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What are the legal and technical issues of taking a franchise to the USA?

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WHAT ARE THE LEGAL AND TECHNICAL ISSUES OF TAKING A FRANCHISE TO THE USA?

Introduction and Background

1. The premise upon which the paper is based: A franchise system based in Australia seeks to expand overseas, specifically to the United States of America (U.S.).

2. There are a myriad of legal, technical, commercial and practical issues to address. This paper will discuss some aspects only. The paper is not intended to be a substitute for those previous papers and articles relating to the international expansion by franchisors and franchise systems.

3. Such publications[1] as the Franchise Council of Australia (FCA) joint publication with the Australian Government (Austrade), "Expanding Internationally – a Guide for Australian Franchise Systems", is an excellent compendium of the wider issues that need to be considered. We commend that to you.

4. There are other publications[2]. Of particular note for its U.S. perspective is the publication of which the co-author of this paper, Mr Rupert Barkoff, is the co-editor[3].

5. As to the perspective from an Australian franchisor, rather than reiterate what these publications adequately cover, and as this publication is to the Legal Symposium of the FCA National Franchise Conference, the paper will address some specific legal and tax issues to consider. It presupposes a reasonable working legal knowledge of 'corporate' structures used by some Australian franchisors, as well as trusts and general Australian 'tax' concepts.

6. As to the U.S. perspective, the paper identifies some fundamental issues, about which to obtain further knowledge would require specialist franchise advice from a U.S. attorney, and accounting professionals.

U.S. Market

7. Why is the U.S. market attractive to an Australian franchisor, from the general perspective?

8. It is not surprising that Australian (and other) franchisors find the United States market attractive. It is large—with over 320 million people. Its residents have a high level of income. It is culturally similar to Australia. Its economy is very consumer-oriented.

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[1] "Expanding Internationally – A guide for Australian Franchise Systems", Australian Trade Commission 2004. A joint publication with FCA available from the FCA library of publications on the FCA website.

[2] The Guide to Franchising. Martin Mendelsohn. Published by Cassell 1997.

[3] Fundamentals of Franchising. 3rd Edition. Editors: Rupert M Barkoff and Andrew C Selden. American Bar Association.

9. The size of the marketplace seems to be the greatest attractor. There are 16 persons in the United States for every one person in Australia. The California market alone is substantially bigger than all of the Australian market.

10. Much of the U.S. population is attracted to anything Australian. The typical American knows very little about Australia. He or she thinks of it as a land halfway around the world, with strange animals and people who talk 'funny', even though they essentially speak the same language. The perception of exoticism peeks the American's interest in any concept that is Australian focused or originated.

11. The language similarity is also a very attractive feature. There is no need for translation or translators. And the cultural similarities makes business dealings considerably more attractive than moving into countries that may be large and geographically closer to Australia, but nevertheless more challenging to deal with.

12. So, before the Australian 'franchisor' returns from the exploratory U.S. trip excited about the possibilities, and wanting to 'open' the franchise for business in the U.S. immediately, there are some legal and related fundamental technical issues which the Australian franchisor will need to review. In the context of this paper, the term 'franchisor' is used in a wide sense as a short representation of the interests underlying the whole of the franchise system, that is recognising that not all the relevant legal rights and interests may rest in the 'franchisor' entity alone. The short term 'franchisor' is used for convenience.

The Australian Structure

13. Background information, such as existing legal and accounting structure of the Australian franchise system.

14. The premise of this paper is that the franchisor considering expansion to the U.S. has an existing franchise operation in Australia, allowing it to do so.

15. The presumption is that the franchisor has had sufficient success, or reached a stage of 'critical mass', where such an expansion can be reasonably contemplated, and without an adverse impact upon its Australian operations.

16. Possibly, such a franchise may have evolved from a basic structure i.e. one entity, such as one company only owning the franchise system, holding the intellectual property and entering into the franchise agreements, holding the leases and so on. Even if this 'basic' structure was in place initially, the franchisor would need to address whether this structure was presently appropriate, and how it could be improved domestically, and then consider internationally in such terms of asset protection, risk reduction and tax effective structuring, particularly given the potential international activities.

17. Alternatively, if the franchisor had taken a more sophisticated approach and earlier invested in appropriate legal, accounting and franchise consultancy advice, the franchisor may have already

18. From a legal perspective, in addition to the legislative and regulatory compliance issues, in particular the Corporations Act (Cwth) 2001, the Income Tax Assessment Acts (Cwth) 1936 and 1997 and related Acts, the Australian Competition and Consumer Act 2010, and the Trade Practices (Industry Codes – Franchising) Regulations 1998, as amended, incorporating the Franchise Code of Conduct, there are the other aspects about which a prudent franchisor would seek advice. This includes the protection of the franchise system and its intellectual property including its trade marks, copyright, franchise system, trade get up or indicia, confidential information and so on, usually the subject of the extensive definitions of intellectual property, franchise system, franchise business, confidential information and so on in the franchise agreement. Franchise lawyers and participants are well familiar with the wide scope of the definitions.

19. In general terms, a common structure in franchising is to establish a holding entity for that wide compass of intellectual property, be it a company, or trustee company for a trust (unit or discretionary) and a further entity (the operating entity) which may negotiate, provide the disclosure documents and enter into the franchise agreement and related documents. Of course, there are other legal variations and combinations.

20. Moreover, for those franchise systems where 'premises' are necessary, separate entities are often established to own that real estate, or hold it as lessor.

21. Provision for the interplay between the separate entities for the ownership, operations and real estate purposes, and the franchisee (and guarantors) are then provided for in respective licence and/or service agreements, lease (or licence to occupy) and other agreements between the parties.

22. To complete the chain of these related parties (leaving aside the issue of where they have different ultimate owners/beneficiaries), the licences and/or service agreements are put in place on arms length (or non arms length) terms, which provide for protection, risk reduction and asset allocation, in line with the relevant accounting advice.

23. Often, in the Australian context, as part of this 'corporate' structure, are interspersed trusts (either unit or discretionary). That species of property, rising out of the Court of Chancery but having its original genesis under Roman Law, whereby, in essence, property is held by one party for the benefit of another. It is not the purport of this paper to provide a detailed analysis of the various corporate, trust and tax structures available in Australia, other than to recognise that a franchisor may have already invested significant time, effort, resources and money in obtaining sophisticated legal and accounting advice underpinning their operations in Australia, and this structure is working, at least to the extent that the franchisor is considering expansion of the franchise system to the U.S.

U.S. Structure: some general considerations

24. Having so invested, and developed a working structure with which the franchisor, its Board of Directors, Senior Executives, Managers and employees, with internal departments reflecting this, and its lawyers, accountants and consultants (franchise or others), familiar with this model, the franchisor may approach an expansion on the basis that this structure can be maintained, and used or adapted with minor variations for use overseas. Or at least, ask the question, why not?

25. After all, with such a significant investment, will not this be satisfactory as the base to use to expand to the U.S.? This investment will have included the development of a Franchise Disclosure Document compliant with the Franchising Code of Conduct, the Franchise Agreement and the ancillary agreements which include not only those documents required pursuant to clause 11 of the Franchise Code of Conduct (such as the advice statements about independent legal, business and accounting advice) and such annexures as the prior representations statement (or rather prior 'non-representation' acknowledgement), authorities to complete documents, with particular powers of attorney, such as to ASIC, in respect of business name and other requirements, trade mark user agreements, software licence agreements, and where a previous franchisee has had an interest, specific disclosure about that, such as in a 'franchise territory history' document, guarantees and so on.

26. We will return to consider specific aspects relating to the suitability of a common Australian structure to expansion to the U.S. shortly.

27. The existing Australian operations and the past experience of expansion in Australia.

28. These considerations are primarily business orientated. That is, for the franchisor to have done its 'due diligence' on the state of its current franchise operations and that they are well managed, the systems support the franchise, they are working smoothly and the business lessons of expansion have been learnt. That is, those litany of commercial aspects that are part of a franchisor's expansion, which are covered in the publications previously referred to at the beginning of this paper and which issues include:

- the Australian geography and demography and its logistical challenges to extend new franchises, not only to neighbouring suburbs, but across our expansive cities, and the tyrannies of distance and the limited markets, in less populated locations. For a franchisor to have coped with these challenges in the Australian market with its comparatively low population base, the increased size and concentration of populace in the U.S. can be inviting;

- the attendant support/training challenges that arise;

- the capital requirements, and the increased franchisor expenses that seem concomitant with the increase in franchisees, let alone to support the franchise system in the U.S.;

- the franchisor's additional employees/consultants/field representatives/agents etc to help support the expanded franchise network;
- new premises or facilities either being purchased or leased by the franchisor (or by a related entity) and consequently, whilst the acquisition may assist the asset side of the financial statements, there is also a usual increase to the liabilities on the balance sheet. Some franchisors where 'sites' or premises are relevant, and seen as critical, may choose to take the head lease, whilst others have the franchisee do so. Protection of the site and access to it by the franchisor in the event of a change is built in to the franchise agreement, lease or licence to occupy;
- whether warehouse/manufacturing/supply requirements are able to be met and that the supply chain logistics have been fine tuned.

29. Whilst it may not be strictly part of the lawyer's retainer, depending upon that scope, the franchisor in answering the questions that are relevant for the lawyer's advice about the franchisor's current legal documents in Australia for use overseas will also raise, perhaps indirectly, that experience. In particular, underpinning the franchisor's system will be the 'Operations Manual(s)' and other necessary documents supportive of the franchise system, which are the backbone of the franchise system and which have legal significance. They are inevitably made subject to the terms of the franchise agreement and a critical part of the legal arrangements with the franchisee.

30. In the absence of a new financial participant, by way of equity, funding or otherwise, it will be the Australian operations, profits, and perhaps capital contributions from the owners, and/or lenders and/or new equity participants which will have to fund the U.S. expansion.

31. Will the franchisor be able to utilise its, e.g., Operations Manual(s) in the U.S. without change and, if change is necessary, the cost involved in adjusting the Operations Manual(s) for the local circumstances to be found there. As we will see, local circumstances in the U.S. may mean not only which State, but which County or local area a particular franchise is located.

32. Reference has been made to the existing franchise documentation being used in Australia by the franchise system, including the Australian Disclosure Document, the Franchise Agreement, and such ancillary documents as the independent advice certificate, the non-representations deed, the software licence, the trademark licence, the guarantees and so on.

Approach to U.S. structure

33. A question posed was this; Can an entity (entities) in the franchisor's existing structure be used to franchise directly to the U.S.? This is distinct from the question <u>should</u> the franchisor do so ... this is an issue that shall be addressed from the American side of the equation. Some American franchisors coming to Australia have sought to maintain as much of the structure and integrity of their existing system and franchise documents as possible and, for example, kept them subject to U.S. law (usually of a State ,such as for example, New York or Delaware and others). Why cannot the reverse apply? Can an Australian franchisor franchise into the U.S. with minimal changes to

its existing structure and franchise documentation and for example, subject to the law of Australia? This question is posed to test a possible presumption and belief that before further detailed consideration is given to its Australian position, and what legal options are available to the Australian franchisor in the Australian context. An Australian franchisor 'rushes off' to the U.S.

34. And, if an existing Australian franchisor franchises directly to the U.S., what are some of the legal tax and accounting concerns that arise? An approach on this basis raises some interesting topics for discussion.

35. For many years, particularly in the 70's to 90's era, the Australian franchise market has seen American based franchise systems come to Australia and seek to use franchise documentation almost unchanged. This occurred particularly before the Franchise Code of Conduct and its mandatory requirements came into effect in 1998. To a certain extent, it also continued until the change of the Franchise Code of Conduct in 2008 when foreign franchisors were obliged to comply with the Franchise Code of Practice and provide a Franchise Disclosure Document[4]. A 2008 Amendment to the Franchising code removed an exemption from the Code's requirements for foreign franchisors. As a result the Franchising Code applies to a franchise agreement even if the franchisor is "resident, domiciled or incorporated outside Australia", and grants only one franchise or master franchise to be operated in Australia.

36. U.S. sourced franchise systems, which have been in Australia for some time, and recognised that adaptation to local legal and other requirements is appropriate, have made those changes.

37. What if a franchisor uses an Australian franchise agreement, subject to the law of an Australian State, e.g. Queensland or Australia, and enters into franchise agreements directly with the U.S. sub-franchisor or sub-franchisee? (This is the terminology recommended by the International Franchising Committee of the Business Law Section of the International Bar Association which prepared a lexicon of terms in 1987 to promote the uniformity of use of terminology in international franchise transactions.) This terminology now seems to vary and some systems have adopted their own nomenclature, such as the term master franchisee instead of sub-franchisor, and franchisee for sub-franchisee, where a master is involved.

38. Let's postulate this scenario; Say the franchisor has its officers or employees (from either the franchise entity or, indeed some other entity established in Australia for the U.S. expansion), travel to the U.S. That is, such travel and work being subject to the appropriate U.S. visa requirements, or alternatively, the non-immigrant Visa Waiver Program (VWP) with an approved Electronic System for Travel Authorization (ETSA). At the time of writing up to a 90 day work visa or VWP was reasonably readily granted by the U.S. Consulate, provided compliance with those conditions for entry to the U.S. is established.

39. Besides this compliance with U.S. immigration requirements, albeit for temporary work, and the necessary repeat visits, care needs to be taken for other reasons.

[4] Review of the Franchising Code of Conduct. Mr Alan Wein. 30 April 2003 @ p23, et seq. Which comments on the history of the changes.

Some tax issues

40. There are obviously costs and expenses involved with the travel, accommodation and meetings in the U.S. It is trite to say these could quickly become significant and an issue relates to the maintaining the deductibility of those expenses, such as provided for pursuant to section 8-1 of the Income Tax Assessment Act 1997 which, in part, states:

"8-1(1) You can deduct from your assessable income any loss or outgoing to the extent that:

(a) it is incurred in gaining or producing your assessable income; or

(b) it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income."

41. So, consideration needs to be given where those expenses related to this U.S. expansion are allocated for local Australian income tax purposes.

42. Where there is a sophisticated structure involved, care needs to be exercised as to which officers or employees are involved (from which 'franchisor' entity) and against which entity the travel, accommodation, wages and other expenses are properly attributed. This may seem a self evident observation, but, in practice, the accountants will recognise the not inconsiderable tax and accounting issues which may arise for franchisor's where there are, for example, a number of inter-related companies, corporate trustees, trusts, partnerships and individuals involved. Such attribution of expenses to a particular entity may have other tax consequences, as this paper refers to later, and so this aspect needs to be monitored carefully. A corollary is that the 'franchisor' may find itself in a position where the expenses are not a deductible expenses for their 'preferred' entity or at all.

Some more tax aspects - treatment of income and mode of business

43. Let us assume for present purposes, that there is sufficient compliance with a U.S. State's franchise system registration and/or other non-registration States requirements, and income under the franchise agreement, being 'royalty' payments, commence to the Australian franchisor directly from the U.S. What are the legal and tax implications?

44. Australia's tax treaties are given force of law by the *International Tax Agreements Act 1953,* such as with U.S. Australia Double Tax Convention[5].

45. Of particular relevance for Australian franchisors is Article 12, "Royalties", of the U.S. Convention. I set out Articles 1, 2 and 3 as they are informative, and for convenience:

[5] The International Tax Agreements Act 1953 (Cwth) defines the United States Convention to mean the Convention between the Government of Australia and the Government of the U.S. for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes of income, being the convention a copy of which is set out in Schedule 2, as amended by the United States protocol. The United States protocol means the Protocol amending the above Convention, being the protocol a copy of which is set out in Schedule 2A.

"(1). Royalties from sources in one of the Contracting States, being royalties to which a resident of the other Contracting State is beneficially entitled, may be taxed in that other State.

(2). Such royalties may be taxed in the Contracting State in which they have their source, and according to the law of that State, but the tax so charged shall not exceed 5 per cent of the gross amount of the royalties.

(3). Paragraph (2) shall not apply if the person beneficially entitled to the royalties, being a resident of one of the Contracting States, has a permanent establishment in the other Contracting State or performs independent personal services in that other State from a fixed base situated therein, and the property or rights giving rise to the royalties are effectively connected with such permanent establishment or fixed base. In such a case, the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply."

Article 4 determines what payments are 'royalties' for the purposes of the Articles. Relevantly, if an Australian franchisor is able to fall within this Article, the tax withheld in the U.S. is no more than 5%. This is obviously attractive to Australian franchisors where there is not a necessity, nor other reason, not to repatriate income and profits to Australia.

46. A relevant financial aspect to maintain this financial benefit for Australian franchisors is how to expand into the U.S., and not fall within other provisions of the Australian or U.S. 'tax' legislation.

47. Of particular note, subsection 6(1) (of the *Income Tax Assessment Act 1936(ITTA)*) which refers to "a place at or through which the person carries on any business" relevant to the definition of "permanent establishment". The reference to permanent establishment in subsection 6(1) is also picked up by Article 5 of the U.S. Convention. This provides, inter alia, that the term "permanent establishment" means "a fixed place of business through which the business of an enterprise is wholly or partly carried on, and shall include especially:

(a) a place of management,

(b) a branch,

(c) an office",

(d) ... (i)."

48. A permanent establishment does not necessarily require a location but can be met by having a person who has authority to conclude contacts and habitually exercises that authority (Article 12 (4)(a)).

49. The relevance is that if the activities of the Australian franchisor in the U.S. lead to it 'carrying on a business' within that meaning and that of a 'permanent establishment', it will alter the incidences of taxation and the obligations in respect of both the Australian and U.S. taxation regime.

50. For further clarification, reference also needs to be made to Taxation Ruling TR2002/5:

"Income Tax: Permanent establishment – What is 'a place at or through which [a] person carries on any business' in the definition of permanent establishment in subsection 6(1) of the *ITAA 1936*?"

51. Taxation Ruling 2002/5 applies to an Australian resident such as a franchisor (a person includes company, trust or partnership) which carries on business overseas, such as in the U.S.

52. Article 12(3) of the U.S. Convention provides that where a party (eg the Australian franchisor) has a permanent establishment in the U.S., the franchise fees, in effect, shall not be subject to the lower U.S. royalty withholding tax of 5%. Articled 12(3) picks up Article 7 (Business Profits) and Article 14 (Independent Personal Services).

53. For instance, Article 14(a) has an aggregation provision, so that if more than 183 days in aggregate are spent in the U.S. by a relevant person in the taxable year (noting the U.S. tax year equates to its calendar year), tax is payable, in effect, in the U.S. This provision relates to individuals.

54. The Australian franchisor entity which carries on the franchise business needs to carefully manage such details. This includes consideration of the usual criteria about 'control and management' which forms part of the assessment whether that particular franchisor entity is carrying on the business in the U.S. and through a permanent establishment there.

55. If that entity does not fall within Article 12(2) but Article 12(3) applies, that franchisor entity may be obliged to lodge a U.S. Federal Income Tax return, as well as U.S. State income tax return and a local income tax return.

56. The financial and practical consequences include that the entity may become liable for income tax in the U.S. at a rate up to 35%, together with other possible U.S. State income tax and other local taxes. This may constitute a significant financial difference in terms of cash flow and possible tax effect to the Australian franchisor. Generally, the repatriation of that income is not subject to further tax in Australia by a Company (with S23AH of the Income Tax Assessment Act 1936 providing it will not be taxed) but this is not the same for a trust. Note that the effect is such that on a distribution to shareholders there is no franking credit. It can be tax inefficient.

57. From the Australian franchisor perspective, if the expansion in the U.S. can be managed through the appointment of a sub-franchisor(s) or master franchisee(s) and the more familiar area developer model, so successful in the U.S., and the Australian franchisor itself (or the relevant entity) not be found to "carry on any business through a permanent establishment", it is worth serious consideration.

U.S. structure – commercial issues

58. Of course, much will depend upon the nature of the franchise and the extent to which, in this digital age, the Australian franchisor is able to structure itself and its operations that it will not be held to be carrying on a business in the U.S. and have a permanent establishment there.

59. However, for many Australian franchisors, they will have other commercial and practical aspects to consider. It may be inevitable that for a range of reasons, including the preference to have executives and employees on the ground in the U.S., the logistical reasons, supply, training and development, market development, growth, management of operations, just mentioning some of a long list, that the carrying on a franchise business from a permanent establishment within the meaning of the respective Australian and U.S. tax legislation occurs either by deliberate selection or because of the deeming provisions and the conduct falls within the definitions. At some stage of the franchise system development in the U.S., it may become necessary or preferable not to repatriate cash and profits to Australia on the lower royalty rate, but to retain those earnings in the U.S., such as for further investment in the franchise business. Each decision will of course depend upon the particular circumstances of a franchise system.

60. Reverting back to the consideration of the structural aspects, if it happens that the franchisor entity is or deemed to be carrying on any business through a permanent establishment, consideration needs to be given to the potential establishment of a U.S. entity or corporation and what type. This moves to professional legal and accounting advice from the U.S. in relation to whether that U.S. corporate, should it be a subsidiary, and whether it should be a limited liability company (LLC) or a U.S. C-Corporation or other type of entity.

61. Recalling our earlier mention of trusts, whilst they are a familiar feature of the English and Australian tax landscape, as a general comment, trusts are not a favoured entity for the purposes of carrying on business in the U.S. More prevalent is the U.S. LLC which is treated as a partnership for Australian tax purposes and has some 'flow through' advantages, in general terms, similar to Australian trust provisions. Again, it is not the purport of this paper to provide detailed legal advice about these types of legal entities and what may be more suitable for any particular Australian franchisor crossing the Pacific. This paper is not meant to be exhaustive but rather is intended to touch upon some legal issues which may arise in the panoply of choices.

62. Turning to a different perspective besides the tax aspects, of which there are many, is the choice of law aspects relating to the franchise agreement and ancillary documents. For an Australian franchisor, there is an immediate attraction (just as there is for U.S. franchisors coming to Australia) in having the law governing the franchise agreement and ancillary documents that of Australia or a particular State. The Australian franchisor is familiar with it.

63. Additionally, there may be provisions in the franchise agreement that, in the event of a dispute, that the Australian courts are nominated and/or alternatively mediation provisions under the Franchising Code of Conduct and/or arbitration provisions are prescribed for Australia.

64. Aspects of this may be attractive to an Australian franchisor in that if a U.S. sub-franchisor, franchisee or sub-franchisee seeks legal recourse against the Australian franchisor, they may have to come to the Australian courts. On the other hand, without going into the detail of the choice of law provisions and the appropriate venue considerations 'forum non conveniens' under international law, it may be that the American party seeking recourse sues in an American court which, if it decides it has jurisdiction, is then tasked with receiving expert evidence about Australian law. Of course, there may also be local U.S. laws which are held to apply and which cannot be contracted out of, irrespective of the clauses in the franchise agreement.

65. To the extent it may be relevant, there is no reciprocal enforcement of judgments act with the U.S., such as we have with the United Kingdom and other countries.

66. However, if it is the Australian franchisor which seeks recourse against an American sub-franchisor, franchisee or sub-franchisee, whilst in theory it could bring those proceedings in an Australian court, in the absence of a reciprocal enforcement of judgments act, there is an involved legal process to register a judgement or order. Even with arbitration proceedings and the ability to enforce an arbitration award, particularly pursuant to such as the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (commonly known as the New York Convention), and to which over 125 countries are signatory, legal process, time, resources, costs and practical difficulties would continue to apply. The direct approach of seeking recourse against the American party in the appropriate American court where a judgment may be enforced could well be a more effective outcome.

67. Consequently, depending upon the nature of the Australian franchise system and how it could develop a plan to successfully expand in the U.S., if the Australian franchise could grow quickly, and across various U.S. States the desirability of addressing the legal, accounting and tax requirements earlier in the life of the franchise expansion in the U.S. would appeal.

68. Having liked what the Australian franchisor finds in the U.S., and subject to all the other commercial and practical considerations, the level of visits, work and optimism arises. A U.S. sub-franchisor, direct franchisee or sub-franchisee is interested and the question arises; what compliant steps need to be taken to use the Australian franchise documents in the U.S. and meet U.S legislation, Federal and State, and which may apply and cannot be excluded, even by agreement of the parties.

69. As the paper later elucidates, there are a significant number of other legal aspects to take into account.

U.S. specific considerations

70. Having established the current legal and accounting structure of the franchise and its historical operations, we move to the U.S. specific considerations, including:

Where in the U.S. should the franchisor start, where should it locate its headquarters?

71. Demographically, the U.S. is very similar to Australia, but not extremely so. Australians often fail to realize that a majority of the population of the U.S. lives east of the Mississippi River. At first blush, Australians consider California as the preferred location for their headquarters: It is geographically closer and easier to commute to and from, and the time difference is easier to deal with, as compared to the time difference in the eastern part of the U.S.

72. However, Eastern cities (and in particular Atlanta and Chicago) are more central to the majority of the population.

73. California is also less business friendly than many of the other U.S. states. It is jokingly referred to as the "Left Coast." The regulations in that state are often much more cumbersome than in other states, and its tax structure is more burdensome.

Can the franchisor's franchisees operate profitably in the U.S.?

74. The challenge here is to build a prototype that will demonstrate that the franchisees will be economically successful without violating the U.S. franchise sales regulation statutes or the Federal Trade Commission's Franchise Rule. The easiest way to do this is to start with a company-owned unit. There is no legal requirement to do so, but it will be harder to attract a prospective franchisee without having a least one prototype on the ground running in the U.S.

75. Unfortunately, many foreign franchisors jump right into franchise sales, only to discover that the economic model that has prospered in their native country does not translate well into the U.S. market.

76. First, the potential sales revenue may be significantly less than would be the case in Australia because the business being franchised may be less appealing to residents of the U.S. than it is to Australians.

77. Second, the cost structures may vary considerably between these two markets. Typically, labour and rent or real estate costs are the variables that affect profitability the most. However, these are generally more favourable in the U. S. than in Australia. Also, the availability of capital can affect a franchisor's ability to operate profitably in the U.S.

What is the status in the United States of the franchisor's trademarks?

78. Trademark law is different in the U.S. than the trademark laws of most other countries in that trademark rights in the U.S. may accrue simply by the use of the mark as well as by registration. Filing and prosecuting a trademark application does not pre-empt prior use.

79. For example, if Fred's Burgers wants to enter the U.S. market, it should have a trademark search undertaken to see not only if there are any registrations of similar marks, but whether other businesses are using the proposed marks without having filed for or obtained registered status for their marks. If the search determines that there are other users of similar marks, the non-

registered marks will have priority over Fred's Burger in the markets where the senior users have been doing business. Under U.S. law, the validity of the Fred's Burger mark, even if successfully registered by the Australian franchisor, may be challenged for five years after a registration is granted.

80. One way to reduce this risk in these circumstances is to file a federal registration that excludes the area where the Fred's Burger mark is then being used by another business. This is known as a concurrent use application, which effectively limits the senior user from expanding into markets where its non-registered mark is not being used at the time the junior files its concurrent use application. However, when the mark has already been registered by the senior user, this strategy will not protect the junior user if the senior user later expands into the junior user's market, regardless of when this occurs.

81. Given the risk involved in not having secured trademark rights, the expenditures to have a search performed and analysed is well worth the cost.

What entity will be the franchisor, and who will own that entity?

82. As noted earlier, franchisors should involve lawyers or accountants familiar with international tax issues before finalizing their U.S. franchise programs. This is not a problem unique to franchise systems. Among other issues, the franchisor or an affiliate of the franchisor will need to include its audited financial statements in the franchisor's Franchise Disclosure Document ("FDD"—the U.S. term used to describe the franchisor's offering circular), and the net worth of that entity will be at risk if something should go wrong. Hence, it is common to set up a U.S. entity to avoid exposing the Australian franchisor's net worth to tort, vicarious or contractual liability.

83. There are also significant tax issues that should be addressed before the U.S. franchise program commences.

84. One other notable difference between the U.S. and Australia is that no one uses trusts as part of their corporate structure in the U.S.

Will Australian executives or other Australian personnel be based in the U.S. and if so, where?

85. For the most part, Australians who plan to relocate to the United States will not have any significant immigration problems. The U.S. immigration laws are generally business friendly.

86. The tax effects on Australians who are employed in the U.S. should be investigated before it is decided that Australians should be relocated to the U.S.

87. There are many other factors that should be investigated from the personnel's individual standpoint: how easy will it be to commute to and from Australia? Climate? The quality of elementary and secondary schools, and whether private schools, which are very costly in the United States, need to be given consideration in lieu of public schools.

Where does the franchisor plan to sell franchises in the United States?

88. Franchise regulation, both in the sales and relationship areas, is considerably more complex than franchise regulation in Australia. This adds considerable cost and complexity to setting up and operating a franchise system in the U.S.

89. In the U.S., franchise sales are regulated at both the federal and state levels. The U.S.'s Federal Trade Commission's Franchise Rule is similar to Australia's Franchise Code of Conduct, in that both require disclosure to the prospective franchisee before a franchise sale can be consummated. However, in the area of franchise sales, there are also thirteen U.S. states that require franchises to be registered with state governments before they can be offered for sale in those jurisdictions. In all of the other states, the franchisor must comply with the FTC's Franchise Rule, but no registration is required under the FTC Franchise Rule.

90. With the exception of sales of petroleum and automobile franchises, there are no federal laws governing issues of franchise relationships (i.e., terminations, non-renewals, restrictions on franchise transfers, organizational rights of franchisees, and restrictions on product sourcing). At the state level, some seventeen states regulate the franchisor's conduct in one or more of the areas identified above (as well as a few other areas). The statutes vary considerably from state to state.

91. Franchisors may have to comply with U.S. business opportunities laws, which have been enacted in 23 states. The definition of a business opportunity is, in many states, broad enough to cover franchises, but most of the time, franchise sales will be exempt from the disclosure or registration provisions of these statutes.

92. Returning to the subject of franchise sales, often foreign franchisors decide to register in all the states that require registration immediately upon entering the U.S. market. This is not necessarily a cost effective strategy. There are several registration states where t is unlikely that the franchisor will be offering franchises in the beginning because the population of those states is small, or the locations of those states are not where the franchisor plans to begin its campaign to penetrate the U.S. market. As most Australians will acknowledge, it is difficult to penetrate any market completely all at one time. Imagine how difficult this is when the market is 15-20 times larger than the Australian market. It is said, "when you eat an elephant, take one bite at a time."

Documentation

93. In addition to the above necessary and relevant questions to test the extent to which the franchisor has done its homework and is prepared to venture across the Pacific, there are further questions which arise, such as:

Can the Australian Disclosure Document, the Australian Franchise Agreement and other ancillary documents be used in the U.S. without change?

94. While the Australian Disclosure Document and form of Franchise Agreement, and if needed, Area Development (often referred to in the U.S. as an "Area Representative") Agreement, or Subfranchise Agreement, will be helpful to whoever prepares the documents needed to sell franchises in the U.S., U.S. laws and best business practice will require or suggest that these documents be altered considerably in order to effectively sell franchises in the U.S.

95. The U.S. laws affecting franchise sales have disclosure requirements that have marked differences from the Australian documents. To give only a couple of examples, the U.S. laws are very burdensome when it comes to disclosures of information about expected financial performance of prospective franchisees (these kinds of disclosures are referred to as "financial performance representations" and will be discussed further below). U.S. disclosure laws will also require that the franchisor's financial statements be audited in accordance with U.S. generally accepted accounting principles.

96. There are few restrictions on what can and cannot be included in the franchise agreements. However, franchise documents used in Australia have different attributes than U.S. documents, and therefore may appear strange to prospective franchisees if they compare them to documents used by domestic franchisors.

97. First, stylistically, U.S. agreements read more like prose, while Australian documents are more staccato like—with each phrase being identified with section, subsection and further levels of subsection monikors.

98. Second, Australian documents tend to be more specific on many operational aspects of the franchise, while U.S. franchisors tend to place these provisions in their operations manuals.

99. Third, some Australian legal concepts or practices, such as the use of trusts, or the language to describe arrangements granting franchisors security rights in tangible or intangible property, are either foreign to the U.S. franchise market, or have to be rewritten to conform to U.S. practices.

100. And finally, there are some language differences, especially in spellings. In the U.S., the Australian "z" often translates into an "s", and "ou" translates simply into the letter "o." And "trade mark" in the U.S. becomes "trademark."

Structure of the franchise system in the U.S.?

101. What will be the structure of the franchise system in the U.S.? E.g., Will there be a simple two-level franchise (franchisor/franchisee)? Or will there be sub-franchisors or area developer structures (three-level franchising)?

102. These are critical questions for a franchisor coming to the United States. For the most part, the business considerations are very similar in both countries. Historically, the Australians have been more attracted to three-level franchising, while only recently have three-level franchise systems become more prevalent in the U.S.

103. The U.S. state registration requirements in 13 jurisdictions can be very difficult to comply with in three-level franchises, because area development rights themselves are considered franchises. Thus, a three-level system will need registration filings and the sub-franchisor or area developer will have to file and prosecute registration applications as well. It can easily cost three or four times as much in legal fees and filing fees to set up a three-level system as compared to the cost to set up a two-level franchise system.

Additional legal aspects

104. Additional legal aspects need to be addressed to adjust an Australian franchise to the U.S. legal environment.

105. Financial performance representations and limitations and qualifications on use.

105.1. As referenced above, franchisors are allowed to make financial performance representations ("FPR's") when offering franchises for sale in the United States, subject to certain conditions. First, the FPR must be included in the FDD, with limited exceptions. Second, there must be a reasonable basis for the FPR. Third, the franchisor must be willing to give a prospect access to the information that substantiates the FPR.

105.2. This is a topic that needs careful attention for franchisors coming to the United States. In particular, the foreign franchisor must be aware as to what constitutes an FPR. It need not be expressed in dollars (e.g., "You can earn enough to buy a new Jaguar in your first year of operations."), and approval of business plans by a franchisor can constitute a FPR. Surprisingly, less than 50% of franchisors make FPR's, although this percentage has increased dramatically in the last decade.

106. Mandatory arbitration or mandatory mediation, or neither.

106.1. Thirty years ago, mandatory arbitration clauses were found in very few U.S. franchise agreements. Today, they appear in about half. Arbitration is a very controversial process in the U.S. for reasons too lengthy to delineate in this article. In many instances, it has not proven to be quicker, cheaper or more private, some of the virtues espoused by supporters of arbitration. Often, the presence of an arbitration clause leads to numerous side shows, especially when portions of claims remain subject to judicial resolution. Should these side show issues be resolved in court or in the arbitration?

106.2. Mediation has a much different history. Unlike Australia, there are no mandatory mediation requirements in the U.S. unless the franchise agreement so provides. However, courts have recently required disputants to engage in mediation at various points in a judicial proceeding. Also, both franchisor and franchisee advocates have seen mediation lead to resolution of disputes early on and with substantially less cost than would have been the case with litigation. Thus, at this moment, mediation is the fair-haired child for the resolution of disputes, and it is now more common to find mandatory mediation clauses in franchise agreements.

107. Excluding jury trials.

107.1. Unlike Australia law, U.S. law permits one or both of the parties to demand trials by jury in most civil matters. Franchisees generally like jury trials; franchisors generally do not. In any event, it is quite common to find waiver of jury trial provisions in U.S. documents.

108. Selection of relevant law of the contract, e.g. Australia or that of a U.S. State.

108.1. Lawyers and other professional advisors may have different views about this aspect. As part of the tapestry of overseas franchises which have come to Australia, particularly those from the U.S, there remain U.S. lawyers adamant that the franchise agreement and other documents be subject to U.S. law. It is not the intent of this paper to debate that in detail.

108.2. From the Australian franchisor's perspective, just like the U.S., there are a number of different aspects to consider. Without setting out all of the arguments, some of which have been earlier eluded to in this paper, there are certainly benefits in having a choice of law clause and the forum which are directly relevant to the country in which the franchise system (not necessarily the franchisor) is carrying on business.

Professional advisors and other support

109. Should a franchisor retain a franchise consultant?

109.1. There is no legal requirement that a franchisor entering the U.S. market retain a franchise consultant. Nevertheless, franchise consultants can be most helpful to the franchisor who is new to the U.S. market. Franchise consultants typically will provide full franchise system preparations in their entirety or advice on narrower subjects. Some franchise consultants will prepare franchise documentation, although, not surprisingly, U.S. lawyers consider this to be the unauthorized practice of law and hence illegal.

110. Banker, banking and finance arrangements.

110.1. One important issue a franchisor coming to the U.S. must address is financing. Will it be needed? If so, would it be better to arrange franchisor financing with an Australian bank or other lender, or with a U.S. bank or lender. Establishing a relationship early with a U.S. bank or other lender can be a good use of resources even if no borrowing is contemplated.

110.2. There are also numerous companies that specialize in franchisee lending. While institution interest in making loans to franchisees may be limited at first, as the franchise system evolves, interest in franchisee lending should increase. It is never too early to start talking to lenders.

110.3. The U.S. Small Business Administration (“S.B.A.”) will guarantee certain loans made to franchisees. The terms of the franchise agreement will often be one of the main points of

objection by the S.B.A. in determining whether to make a loan. The S.B.A. does not want franchisors to retain excessive control. The S.B.A. now allows franchisors to apply to get their form of franchise agreement pre-approved, simplifying the path to successful borrowing by franchisees interested in taking advantage of S.B.A. guaranteed lending programs.

111. Insurance arrangements

111.1. Insurance for the franchisor and its franchisees is a must, not legally but practically, and experience has suggested that the scope of insurance policies in the U.S. and Australia are similar. Among other types of insurance, in the U.S., franchisors can obtain "Errors and Omissions" insurance covering their and their employees' sins in connection with franchise sales and operations. This kind of insurance is generally very expensive.

111.2. Franchisors are recommended to find a good, commercial insurance broker early on in the process of going abroad.

112. Does the franchisor have a U.S. accountant? If not, how does the franchisor find one?

112.1. The choice of accountant in the U.S. is critical for several reasons. First, as noted above, the rules governing federal and state franchise sales require that the franchisor provide prospects with audited financial statements, and these statements must be prepared in compliance with United States generally accepted accounting principles. The FTC Franchise Rule does not permit the use of international or foreign financial statements unless they meet this requirement or the audit report shows how application of U.S. accounting rules would alter the financial statement presentation.

112.2. Second, a good accountant will be helpful in the preparation of a financial performance representation should the franchisor elect to include one in its FDD. The accountant can also be helpful in assisting franchisors to test their concept's profitability.

112.3. It is not necessary that the accountants be one of the Big Four or otherwise a very sizable accounting firms, although an accounting firm experienced in international business transactions should certainly be considered. Certification of financial statements by a large accounting firm does not necessarily increase the saleability of franchises.

113. And finally, the lawyer.

113.1. In the U.S., the lawyers often play multiple roles for inbound franchisors. Of course, their primary role is to give legal advice to the franchisor coming across the pond. Second, they often give business advice to the franchisor, depending upon the lawyer's experience. And third, lawyers can be excellent sources for referrals to other professionals and companies who are suppliers of professional services to franchisors—accountants, lenders and insurance brokers, to name only a few.

113.2. Lawyers are licensed by the states in which they practice. It is rare that lawyers will have licenses to practice in more than two states, although it is commonly accepted in the U.S. that lawyers who focus their practice on franchising may give legal advice to clients in other jurisdictions in which the lawyer is not licensed. With the exception of California, no state certifies lawyers as being expert in franchise law.

113.3. There are many sources for referrals to U.S. lawyers who are experienced in franchise matters. An Australian attorney who practices franchise law is likely to know colleagues in the U.S. who practice in this area. The American Bar Association's Forum (i.e., section) on Franchising has a directory that names lawyers who are members of that group, as do some State Bar Associations that have franchise law committees. Other professionals can also be sources for referral names.

113.4. The two important points to keep in mind when hiring a U.S. lawyer are: (1) to find someone who has more than casual exposure to franchise issues; and (2) to bring him or her into the process earlier rather than later.

113.5. Legal fees in the United States, on an hourly basis, are generally in the same range as Australian legal fees.

Conclusion and caveat

114. The U.S. market has its challenges for franchisors interested in going abroad, but the mere size of the market and the common cultural backgrounds nevertheless make it an attractive market for expansion.

115. U.S. laws relating to franchise are numerous and, not unexpectedly, complex. The discussion above is by its nature only a summary of a part of the legal regulatory scheme in the United States, and should not be construed as complete, or as legal advice , or as establishing any type of attorney-client relationship between the authors of this article and any readers or attendees at the conference for which this paper was created.

Reference Materials

116. There are a myriad of articles and books discussing franchise law in the United States. Sources for more information about the U.S. legal system as it relates to franchising include:

116.1. *Franchising For Dummies* — A book covering in very basic terms some of the issues that prospective franchisors and prospective franchisees will face.

116.2. *Fundamentals of Franchising* (*3rd edition*) — A primer on franchise law published by the American Bar Association's Forum on Franchise [Mr. Barkoff is a Co-Editor-in-Chief of this publication.]

116.3. *The Franchise Lawyer* — A quarterly publication by the American Bar Association's Forum on Franchising containing practical articles on franchising.

116.4. *The Franchise Law Journal* — A quarterly publication by the American Bar Association's, Forum on Franchising containing scholarly articles on franchise law and related subjects.

117. For information about membership in the American Bar Association by foreigners, contact Yolanda Muhammad - at the American Bar Association (312.532.5014; e-mail Yolanda.Muhammad@americanbar.org).

118. This paper is a co-production by Mr Rupert Barkoff, of Kilpatrick Townsend. Mr Barkoff is the author of those portions relevant for the U.S. jurisdiction. Tony Conaghan of Thomsons Lawyers is the author of the Australian aspects and solely responsible for that part of the paper. Mr Conaghan would like to acknowledge the contribution made by his corporate and tax partner Mr Philip Byrnes also with significant international experience.