their need to be supporting your business with the best pricing options.

Tactic X — Inventory turnover

Inventory turnover assessment can assist in reducing product shortage, shrinkage, and preventing your franchisee's organization from tying up excessive capital in inventories. The key is in making your franchisee understand your product usage and purchasing habits, and then analyzing them on an ongoing basis. For example, an operator should take inventory of liquor, food and paper products separately, as noted earlier in this article. If you are examining your food turnover, for example, you would take the total cost of food used for the period and divide it by the food inventory at the end of the period to assess your food turnover rate (for example, food used during the period was $100,000, divided by ending food inventory of $33,000, equals a turnover rate of 3 times per month or 36 times per year). In an ideal operation, food turnover should be 36 to 42 times per year or a minimum of 3 times per month. A proper inventory turnover indicates that the restaurant is not carrying too much inventory in stock and, therefore, does not have excess capital tied up. It also suggests that the stock is being used effectively. Beverage products should turn 24 to 30 times per year and paper should turnover 12 to 18 times per year. If you teach your franchisees how to do this, you will make them more profitable and happier.

Conclusion

The foodservice industry is booming. We recommend you take advantage of it by assisting your franchisees in increasing and maximizing the profit they take from the business so that they can reap and enjoy the rewards off-site. While franchisors and franchisees have diametrically opposed financial interests, it would behoove franchisors to provide their franchisees with all the tools necessary to become financially successful. The franchisees' goal is to make profit, not necessarily sales. Strengthening the franchisor/franchisee relationship will help both parties survive lean times and prosper. Take a look from their standpoint and help them out!

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FRANCHISE LAW

Managing Income Trusts in a Franchised Business Model: Keeping an Eye on the Duty of Good Faith and Positive Franchisee Relations

*Allan D.J. Dick**

Overview

THE USE OF INCOME TRUSTS (SOMETIMES known as income or royalty funds) has proliferated in Canada over the past several years as the public financing vehicle of choice. Not surprisingly, a variety of large franchising businesses are counted among those that have been restructured into income trusts and have experienced success with their public offerings.

The restructuring of a franchising business into an income trust has required a marked but, for the most part, unspoken change in the focus and goals of management for the franchisor and its related entities. This change is important to franchisees operating within the franchise system. This change may also have a significant impact on the franchisor/franchisee relationship, which, in turn, might not only affect investor decisions but also give rise to potential claims by franchisees over alleged breaches by the franchisor of its duty of good faith and fair dealing.

The Rise of Income Trusts

OVER THE PAST DECADE, THE USE of income trusts in Canada has become the predominant method for businesses to maximize their value through a public offering. The creation of an income trust is considered attractive to businesses that have relatively reliable histories of stable earnings and generally do not have extraordinary capital needs. Many large franchising companies display these particular characteristics.

The primary benefit of establishing an income trust in Canada is that the investor who purchases units in the trust receives regular cash distributions from the pretax cash flows generated by the underlying business. The cash is flowed through the business to the investor without attracting any tax in the hands of the business. The investor in the trust unit, therefore, pays the income tax on the revenues generated by the business.

Although concerns about the inequality of treatment between investors in income trusts and investors in share capital corporations in Canada were raised within the Canadian federal government in 2005, the solution to the inequality is expected to be a somewhat improved tax treatment for the investor in the share capital corporation rather than an elimination of the favourable tax treatment of the unit trust holder's income derived from the trust. As such, it can be expected that the income trust model for public investment in business in Canada will continue to flourish at least as long as income trusts continue to outperform the rest of the market as they have done for the past several years.

Competing for Investment Dollars — The Need for Growth

ALTHOUGH INCOME TRUSTS HAVE BEEN VERY attractive investments over the past several years because of their predictable, stable and relatively high rates of return, the proliferation of income trusts has naturally resulted in competition among companies within the sector. No longer is it sufficient that income trusts outperform other segments of the market. As against each other, they must achieve greater returns for their investors. This is particularly important for income trusts, which generally must look to the public markets to raise capital for expansion.

This phenomenon raises the issue facing management of income trusts as to how to grow its underlying businesses. To date, in order to generate ongoing, consistent returns, managers of income trusts have generally been required to forgo the accumulation of cash in favour of distributing cash to their investors and forgo large capital investments utilizing their own capital that might impair

the capability to sustain regular distributions. Today, however, management must determine a growth strategy designed to maximize the value of its trust units in circumstances where it is still expected that the distributions will continue.

For most businesses, the concerns raised by this phenomenon are no different from other businesses that want to grow while carefully managing their cash flows. However, where the underlying businesses are franchised-based, the concerns and considerations are unique in that management must also consider its obligations to its franchisees.

Franchising — The Duties of Good Faith and Fair Dealing

The *Arthur Wishart Act (Franchise Disclosure), 2000* ("Act") was proclaimed in force effective June 2000, ushering into Ontario statutory duties of good faith and fair dealing on the part of franchisors and franchisees to one another.

Lively debate preceded the proclamation of the Act as to whether this new statutory duty was nothing more than a mere codification of Ontario's common law on when and how one party to a contract owed a duty of good faith to the other. It was generally accepted, prior to the proclamation of the Act, that a franchisor owed a duty of good faith in how it carried out its *contractual* obligations to its franchisee. Attempts by franchisees to expand that duty to matters not specifically addressed in the franchise agreement were far more problematic.

The decisions of the Ontario courts since the proclamation of the Act have not, to date, indicated any significant expansion of what was considered the common law duty of good faith between contracting parties. Unquestionably, however, the Ontario Legislature's decision to express the duty within the Act is a fact that all courts will consider when faced with an alleged breach of the duty. Franchising lawyers, as a matter of safe practice at the very least, have also brought the statutory provisions to the attention of their franchisor clients whenever decisions are being made by their clients that may have a negative impact upon their franchisees, whether or not there is an express contractual provision relating to the decision to be made. The simple reason for this is that it is completely unknown how and to what extent the courts will apply the statutory duty of good faith in the future.

Before a franchisor can create an income trust, it will have carefully considered its ability to restructure itself to create one of the common structures that have been utilized to allow it to go to the public as an income trust. Regard must be had to any possible restrictions that may be contained within its franchise agreements on its ability to restructure. Assuming there are none, there is nothing fundamentally offensive from the point of view of a franchisee when its franchisor decides to convert to an income trust. As pointed out earlier, however, the fact that the focus of management will almost invariably change because of the demands of being an income trust may be of concern to a franchisee.

Growing a Franchise — The Contractual and Practical Context

Franchise agreements tend to confirm the ability of the franchisor to allow the franchisee to make use of trademarks and other proprietary rights that the franchisor either owns or is itself contractually entitled to exploit. The agreements themselves otherwise tend to focus on the specific obligations of the franchisee related to the utilization of these marks and rights. Rarely is anything stated in the agreements relating to the franchisor's intentions or interest in expanding the franchise system. At best, the parties to a franchise agreement have put their minds to whether the franchisee will have a territory to operate within and whether that territory will be protected by restrictions on the franchisor's ability to locate another franchisee, or operate itself within the territory. Franchise agreements do not, as a matter of practice, protect the franchisee against third-party competition.

The reality, however, is that franchisees commit their investment for periods of five, ten, fifteen years or longer. During the terms of their agreements, franchisees expect (usually without any contractual commitment on the part of the franchisor) that the franchisor will focus its management time on doing everything it can to help the franchisees maximize their sales. This expectation is quite reasonable given the usual interest the franchisor has in receiving royalties based on the volume of the franchisees' sales. If the franchisor can help improve the franchisees' sales, it too will benefit from increased royalties.

In addition to this source of revenue, franchisees expect that their franchisor will have an interest in selling more units of the franchised business. They expect management time to also be spent on growing the system, adding units and exploiting new markets. Although franchisees rarely benefit directly from the franchisor's successful sale of a new unit, they do expect to benefit from the growth of the brand, accomplished both through successful marketing and expansion.

For a variety of reasons, however, a franchisor may decide that growing the franchisee's business or expanding the brand may not be in its best interests or the best use of management time. Any owner of a franchise may decide that a new or different concept has better potential. The owner may be focused on acquiring or establishing other brands and developing systems relating to those brands. In such circumstances, franchisees are almost entirely without any contractual rights or remedies given the absence of any agreement on the part of the franchisor to expand the franchised business or grow the system.

Will the courts of Ontario allow a franchisee to resort to the specific provisions of the Act to find some duty of good faith and fair dealing to assist a

franchisee in those situations? Only time and the development of the law will tell. Certainly, however, whenever a franchisor is considering a change in management focus away from the growth of the system or the enhanced profitability of its franchisees, it ought to be alerted to its statutory duties and the uncertainty of how those duties may be expanded in the future. It will then need to decide whether it is opening itself up to potential litigation and possible liability premised on an alleged breach of the statutory duty of good faith and fair dealing.

Impact on the Market

Investors in income trusts can be expected to have sustainable profits, growth and growth potential foremost in their minds when considering their choice of investments. For franchise-based income trusts, investors must also consider the impact that the quality of the relationship between the franchisor and its franchisees can have on the potential profitability and growth of the system.

Decisions concerning the structure of a franchisor must therefore be premised on considerations that extend beyond the contractual obligations of franchisors to their franchisees. These considerations may prove critical in deciding whether to move to an income trust and how to expect management to create and sustain growth to maintain the value of the trust, once created.

Conclusion

It can be expected that franchisees operating within a system managed through an income trust will be keenly aware of the impact they can have on the value of the public entity. Understanding that the focus of the franchisor's management team may be inclined to wander to include potential sources of growth that may not be in their best interests, increased scrutiny of management's activities by franchisees can also be expected. The availability on the part of franchisees to raise possible breaches by the franchisor of statutory duties of good faith and fair dealing, particularly at a time when there has not yet developed a body of case law expounding on the parameters of those duties, reinforces the need for management of income trusts in the franchising sector to keep its focus both on the investing public and its franchisees when planning growth strategies.

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Privacy Issues in Franchise Relationships: A Practical Guide

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A. Introduction

ON JANUARY 1, 2004, THE FEDERAL government activated Part I of the *Personal Information and Protection of Personal Privacy Act* (Canada) ("*PIPEDA*" or "Act")[1] to protect personal information collected, used or disclosed in the course of a commercial activity. Since that time, private businesses have been adjusting to Canada's new privacy regime. Businesses have been required, at a minimum, to develop a comprehensive privacy policy, appoint a privacy commissioner, familiarize themselves with the elements of Canada's new private sector privacy laws and realign their practices in order to ensure that personal information collected, used or disclosed in the course of business is handled in the appropriate manner.

Franchised businesses have not been exempt from the requirements of privacy legislation. A franchise typically requires the collection, use and disclosure of personal information at all stages of the business cycle: at the franchisee recruitment stage, at the operations level, for marketing and advertising purposes and upon the sale of a franchised system. While privacy compliance is not without costs, the prospect of lost revenues and eroded goodwill as a result of a highly publicized privacy complaint or class action will often more than justify the expense of ensuring that appropriate privacy practices are implemented and followed. The purposes of this paper include first, to briefly describe the private-sector personal data protection laws currently in force in Canada; second, to enumerate the most common privacy issues that are likely to arise within a franchised business; and third, to provide practical suggestions and recommendations to assist franchisors and franchisees in efficiently addressing these concerns.

B. Legislation

WHILE INTERNATIONAL LEGISLATION GOVERNING THE PROTECTION of personal information has been in force for some time,[2] it was not until January 1, 2001 that Canada's federal privacy legislation, *PIPEDA*, came into effect. At that time, Part I of the Act was

intended to regulate the collection, use and disclosure of personal information by federal works, undertakings or businesses and by certain organizations engaged in inter-provincial activities. On January 1, 2004, the remainder of the Act came into effect and has since applied to organizations that use, collect and disclose personal information in the course of their commercial activities. The Act applies in all Canadian provinces that do not have their own privacy statute. The substance of the legislation, a set of ten guiding privacy principles borrowed from the Canadian Standards Association Model Code, is set out in Schedule I of the Act.

At the time of writing, Quebec,[3] British Columbia and Alberta have adopted provincial statutes that are substantially similar to the Act. The laws in British Columbia and Alberta are each called the *Personal Information and Protection Act*[4] and resulted from significant collaboration between the two provinces. Both the B.C. Act and the Alberta Act constitute a more complete package than *PIPEDA*. For example, the B.C. and Alberta Acts each deal expressly with employee information, exclude business e-mails from the Acts' protection and contain exemptions for disclosures of personal information in the context of business transactions. Of notable distinction is the exemption of personal information that was collected on or before the Acts came into force. *PIPEDA* contains no such exclusion, underscoring the retroactive effect of *PIPEDA* on archived and non-current data.

Ontario does not yet have its own private-sector privacy legislation and hence *PIPEDA* applies in that province.

C. General Issues

1. *Franchisee information*

Most franchisors collect personal information from prospective franchisees during the recruitment phase. This is due to the reality that, although franchisees are almost exclusively corporate vehicles that hold the licensed rights to a franchise, the franchisor ultimately views the individual principals behind the corporate licensee as the actual franchisees who uphold and perform the covenants under the franchise agreement. Accordingly, a franchisor's due diligence typically requires the disclosure of basic personal information in addition to more sensitive data such as age, marital status, banking information, salary, financial condition, employment information, credit information, driver's licence number, social insurance number, criminal records and, in some cases, health information. The franchisor's practice might be to use this information internally, to transfer it to local area developers or master franchisees or to disclose it to third parties such as consumer reporting agencies for further analysis. Assuming a franchisee candidate is not selected to operate a franchise, the franchisor must determine what to do with the candidate's personal information, how long to retain it, if it proposes to do so, and how to dispose of it.

Privacy issues also arise at the disclosure stage. Under existing Ontario and Alberta franchise legislation, the franchisor is required to provide a list of all current franchisees, as well as the name, telephone number and last known address of each franchisee that left the system in the previous fiscal year.

Analysis and Recommendations

a. *Recruitment*: The collection of information from a prospective franchisee at the recruitment stage is in the interests of the individual providing the information. If this information is collected without express consent, consent to the use of the information for the purposes of assessing a candidate's suitability may be implied from the candidate's actions in completing and submitting the form for the purposes of being evaluated for suitability for the grant of a franchise. Nonetheless, given the sensitivity of much of the information, the purposes for which the information is collected should be expressly stated in the form and the explicit consent to such purposes should be obtained from each prospective candidate. The purposes for the collection of the information should include (i) use of the information to assess the candidate's suitability as a franchisee or guarantor of a franchisee; (ii) transfer of certain of the information to a third party, such as an accountant or consumer reporting agency to conduct further due diligence; (iii) transfer of the information to a master franchisee or area developer for assessment; (iv) use of the information for statistical, modelling or other franchisee marketing purposes, if applicable; (v) administration of the franchisee; (vi) sale or transfer of the franchisor and all or any portion of its assets; (vii) disclosure to future franchisees as required by law and otherwise restricted to non-sensitive personal information; and (viii) such other reasonable purposes as may be required from time to time. The consent should clearly relate to the purposes stated.

b. *Disclosure*: Under *PIPEDA*, the B.C. Act and the Alberta Act, personal information may be disclosed without consent where required by law and where the information is publicly available. "Publicly available" includes personal information in a telephone, or professional or business directory.[5] As noted, Ontario and Alberta franchise legislation require the disclosure of past franchisees and their contact information and, therefore, in accordance with the above-noted privacy statutes, no specific consent is required for the disclosure of prior franchisees in those provinces. In all other provinces without active franchise legislation,[6] and where the information disclosed is not also contained in a professional business directory available to the public, the prior consent of the franchisee is required.

As a matter of good practice, it is advisable for franchisors to obtain consents

to such disclosures, as indicated in item (a)(vii) above. The franchisor's privacy policy should stipulate that such information will be retained by the franchisor only for as long as may be reasonably necessary to give effect to the purposes for which it was originally collected, or as otherwise required by law.

2. Consumer information

Consumer data are frequently collected from individual retail consumers by franchisors and franchisees for the purposes of marketing, order processing and ongoing services. Often, information is collected by the franchisee and subsequently disclosed to the franchisor, or it is provided by the consumer directly to the franchisor. Information is collected from a variety of sources including customer surveys, contests, online shopping, centralized reservations, warranty programs, affinity programs, gift cards, customer website registration and pursuant to returns policies.

This information is a treasure-trove to marketers. The ease with which vast amounts of data can be manipulated in the electronic age and the resulting assault on individual privacy in the form of junk mail, spam and telemarketing has been the catalyst to the modern private-sector privacy law movement. The information requested often includes the name, address, phone, e-mail address, gender, age, income, consumer preferences, credit information, credit card information and even digital information from the magnetic strip on debit or credit cards.[7] Prior to the advent of consumer privacy legislation, this information was often collected by distributors and franchisees and freely exchanged with manufacturers and franchisors pursuant to the terms of existing agreements. The information may have been used for primary marketing purposes and in certain cases may have been sold or rented to third parties including data brokers and commercial database operators. In addition, the information may have been transferred intra-provincially, across the border to the United States or another country or may have been forwarded to a third party for warranty service, affinity program administration, order processing or some other ancillary purpose.

Analysis and recommendations

Franchisors and franchisees must ensure at the outset that in all their direct dealings with consumers they obtain appropriate consents for their use of personal information. As a matter of practice, the collection of non-sensitive information pursuant to an application or registration form may be construed to imply consent, especially where the purpose of the document is plainly set out, and where a franchisor's or franchisee's privacy policy is readily available and discloses the express purposes for which personal information is collected. The practice of providing consumers with the right to opt-out of receiving future communications seems to be gaining acceptance, especially in online data collection.

The collection of sensitive information, such as financial or credit card information, should always be accompanied with the appropriate consent to use. In addition, principle 4.7 of *PIPEDA* requires that appropriate security safeguards, including the use of encryption in the case of electronically stored information, be used by the recipient to ensure the integrity and security of the disclosed information.

All consents must be prefaced by the appropriate notice of intended purposes. The consent should state that the information, as between the franchisor and the franchisee, will become the property of the franchisor (if this is in fact the agreement between the parties), and that the consumer consents to this information being transferred to any subsequent assignee or purchaser of the franchise system.

Where personal data are being transferred extra-provincially, out of the country or to a third-party service provider for any purpose, including marketing, contest administration, warranty servicing, affinity program administration or order processing, the transferor must ensure first that it has obtained the informed consent to such disclosures from the affected individuals. Second, the transferor must ensure that the privacy standards adopted by the transferee, irrespective of jurisdiction, are at least the equivalent of the privacy protections afforded the consumer by the transferor. The transferor must employ contractual means in order to ensure that personal information enjoys the same levels of protection in the hands of the third party as it does in the hands of the transferor.

Franchise agreements should require that customer lists and personal information collected by the franchisee become the property of the franchisor upon termination or expiry of the franchise agreement. Both the franchisor and the franchisee's privacy policies should provide for this anticipated disclosure as should the consent upon which the initial disclosure was based.

3. Sales of a franchise system

The now infamous *Toysmart* case underlined the importance of obtaining consent to the subsequent transfer and sale of consumer data. In that case, the failed Internet toy vendor Toysmart.com sought to sell its customer list, which was collected online and included personal information of children. The Federal Trade Commission ("F.T.C.") claimed that the sale constituted a deceptive act or practice contrary to section 5 of the F.T.C. Act, in that the sale would have been in express violation of Toysmart's privacy policy. The F.T.C. was successful in its claim and ordered Toysmart to destroy all personal information in issue, involving nearly 200,000 customers.

PIPEDA does not waive the requirements of the Act to obtain an individual's informed consent prior to disclosing his or her information to a third party in the context of the purchase and sale of business assets. The B.C. Act and the Alberta Act do, however, permit disclosure without consent in certain business transactions, such as acquisitions, sales, leases, mergers, amalgamations or

financings. In transactions to which those provincial Acts apply, the information may be collected during the due diligence period under agreement of the recipient to use the information only for the purposes related to the business transaction, where such information is necessary for the parties to determine whether to proceed and close the transaction. The purchaser of, or successor to, the information may continue to use the information only if it has undertaken to use and disclose the information for the purposes for which it was originally collected and the information relates solely to the operation of the target business or relates to the objects of the business transaction. If the transaction is not completed or does not close, the recipient must destroy the personal information. Under the B.C. Act, there is also a requirement that, where a transaction proceeds, an organization may disclose information without consent provided that any employees, customers, directors, officers and shareholders whose personal information is disclosed are notified that the transaction has taken place and that their personal information has been disclosed to the recipient.

Analysis and recommendations

In order to prepare for the sale of a franchise system and valuable customer lists in *PIPEDA* jurisdictions, the franchisor should ensure that it has obtained informed consents from all individuals whose personal data are collected by a franchisor or a franchisee. As indicated above, the principle is one of simple contractual consideration: in exchange for the delivery of certain products or services, the consumer agrees to provide financial consideration and its personal information for a certain number of limited purposes. If the purposes enumerated fail to include the subsequent transfer of the information to the franchisor for marketing purposes, for sale or lease to a data broker, or for subsequent assignment to a potential purchaser of the franchisor's business assets, then these activities simply cannot be undertaken without obtaining such express consents. At a minimum, a franchisor's website privacy policy should include the statement that personal information collected from customers may be transferred to purchasers of the franchisor's business.

In British Columbia and Alberta, provided the notice requirements of the respective Acts are complied with and provided that the statute is complied with in all other respects, prior notice of the transfer will not be required.

4. *Franchisor's and franchisee's privacy obligations to employees*

Currently, *PIPEDA* only imposes privacy obligations on employers of federally regulated undertakings. Private employers in those provinces without their own privacy legislation are not technically required to provide their employees with the protections legislated under *PIPEDA* where employee information is collected for the purposes of administering the employee relationship and not for a commercial purpose.

The Quebec Act, the B.C. Act and the Alberta Act all apply to employee information of provincially regulated businesses. The B.C. and Alberta Acts provide for the collection, use and disclosure of employee information without the employee's consent, but upon prior notice to the employee provided that such collection, use and disclosure are reasonable for the purposes of establishing, managing or terminating the employee relationship.

Recommendations

Employees should maintain strict privacy standards for all collected personal information, including both consumer and employee information, whether or not they are operating in a *PIPEDA* province or a jurisdiction in which "substantially similar" legislation has been enacted. Consents are often easily obtained at the outset of the employment relationship in application forms, employment agreements and confidentiality agreements and can include all anticipated reasonable uses of personal employee information, such as criminal checks, credit checks, reference verification, performance evaluation and outsourcing of payroll.

D. Conclusion

Privacy compliance need not impose a burdensome cost to franchisors and franchisees. The establishment of a sound privacy policy, the institution and enforcement of good practices and the appointment of a diligent privacy officer are the minimum requirements. If, in addition to the above, a proactive, well-thought-out and privacy-sensitive approach is taken by franchises that collect, use and disclose personal information, then business disruptions due to privacy-related matters will rarely, if ever, arise.

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1 S.C. 2000, c. 5.

2 The European Union adopted Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data ("E.U. Data Directive").

3 Article 35 of the *Code Civil du Québec*, L.Q. 1991, c. 64, provides that "every person has a right to the respect of his reputation and privacy. No one may invade the privacy of a person without the consent of the person unless authorized by law." The *Loi sur la protection des renseignements personnels dans le secteur privé* ("Quebec Act") came into effect on January 1, 1994 and was declared to be substantially similar to *PIPEDA* on November 19, 2003.

4 S.B.C. 2003, c. 63 ("B.C. Act") and S.A. c. P-6.5 ("Alberta Act").

5 See *PIPEDA* Reg. SOR 2001-7, ss. 1 (a) and (b); B.C. Reg. 473/2003, s. 6; and Alberta Reg. 366/2003, s. 7.

6 Prince Edward Island enacted its *Franchise Act* on June 7, 2005, but the Act will not be proclaimed into force until its regulations have been finalized.

7 See *Re BJ's Wholesale Club, Inc.*, File No. 042-3160 (F.T.C.).

Five Strategies to Creditor-Proof Your Business Assets

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THE NEED FOR A BUSINESS OWNER to protect his or her assets against the claims of future business creditors is critical. A common step taken by most business owners is to operate the business through a corporation. Since a corporation is a separate legal entity from its shareholders, incorporation limits the liability of, or risk to, the business owner and his or her personal assets. Yet the business assets owned by the corporation are still at risk to the creditors of the corporation. "Creditor-proofing" refers to the process of protecting assets from the claims of, and seizure by, creditors of a business. A business owner should undertake, or at least consider, appropriate creditor-proofing strategies in order to protect his or her business and assets from potential future claims by creditors.

There are many creditor-proofing strategies a business owner can implement. In this article I have focused on five basic and common strategies that can be used by almost any business owner in developing a creditor-proofing plan. However, in implementing such a plan, a business owner should have regard to the ways a creditor can seek to attack or cancel transactions undertaken as part of the creditor-proofing plan. These grounds for attack are discussed in more detail below. Only by understanding and anticipating such possible future attacks by creditors will a business owner be able to effectively implement a creditor-proofing plan.

Finally, I point out that the strategies discussed below are only considered from an asset protection perspective. While beyond the scope of this article, there are other factors that should be considered when developing a creditor-proofing plan. In particular, the tax impact of such strategies should be considered as an integral part of such planning.

Common Creditor-Proofing Strategies

THE FOLLOWING ARE FIVE BASIC AND popular creditor-proofing strategies that a business owner should consider in developing an appropriate creditor-proofing plan for his or her business.

1. Invest Using Secured Debt

BUSINESS OWNERS TYPICALLY CAPITALIZE THEIR CORPORATIONS using one of two methods: by way of equity investment (by the purchase of shares of the corporation), or debt investment (by loaning money to the corporation). Particularly in the start-up phase of the business, regardless of the capitalization method, the funds invested in the business are usually those of the business owner. In later phases of the business, investment funds may also come from outside investors, including private investors and banks and other institutional lenders.

Obviously, an equity investment will be reflected more positively on the balance sheet of the business than a debt investment. This may be important to a franchisor, given the requirement to disclose financial statements to prospective franchisees and the marketing function such financial statements serve. However, where a business owner uses personal funds, an equity investment will not be protected if the business runs into financial difficulty. Should the corporation fail, a shareholder's investment ranks behind all secured and unsecured creditors of the corporation. However, if the business owner loans his investment funds to the corporation, he becomes a creditor of the corporation. The loan should also be secured against the assets of the corporation. If the corporation fails, the business owner will then rank as a secured creditor and will take priority over later secured creditors and all unsecured creditors of the corporation (subject to certain special priority creditors, such as governments with respect to tax withholding obligations of the corporation).

2. Use Separate Operating Corporations

WHERE A BUSINESS OWNER CARRIES ON more than one business, each such business should be carried on through a separate corporation. For example, many franchisors own more than one franchise system. While there may be tax or operational benefits to operating multiple franchise systems or businesses as separate divisions within the same corporation, there is great risk in doing so. Where only one corporation is used, in the event that one of the businesses should fail, the assets of the successful business will be subject to the liabilities of the failed business. If instead the businesses were operated within separate corporations, the

assets of the successful business would be protected from the liabilities of the failed business. In addition to keeping core business operations in separate corporations, non-core related operations, for example a call centre that services franchise system customers, can also be set up within yet another separate corporation and continue to service both core business operating corporations.

3. *Isolate Valuable Assets*

Valuable business assets should be isolated from the operations of the business. In the franchising context, the most valuable asset that a franchisor owns is typically the franchise system trademarks. The valuable assets should be held by a corporation that is separate from the one used to operate the business. The valuable assets could then be leased or licensed (depending on the type of asset) to the operating corporation by the holding corporation. In the event the operating corporation becomes subject to a liability, the valuable assets will not be available to satisfy such liability.

4. *Strip Out Cash*

Since cash within an operating corporation will be subject to the liabilities of the corporation, any surplus cash in an operating corporation should be removed. The surplus cash can be distributed to shareholders by way of a dividend. Organizations are commonly structured so that the sole shareholder of an operating corporation is a holding corporation (with the shareholders of the holding corporation being the "business owner" and other investors). In such a structure, the surplus cash distributed as a dividend by the operating corporation to the holding corporation is done as a tax-free inter-corporate dividend. Where the operating corporation subsequently requires cash, the holding corporation can loan the money back to the operating corporation and take security in the operating corporation's assets.

5. *Strip Out Assets*

As with cash, since assets within an operating corporation will be subject to the liabilities of the corporation, they should be kept to the minimum level possible. One obvious way to do this is to lease instead of purchase assets used in the business. Any assets already owned by an operating corporation can be turned into cash by selling those assets to a separate corporation. The assets can then be leased back to the operating corporation. Receivables of an operating corporation can also be sold to a separate corporation. The cash received for any such sale of assets or receivables can then be distributed by the operating corporation as a dividend to its shareholders as discussed above.

Common Attacks on Creditor-Proofing Strategies

The following are a number of ways a creditor can seek to attack or cancel transactions undertaken as part of a business owner's creditor-proofing plan. Obviously, these should be kept in mind when implementing a creditor-proofing plan.

1. *Bankruptcy and Insolvency Act (Canada)*

Where a corporation becomes bankrupt, a trustee in bankruptcy is given the power to attack certain transactions that occur within a specified period of time prior to the bankruptcy.

a. *Settlements.* A trustee in bankruptcy may be able to cancel a transfer of assets or a contract entered into by a bankrupt where the transaction (i) was made for no or nominal consideration, and (ii) occurred within one year of the bankruptcy, or if the trustee in bankruptcy can prove that the transaction occurred at a time when the bankrupt was generally unable to pay its debts when due, within five years of the bankruptcy. However, where a transaction is made in good faith and for valuable consideration, it is not subject to cancellation.
b. *Fraudulent Preferences.* A trustee in bankruptcy may be able to cancel a transfer of assets, the giving of security in assets, a payment made or an obligation incurred by a bankrupt where (i) the transaction was in favour of a creditor of the bankrupt; (ii) the bankrupt intended to give that creditor a preference over its other creditors; (iii) the transaction occurred at a time when the bankrupt was generally unable to pay its debts when due; and (iv) the transaction occurred within three months of the bankruptcy, or if the creditor in whose favour the transaction is made is related to the bankrupt, within one year of the bankruptcy. There are certain defences available to this type of claim, including that the transaction was done in the ordinary course of business or done to enable the bankrupt to receive additional goods that were necessary for it to remain in business.
c. *Reviewable Transactions.* A trustee in bankruptcy may ask a court to review any sale, purchase, lease, supply or receipt of property or services by a bankrupt where the transaction (i) was with a related person or other person not at arm's length with the bankrupt, and (ii) occurred within one year of the bankruptcy. If the consideration for the transaction was "conspicuously" greater or less than the fair market value of the property or services, the court can give judgment to the trustee against such related or non-arm's-length person for the difference between the actual consideration and the fair market value.
d. *Dividends and Share Redemptions.* A trustee in bankruptcy may ask a court to review any payment of a dividend by a bankrupt corporation or redemption by a bankrupt corporation of its own shares that occurred within one year of the bankruptcy.

If the transaction occurred when the bankrupt was, or resulted in the bankrupt being, generally unable to pay its debts when due, the court can give judgment to the trustee (i) against the directors of the bankrupt corporation for the amount of the dividend or redemption price, and (ii) against a shareholder who is related to the corporation or a director and who received funds from such transaction for the amount of such funds.

2. *Assignments and Preferences Act (Ontario)*

A creditor can challenge a transfer or payment of property made by a corporation where (i) the transfer occurred when the corporation was, or was on the eve of being, generally unable to pay its debts when due, and (ii) the corporation made the transfer with the intent to put such property beyond the reach of its creditors, or where the transfer was to a creditor of the corporation, with the intent to give it an unjust preference over other creditors of the corporation. In such a case, a court may cancel the transfer. Unlike the federal *Bankruptcy and Insolvency Act*, no specific time limitations for a challenge are set out in the provincial legislation. However, where a transfer is made in good faith and for a fair and reasonable value, it is not subject to cancellation.

3. *Fraudulent Conveyances Act (Ontario)*

A creditor can challenge a transfer of property made by a corporation where the corporation made the transfer with the intent to defeat creditors. A court will look for "badges of fraud" as evidence of the intent to defeat creditors, including that (i) the corporation was in financial difficulty; (ii) the transfer occurred between non-arm's-length parties; (iii) the corporation retained an interest in the transferred property after the transfer; (iv) the transfer substantially depleted the corporation's assets; (v) there was no or inadequate consideration; (vi) the effect of the transfer was to delay or defeat the corporation's creditors; (vii) the transfer was made in secrecy; (viii) there was unusual haste in completing the transfer; (ix) the location of the property did not change; and (x) the payment for the transfer was made in cash. Where a court finds there was intent to defeat creditors, it may cancel the transfer. However, where a transfer is made in good faith and for good consideration, and the transferee does not have knowledge that the transfer was made by the transferor corporation with the intent to defeat creditors, it is not subject to cancellation.

4. *Business Corporations Act (Ontario)/Canada Business Corporations Act*

Under the *Business Corporations Act* (Ontario) and *Canada Business Corporations Act*, a security holder, director, officer or other person may apply to the court for an "oppression remedy" order where there was a corporate act or omission that was oppressive or unfairly prejudicial to or that unfairly disregarded the interests of any security holder, creditor, director or officer of the corporation. Most actions for oppression remedy are brought by minority shareholders complaining of oppressive conduct by majority shareholders. However, the courts have granted orders in favour of creditors against directors, officers and shareholders of the corporation where the corporation transferred property or assets to such persons and subsequently was unable to pay its debts. In such a case, the court may make any order it thinks fit.

5. *Income Tax Act (Canada)*

Under the *Income Tax Act* (Canada), where property is transferred at less than fair market value to a non-arm's-length person, the transferee becomes liable to Canada Revenue Agency for the tax liability of the transferor in the year of and the years preceding the transfer. The tax liability of the transferee is capped at the amount by which the fair market value of the transferred property exceeds the consideration paid by the transferee for that property. Canada Revenue Agency may pursue the transferee directly for such tax liability. There is no requirement that the transfer take place with the intent to defeat creditors, nor that the transferee be aware of the outstanding tax liability of the transferor. This provision is particularly onerous in a situation where the transferred property is depreciable, for example, a car, since Canada Revenue Agency may be pursuing the transferee years after the transfer occurred at a time when the fair market value of the transferred property is a fraction of what it was at the time of the transfer. This provision may also be used in the case of a dividend payment to a shareholder to enable Canada Revenue Agency to pursue that shareholder for the amount of the dividend.

Conclusion

It is a prudent business owner who develops a creditor-proofing plan to protect business assets from creditors. However, in implementing such a creditor-proofing plan, a business owner should have regard to the ways in which a creditor may attack the plan. In particular, such a plan should be implemented long before the corporation is experiencing any financial difficulties, and transactions involved in the plan should be made at fair value and should avoid the "badges of fraud" discussed above. Doing so will help defend against possible future attacks by creditors to overturn the plan and seize the assets of the business.

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Electronic Disclosure in the U.S.: Are We There Yet?

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FOREIGN FRANCHISORS OFTEN INQUIRE WHETHER THE United States permits electronic disclosure of Offering Circulars. The answer may be, it depends on how you do it. But should you disclose electronically?

In 1997, the Federal Trade Commission ("F.T.C.") issued Informal Staff Advisory Opinion 97-2, concluding that a franchisor could satisfy the F.T.C. Franchise Rule by delivering a disclosure document via computer diskette if certain conditions were satisfied. Then, in October 1999, the F.T.C. published a Notice of Proposed Rulemaking ("N.P.R.") in connection with the F.T.C. Franchise Rule, including proposed instructions allowing franchisors to furnish disclosure documents electronically, including over the Internet. The N.P.R. (i) required the franchisee's consent; (ii) gave the franchisee the right to obtain a paper disclosure document; (iii) required a paper summary document if electronic disclosure was made; (iv) specified the general format of electronic disclosure documents; and (v) permitted the use of navigational tools.

Then along came the *Electronic Signatures in Global and National Commerce Act* ("*E-SIGN*") on June 30, 2000. There has been an ongoing debate among U.S. franchise lawyers ever since as to whether *E-SIGN* permits electronic disclosure. Some people think that *E-SIGN* may have trumped the F.T.C. However, in its most recent Informal Staff Advisory Opinion 05-4 on the subject issued August 30, 2005, the F.T.C. stated that "by its terms, *E-SIGN's* preservation of consumer rights may not apply to franchise sales." What then is the F.T.C.'s current position following the enactment of *E-SIGN*?

In July 2000, after *E-SIGN* was enacted, but supposedly not because of it, the F.T.C. solicited demonstration projects for electronic dissemination of disclosure documents. Since then, the F.T.C. has issued several Informal Staff Advisory Opinions giving four companies the right to provide electronic disclosure services to their franchisor clients. (See Informal Staff Advisory Opinions nos. 01-3, 03-3, 03-5 and 05-4.) Thus, a U.S. franchisor can disclose electronically to prospects through one of the existing approved demonstration service providers.

More importantly, in the Staff Report on the Proposed Revised F.T.C. Franchise Rule issued in August 2004, F.T.C. staff admitted that *E-SIGN* may have eliminated certain restrictions such as those the staff had originally proposed for electronic franchise disclosure in the N.P.R. In lieu of specific electronic disclosure instructions, the F.T.C.'s proposed revision to section 436.6(a) of the F.T.C. Franchise Rule would have its general instructions cover the furnishing of all disclosure documents, both paper and electronic. Specifically, proposed section 436.6(a) states, "The disclosures must be in a form that permits each prospective franchisee to store, download, print, or otherwise maintain the document for future reference."

Sounds good, but are we really there yet? We may not be, because the F.T.C. still has not revised the F.T.C. Franchise Rule (six years after it proposed to do so). In Informal Staff Advisory Opinion 05-4, the F.T.C. stated: "We still believe that the best advice we can offer at this time is for franchisors interested in Internet disclosure to follow the procedures outlined in the N.P.R. until such time as the Commission adopts final rule amendments."

However, it does not end there. The United States has a bifurcated franchise disclosure system whereby fourteen states require some type of registration or notice filing before franchises can be sold in their states. Those states all belong to the North American Securities Administrators Association ("NASAA"). NASAA wrote on the subject of electronic disclosure by issuing a NASAA Statement of Policy Regarding Electronic Delivery of Franchise Disclosure Documents ("NASAA Policy") in September 2003. The NASAA Policy contains the text of a proposed regulation or a proposed administrative order that the states would have a choice of adopting, which would allow a franchisor to deliver a franchise disclosure document over the Internet or by other electronic means, or in machine-readable media, provided certain conditions are met.

Under the NASAA Policy, the disclosure document must be delivered as a single integrated document in a form that allows the recipient to retrieve, print and store it. The document can have no extraneous content, and no links to or from external documents, and its content and format must conform to the applicable legal requirements. The franchisor has to prove that it delivered the document electronically in compliance with the requirements and that it did so in a timely manner. Records must be kept.

Recently, our office surveyed the F.T.C. and the fourteen states requiring registration of franchises to see where they stand on electronic disclosure. Twelve of the states said they would permit electronic disclosure, and two said no, they would not. One of the "no" states was California, which takes the position that electronic disclosure is prohibited until it adopts rules or regulations of its own on the subject. The states that said "yes" indicated that they are generally following the NASAA Policy, even if the state has not formally adopted one of its alternatives. Indiana formally adopted a modified version of the NASAA Policy in October 2005.

According to our survey, then, you are permitted to disclose electronically in twelve states, but should you? How difficult will it be to disclose electronically only in some states, and not others? What about disclosure in the other so-called "F.T.C. states"? The F.T.C. does not expressly permit electronic disclosure except through use of the demonstration service providers and there is no safe harbour. The F.T.C. has invited franchisors that want a safe harbour to apply for an advisory opinion. We think a proposal will be approved by the F.T.C. if it complies with the N.P.R. (electronic delivery with a paper summary document). While the F.T.C. will not take a formal position, it is obvious that a franchisor's electronic disclosure that does not conform to the 1999 N.P.R. is not sanctioned by the F.T.C.

So what do you do since we are not really there yet? Until the F.T.C. adopts the revised F.T.C. Franchise Rule, one approach may be for a franchisor to provide a prospective franchisee with an electronic informational copy of a disclosure document if the franchisee requests it, but also provide a paper copy containing receipt pages in order to comply with the F.T.C.'s disclosure requirements. Reasonable minds may differ, but that may be the chicken's (but prudent) way to deal with this subject until the F.T.C. decides what it is going to do.

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