

WORKSHOP – EXPORTING YOUR FRANCHISE SYSTEM

- Overview
- Stewart Germann will cover the following topics:
 - Franchising Laws in other Countries
 - Protection of Intellectual Property
 - Structures
 - Tax Issues
 - Use Experienced Advisors
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- David McCulloch will cover the following topics:
 - What can be exported?
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BRIEF CV OF STEWART GERMANN

Stewart Germann who has the qualifications of BCom/LLB from the University of Auckland, FCIS, MNZIM and Notary Public was Chairman of the Franchise Association of New Zealand from 1997 to 1999. Stewart Germann brings to his clients a wide range of experience in all aspects of franchising and licensing. He has a proven track record in New Zealand and overseas which includes the following:

- First franchisor client in 1980
- Instrumental in the formation of the *Franchise Association of New Zealand* in 1996
- Chairman of the *Franchise Association of New Zealand* from 1997 to 1999
- Affiliate member of the *Franchise Association of New Zealand*
- Member of the *Franchise Council of Australia Limited*
- Member of the *International Franchise Association* (IFA) being the USA association since 1995 and the only New Zealand member
- Board Member of the Supplier Forum of the IFA from 2001 to 2007 and the first person from outside North America on that Board
- New Zealand member of UNIFRAN, a franchise alliance of overseas lawyers currently in Australia, USA and the UK
- Included in the *International Who's Who of Franchising Lawyers* and one of only two New Zealand lawyers in that listing
- Member of *Licensing Executives Society of Australia and New Zealand*
- Affiliated with Mason Sier Turnbull, Lawyers at Melbourne with franchising experience
- Speaker on franchising law at conferences in New Zealand, Australia and the USA
- Has spoken in the UK on franchising on behalf of the British Franchise Association.
- Actively involved in international franchising
- Notary Public for life and able to witness documents for use in overseas jurisdictions

Stewart Germann was judged the **Winner** of the **Service Provider of the Year** in the **New Zealand Franchise Awards 2004**.

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FRANCHISE LAWS IN OTHER COUNTRIES

1 Australia

There is a Mandatory Code of Conduct with emphasis on disclosure and compulsory mediation.

The major proposed changes to the Code relate to the disclosure document and strict time periods and it is also proposed that the auditing of marketing accounts will become mandatory. Importantly, the single foreign franchise exemption which is now available will be removed and the financial disclosure obligations relating to the franchisor will be extended to the consolidated entity of which the franchisor is a member. The unconscionable conduct provisions of the Trade Practices Act will be amended so as to add to the relevant indication of unconscionable conduct, the enforcement of a contractual right to unilaterally vary the terms of the contract and the enforcement of a contractual right to terminate a Franchise Agreement without cause. Previously the changes were due to take effect in late May 2007 but they will now not be implemented until later this year.

2 Canada

There is no Federal franchising law in Canada. However, some provinces have statutes dealing with franchising and they must be complied with. The largest area is Ontario and the relevant laws are contained in the Arthur Wishart Act (Franchise Disclosure) 2000.

3 China

On 1 February 2005 the Measures for the Regulation of Commercial Franchisors issued by China's Ministry of Commerce (franchise measures) came into effect. Since then, the measures have been the subject of ongoing discussion within the international franchising community. On 31 January 2007 the Regulation on the Administration of Commercial Franchise (Regulation) was adopted and it became effective on 1 May 2007. Regulation introduces a number of changes including the "Two Plus One" Rule which means that a franchisor (or its subsidiary) must have operated at least two stores for more than a year before a franchisor can franchise in China. Also, there is a new requirement for the filing of initial franchise documentation including the franchise contract, the operations manual, a market plan and other supporting documentation. Great care must be taken if China is chosen as a future market.

4 European Countries

Most countries like France, Germany and Italy have disclosure laws but relevant due diligence must be done in each country. There is no one rule.

5 India

There is no specific legislation regulating franchise arrangements in India but there are various laws which affect the relationship between franchisors and franchisees, including intellectual property laws, taxation, labour regulations, competition laws, property and exchange control.

6 Indonesia

There is a Franchise Law in Indonesia which defines a franchise. Foreign franchisors have to meet the legal requirements and relevant documents have to be legalised by a foreign authority and attested by the Indonesian Consulate. The franchise agreement must be executed in the Indonesian language (an English translation may be attached) and the agreement must be governed by Indonesian Law. The term of a franchise agreement must be for at least five years and the franchisee is required to submit a report on the development of the business to the Ministry of Trade every six months. There is also Anti-monopoly and Unfair Business Competition law.

7 Japan

Franchising in Japan is one of the least regulated industries. Franchisors are not required to be licensed and do not have to register or file any documents. Franchisors must comply with Guidelines on Franchising under the Anti-monopoly Act. If the Medium-small Retail Business Promotion Act applies then a franchisor must provide a disclosure document.

8 Korea

Franchise contracts must comply with the Commercial Act. Also there is a Fair Franchise Practices Act and a Distribution Industry Development Act.

9 Malaysia

The Malaysian Franchise Act 1998 sets out a legal definition of a franchise and regulates those business models that fall within the legal definition. There is a mandatory requirement for registration of all franchises with the Registrar of Franchisors. Franchise agreements must contain a cooling off period and foreign franchisors intending to sell a franchise in Malaysia must obtain the approval of the Registrar.

10 Philippines

There are no laws regulating the offering and selling of franchises. However, franchise agreements are regulated under the technology transfer provisions of the Intellectual Property Code.

11 Singapore

There are no franchising laws.

12 Thailand

There is no specific legislation in relation to franchising and any franchise agreement must comply with the existing laws which include the Unfair Contract Terms Act 1997.

13 USA

The US has had a Federal registration system for franchising for many years. The Uniform Franchise Offering Circular (UFOC) which is tantamount to a disclosure document must be registered. In January 2007 the Federal Trade Commission announced revisions to the Franchising Rule. All franchisors are now allowed to use electronic means to deliver disclosure documents and financial performance representations (i.e. Earnings Claims) remain optional, not mandatory. A number of States in the US have their own franchising laws so particular care must be taken.

PROTECTION OF INTELLECTUAL PROPERTY

In New Zealand we have the Trade Marks Act 2002.

Australia has a similar Trade Marks Act.

It is essential that a franchisor's trade marks are registered in each overseas country where that franchisor wishes to do business. I brief out all my Trade Mark work to Baldwins, Patent Attorneys, and some relevant information from Baldwins is **attached** to this paper.

In particular, please note the Madrid Protocol and the good news for New Zealand is that it will become a member of that Protocol in late 2007. Expert legal advice must be taken in the area of protection of intellectual property which includes not only trade marks but patents, registered designs, copyright and trade secrets.

LEGAL STRUCTURES

1 International Markets

A number of mature New Zealand franchise systems may look at going overseas into international markets in order to further develop and expand the business. One such New Zealand brand is Fastway Couriers which started over 15 years ago in Napier. Bill McGowan is the originator and owner of the Fastway system and he spread the system by using the franchising model throughout New Zealand. Fastway Couriers then went into Australia, Asia, the UK and Europe and I understand that it will be penetrating USA this year if it has not done so already.

What are the best international markets for New Zealand franchisors? The obvious choice is Australia because it is the closest market with huge franchising activity and success. Other markets are Singapore, Malaysia, the United Kingdom, Canada and USA. Another New Zealand franchisor called VTL (originally Vending Technologies) is franchising in New Zealand, Australia, the UK, Belgium, France, Germany and USA.

In going into any international market care must be taken in relation to the method of exporting a franchise. The methods which a New Zealand franchisor may use include the following:

1.1 Direct Franchising or Unit Franchising

This is a method whereby the franchisor grants a franchise to one person or company to operate one franchised outlet. The unit franchisee obtains the right to operate either from an agreed location such as a retail store within a shopping mall or within a defined territory. This type of franchise does not grant the franchisee the right to operate in different locations or territories in the future and does not permit the franchisee to subdivide or sub-franchise his territory or to sell any interest in the franchise to a third party without the franchisor's approval. A unit franchise agreement does not necessarily protect the franchisee from competition from the franchisor or other franchisees operating under the same trade mark.

1.2 Area Development Franchising

Like unit franchising this only involves two parties. In an area development franchise, the franchisee is granted a territory within which the franchisee agrees to establish a certain number of franchised units during a specified period of time. Area development franchising is usually accomplished through the use of an area development agreement which specifies the territory, the development schedule, and procedures for obtaining the franchisor's consent to open each unit. It is very important for unit franchise agreements to be executed before each separate franchised unit opens.

1.3 **Master Franchising**

Master franchising, also known as sub-franchising or regional franchising, is conceptually different from area development franchising in one material respect – master franchisees are encouraged to recruit third parties who will

1.4 **Conversion Franchising**

Conversion franchising which is sometimes called “affiliation franchising” occurs when a pre-existing business takes on the identity of a franchisor and agrees to conduct future business using the franchisor’s business systems. For example, if a boutique hotel trading under its own name decided to join the Hyatt chain, it would change its name to Hyatt and would participate in the chain’s advertising, reservation system, purchasing, training programme and other material benefits. It would have “*converted*” from one identity to the franchise identity. If rapid entry into a market is desired or if the cost of establishing new businesses is determined as too expensive by a franchisor, conversion franchising is often used. I have seen it used successfully in relation to hair salons.

1.5 **Joint Ventures**

A joint venture is a form of partnership which usually, but not necessarily, is limited to a single transaction or business venture. Normally, the rules of liability for joint ventures are identical to those of general partnerships. The franchisor will form the venture with a local partner. They may create a company, partnership or any other form of business structure recommended by their lawyers. The franchisor usually contributes to the joint venture a licence of its trade marks, its know-how, manuals together with start-up services and on-going support services as agreed. The local partner usually contributes most of the required capital, human resources and the management skills which the business will require. In some cases, the local partner may have a majority interest in the venture but the franchisor will exercise substantial control with many of the controls being of a similar nature to those exercised by any franchisor in a master franchise relationship. The rights and duties of the joint venture partners (sometimes called the joint venturers) may be specified in a separate operating agreement.

Probably the most common mode is master franchising but this method does not fit every franchise system and expert professional advice must be obtained in all cases.

2 **Australia**

Probably the majority of the franchise systems coming into New Zealand come from Australia. Before coming to New Zealand most Australian franchisors should have been operating in Australia for a number of years and they would no doubt have been operating in the states of Queensland, New South Wales,

Victoria and (commonly) Western Australia. Some Australian franchisors may not have penetrated South Australia or may have gone there in a reduced way, and most Australian franchisors seem to leave out Northern Territory and Tasmania. An Australian franchisor will use one of the methods as I have mentioned above but the most common is master franchising whereby the Australian franchisor will appoint a master franchisee in New Zealand. The New Zealand master will have the whole of New Zealand as its territory, will have to open one or two unit franchises and, after a bedding in period, will be able to appoint franchisees in New Zealand. The New Zealand master will have to pay an upfront master franchise fee to the Australian franchisor together with a proportion of the royalty income from the New Zealand franchisees. Often the New Zealand master will also have to pay a percentage of upfront franchise fees receivable from New Zealand franchisees. A double taxation treaty exists between New Zealand and Australia so any monies payable to the other country will require non-resident withholding tax to be deducted in the country of source but the respective franchisor will be able to claim a tax credit in its own country. In all cases involving the exporting of franchises expert taxation advice must be obtained.

3 **Which Court has Jurisdiction?**

In franchise agreements which I write in New Zealand I always insert a governing law clause which says that the governing law is New Zealand law. If a New Zealand franchisor wishes to go into Australia then the governing law clause must be carefully considered. Should it contain a stipulation that the parties must comply with New Zealand law or with Australian law? In relation to Australian law, if a New Zealand franchisor appoints a master franchisee in Queensland then one possibility is for the governing law clause to be the laws of Queensland, Australia. It is no good saying Australia on its own as each state has its own peculiar laws which may or may not be similar to other states. However, the Code of Conduct is a Federal statute which applies to the whole of Australia, and no franchisor can contract out of the obligation to provide a disclosure document pursuant to the Code of Conduct. Further, in Australia there have been many cases involving oppressive conduct and great care must be taken by any New Zealand franchisor not to fall foul of such conduct.

4 **Summary**

In summary, the international aspects of franchising are very exciting. There is always a new international market – for example, India is fast expanding as a franchising country – but great care must be taken. A lot of money can be wasted in trying to go into another country and in all cases a franchisor must complete its own due diligence including a visit to a potential overseas market and a competitive analysis before making the final decision to proceed.

TAX ISSUES

Professional taxation advice must be obtained by overseas franchisors on a country by country basis. A New Zealand franchisor will want to repatriate income from the foreign country back to New Zealand. It is important to know whether a double taxation treaty exists with the country with which the New Zealand franchisor is doing business.

I **attach** a copy of a Paper which has kindly been provided by Chris Lindsay, Tax Partner of WHK Gosling Chapman.

SUMMARY OF TAX ISSUES FOR NZ FRANCHISORS ESTABLISHING FRANCHISES OFFSHORE

1. Determine the Legal Structure

- Offshore Master Franchisee owned by NZ Franchisor
 - o Consider which structure is most suitable
 - § Should Master Franchisee entity be a Trust, Company, Unit Trust, Partnership etc? Consider both commercial and tax implications in both NZ and the offshore location
 - § Should Master Franchisee entity be established in NZ or in the offshore jurisdiction?
 - i.e. should the Master Franchisee be a Branch of a NZ entity or should the Master Franchisee be an entity established in the offshore location?
- Offshore Master Franchisee owned by Third Party
 - o Structure of the franchisee will usually be decided by the Third Party

This paper assumes that in most instances the NZ Franchisor will not own the Offshore Master Franchisee but will appoint a third party to act as the Offshore Master Franchisee.

2. NZ Tax Applies to Worldwide Income of NZ Tax Residents

The NZ tax system generally imposes NZ income tax on the worldwide income of NZ tax residents. Therefore, any income derived from an Offshore Master Franchisee is liable for NZ income tax.

NZ generally allows any overseas tax deducted from that income as a credit against the NZ income tax liability, up to the amount of the NZ income tax liability.

3. Double Tax Agreements

NZ has Double Tax Agreements (DTAs) with numerous countries overseas, including USA, UK and Australia.

The DTAs generally limit the taxing rights of each country (depending on the type of income derived) as well as helping to reduce double taxation. For example, most DTAs limit the foreign country's tax on royalty payments to 10%.

4. Income Tax Implications of Payments Made by the Franchisee

A NZ franchisor will often charge an Offshore Master Franchisee some or all of the following

- Sale of trading stock
- Up-front royalties/licence fees
- On-going royalties/licence fees
- Services eg training

From a NZ income tax perspective, all of these amounts will be liable for NZ income tax where the NZ Franchisor is tax resident in NZ.

Whether or not any foreign taxes are payable or withheld in relation to these types of income will depend on the tax laws of the franchisee's country and the possible application of a Double Tax Agreement.

In general terms, it is unlikely that foreign taxes will apply to the profits from trading stock sold from the NZ franchisor to the franchisee, unless the Franchisor has a base in the foreign country.

Foreign taxes may apply to services provided to an Offshore Franchisee, depending on:

- whether or not the services are physically performed in the foreign country and
- the laws of the foreign country
- the possible application of a Double Tax Agreement

Generally, foreign taxes are withheld at the rate of 10% to 15% on royalties and licence fees paid from offshore entities to NZ tax residents. A credit is usually given in NZ for these foreign taxes, although if the recipient is a NZ company the foreign taxes are not generally recognized for NZ imputation credit purposes and this can therefore result in double taxation.

5. NZ GST

Generally, supplies made by a NZ Franchisor to an Offshore Master Franchisee will qualify for GST zero-rating on the basis that the supplies are exported supplies.

Chris Lindsay
WHK Gosling Chapman

FRANCHISING ADVISORS

- Legal

It is essential for any New Zealand franchisor to work through its New Zealand franchising lawyer in relation to local legal advice in the chosen country. A New Zealand franchise agreement will have to be changed for local conditions and an appropriate experience franchising lawyer should be chosen in the relevant overseas country to peruse the existing franchise agreement and make any necessary amendments. Even before this happens, the New Zealand lawyer will be required to prepare a Master Franchise Agreement if the New Zealand franchisor wishes to appoint a master franchisee in an overseas country. There is no shortcut in my opinion and expert legal advice must be obtained on a country by country basis.

- Tax

As I have already said it is imperative to obtain taxation advice in the relevant overseas country and that advice should be scrutinised and signed off by the New Zealand tax advisor. From an accounting point of view, it is important for your New Zealand Accountant to know which country or countries the New Zealand franchisor is expanding to to ensure that the way of doing accounting in those countries is both robust and understood.

- Consultant

Whether or not a New Zealand franchisor will need the services of an overseas consultant must be determined. Again, only experienced franchising consultants should be used.

- Bank

Any move overseas by a New Zealand franchisor should be discussed with the relevant bank in New Zealand. The ASB, ANZ, Westpac and the National Bank are owned by Australian entities. HSBC and Citibank are also owned overseas so it is important to consider any banking connections.

- IFA Connection

Stewart Germann has been a member of the Supplier Forum Board of the International Franchise Association (IFA), the USA Association, for six years and only left the Board on 1 March 2007. Stewart has an association with many franchising lawyers and consultants in a large number of countries.

SUMMARY

Great care must be taken if a New Zealand franchisor wishes to take its system overseas. David McCulloch will go through the points which the New Zealand franchisor must consider. International franchising is not for everyone. It is crucial that the New Zealand franchisor supports any master franchisees appointed overseas and takes a keen interest in the development and profitability of the system. Intellectual Property protection is crucial in relation to any trade marks and patents for no one can be trusted. To expand overseas is expensive and it is essential to obtain expert legal and taxation advice in the relevant overseas country.

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