

# BITCOIN AND INTERNATIONAL FRANCHISING

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As Bitcoin continues to gain traction, franchisors need to consider how best their documentation can facilitate the use of Bitcoin both in their franchisee's consumer facing transactions and as a method of paying franchise fees. This article considers how this new crypto-currency may impact franchising businesses and suggests some of the steps that franchisors can take to mitigate the resulting risks. The author describes what Bitcoin is, its origins and commercial challenges are, whether and how franchised businesses should consider using, and how developments in regulation and taxation are impacting its use.

Chances are that the "Crypto-currency" Bitcoin is more than a geeky fad. It seems likely that it will have a longer term impact on the franchise sector.

Bitcoin was again thrown into to the glare of public scrutiny when the Tokyo based Bitcoin exchange MtGox was hacked and lost over half a billion US dollars. However, despite the adverse publicity, this crypto-currency seems to be gaining more and more traction. Its use in B2C transactions both on line and on the high street in bricks and mortar stores is increasing and its potential role in the payment of international franchise fees is potentially very attractive to franchisors and developers due to potential costs savings. However, the spectre of regulation is looming and in some jurisdictions it has been ruled to be illegal. Nevertheless, many think that this is just another stage in an ongoing digital revolution. Either way, franchisors need to consider how best their documentation can facilitate the use of Bitcoin both in their franchisee's consumer facing transactions and as a method of paying franchise fees.

It is an international phenomenon. The US based franchisor Burger King has started accepting payment in Bitcoin as has the US online restaurant service Menufy (meaning that Bitcoin can be used to order from over 400 restaurants across 28 states), as well as number of well-known retailers, such as GAP, Amazon, Victoria's Secret, CVS pharmacies etc., through gift cards bought from companies like Gyft, eGifter, iTradeBTC and GiftCardZen. These gift card companies allow a purchaser to top-up their card with Bitcoins and then those gift cards can be used at physical stores or on websites. eBay is also considering accepting payment in Bitcoin. As early as April 2013, there were several businesses accepting Bitcoin within close proximity in Berlin, including restaurants, whilst in Dubai, a pizza restaurant claimed to be the first in the UAE to accept Bitcoin.

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Even in the more conservative UK market the use of Bitcoin is growing. The Mill Cafe in Stratford, and a number of British pubs, such as The Pembury Tavern in Hackney and The Haymakers in Cambridge, started to accept payment in Bitcoin late last year and received country wide publicity. It was something of a novelty. A "Geek-centric" PR gimmick perhaps. The increase in the use of Bitcoin across the world has continued unabated. ATM machines, which allow for the purchase of Bitcoins with cash, are being installed at retail locations in some markets. A large number of online merchants, such as online casinos, auction sites, technology consulting firms, and online adult media websites also accept Bitcoins. And this phenomenon is not just the private sector. The University of Cumbria has started accepting Bitcoin as payment for tuition fees. In California it is shortly to be recognized as a lawful currency. A Bitcoin EPOS system is currently being developed.

To date there has been no news of a franchisor accepting payment of its franchise fees by franchisees in Bitcoins, but for the reasons stated below, this may well happen in the future. It is therefore a matter of considerable importance to franchisors.

This article considers how this new “crypto-currency” may impact franchising businesses and suggests some of the steps that franchisors can take to mitigate the resulting risks.

### **What is Bitcoin?**

Bitcoin is a virtual currency and its value is determined on a daily basis by a fluctuating exchange rate. In reality, a Bitcoin is identified by a computer generated long string of cryptic numbers and letters (referred to as the public and private key) giving each Bitcoin a specific identity. Just like a

£20 pound note, a Bitcoin can be saved in an e-wallet, which essentially means storing the public and private key. These e-wallets can exist on a PC, cloud server, online website or they can take even take physical form by way of an app icon on a smart phone.

There has been significant volatility in the price of Bitcoin, In January 2013 they traded at £12 and in November 2013 peaked at a value of £613 per Bitcoin.<sup>1</sup> At the time of writing a Bitcoin is worth about £350 (although this fluctuates on a daily basis, like all foreign exchange rates) and there are currently around £4.5 billion worth of Bitcoins in existence.

Since it is not pegged to any country's currency it can seamlessly move across borders and integrate with real money whilst simply being saved on a user's computer hard drive. Bitcoin fans firmly support this independence, cash convertibility and convenience. Bitcoin proponents also emphasise that its value does not suffer because of inflation, oil costs or gold values, whilst all those factors significantly de-value fiat money.

### **Where does Bitcoin come from?**

Bitcoins are generated through a process referred to as "mining". An individual can become a Bitcoin miner by simply downloading and running the free Bitcoin open-source software on specialized hardware. The mining aspect is finding solutions to certain mathematical problems. While the actual problem solving is handled by the specialized hardware, the software connects the miners on the Bitcoin network. Once a solution is reached Bitcoins are generated. These solutions are difficult to obtain as each aspect of the process requires unique multi-billion calculations per second. Over time the number of miners engaged in mining Bitcoin can change, however the Bitcoin program automatically adjusts the mathematical problem difficulty to ensure that the supply of Bitcoin does not become faster or slower.

<sup>1</sup> "Bitcoin virtual currency breaks \$1,000 mark" reported by BBC on 27 November 2013, <http://www.bbc.co.uk/news/technology-25120731> (last visited 20 February 2014).

50 Bitcoins are generated per block every ten minutes, every four years thereafter this amount halves so on and so forth. The total number of Bitcoins in existence are programmed to never exceed 21 million. Although this is not a limitation as each Bitcoin can be divided down to 8 decimal places. It has been estimated that the last .00000001 of a Bitcoin will be "mined" in 2140.

### **How can Bitcoin be used by franchised businesses?**

Like cash, gift cards or credit cards, Bitcoin can also be accepted by restaurants, cafes, pubs and so on as a form of payment. The starting point for any Bitcoin transaction is setting up a Bitcoin wallet in order to convert and save real money as Bitcoin. A Bitcoin wallet can be a website or a downloadable program that runs on a personal computer. Franchised businesses (and indeed individuals) can obtain Bitcoins by paying real money in any currency via their bank accounts to Bitcoin exchange houses (a well-known exchange house in the UK is Bitstamp), and then transferring that Bitcoin to their personal or corporate wallet. Certain websites also allow keeping and sending Bitcoins without the need for running the Bitcoin program on a personal computer.

Bitcoin internet payment systems (BIPS), Coinbase, Bitpay etc. offer free services which allow corporates to create an online account (e-wallet) for accepting Bitcoin payments, which are transferred as real money to the merchant's physical bank account by these service providers. These services are accessible by simply installing a plug-in on the merchant's website which when used transfers the funds. Certain websites also allow sending Bitcoins through email.

No special or expensive POS, chip and pin terminals are needed. Any PC tablet or smart phone device can read the QR (quick response) codes and transfer the funds in and out of the relevant account. These are two dimensional black dots against a white background matrix unique to each user, these are linked to identify a Bitcoin wallet and could be displayed on a smart phone screen or printed and pasted at the cash till). Bitcoins received in payment

can be converted instantly into real money and bank wired to any currency in any part of the world using free services offered by companies like BIPS.

### **Should franchised businesses consider using Bitcoin?**

Bitcoin is a secure and inexpensive way to handle payments. With a few exceptions, franchisors and franchisees can make and receive payments using the Bitcoin network with almost no fees. Its sophisticated cryptographic security allows it to process transactions in a secure manner.

As an irreversible and secure means of payment Bitcoin has the potential to combat cyber-crime and fraud. For franchise systems which offer their customers payments via online credit card transactions, there are potentially substantial savings to be made. The need for expensive software, security checks and PCI Data Security Standard compliance and onerous legal responsibilities for sensitive data protection (such as credit card numbers) can be overcome. As the initial set up for these traditional security processes is expensive, the potential savings offered by Bitcoins are attractive. As Bitcoin payments are inherently cryptic they are inherently secure. However, as shown by the MtGox fraud, franchisors will have to ensure they have strong and secure internet access for a Bitcoin wallet to avoid the risk of theft of Bitcoins by computer hackers.

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Use of Bitcoin can therefore lower the cost of transactions and thereby either increase margins or decrease the cost to the consumer. Either way it can deliver real benefits to the franchisor and its franchisees. For international franchisors Bitcoins also offers the further advantage of being easily transferable across the globe with no delays, excessive bank charges or other currency conversion costs. This could reduce the cost incurred by franchisees when paying franchisee fees to the franchisor. This has an obvious implication for the payment of franchise fees to franchisors by their developers and master franchisees. The same potential benefit is available to domestic franchisors too, of course.

As regards customer transactions, the obvious question for franchisors is whether they should require their franchisees to accept Bitcoin, or leave it to their individual discretion. This may well vary from market to market depending upon the regulatory environment. Uniformity of the consumer experience and brand consistency within any given market suggests that either all or none of the franchisees in a particular market should accept payment in Bitcoin. In that respect it is no different to the use of credit cards to accept payment.

### **Risk profile**

There have of course been well published risks and volatility in the Bitcoin prices. MtGox (one of the largest online exchange houses) suffered a massive security breach from a hack of 744,000 Bitcoins (approximately 6% of all the 12.4 million Bitcoins in existence). Computer security is therefore of prime importance for those who use Bitcoins and is probably the greatest risk element in respect of their use in commerce. This is something that a franchisor insisting upon the use of Bitcoin by its franchisees needs to consider. It is also a considerable issue for franchisors accepting payment of their franchise fees from its developers, master franchisees and franchisees in Bitcoins. Franchise agreements are likely to have to be modified to cater for this volatility and possibly introduce appropriate hedging mechanisms. There is also the risk that Bitcoins will be used to launder money.

### **Regulation**

Real money is asset backed by its issuing government and therefore a reliable form of tradable debt. The government is able to get that acceptance and reliability on the basis of its asset reserves (in oil, gold, etc.).

Bitcoin is not asset backed. Its value is established by the number of Bitcoins in existence and its acceptability as a tradable IOU on any given day. The obvious risks to not being asset backed however are also its key advantage. It makes Bitcoin the only currency in the world whose value is free from government intervention, its exchange rate does not depend on price setting monopolies and no institutional authority controls its supply and demand. All of these restrictions apply to normal currencies which are asset backed by governments.

Once you buy a Bitcoin for a certain number of dollars, the value of that Bitcoin goes up or down according to its peer-to-peer demand. This is the main reason why proponents behind Bitcoin promote its non-jurisdictional and non-asset backed status. Jon Matonis, Executive Director on the board of the Bitcoin Foundation describes Bitcoin in three words as "Money Without Government".<sup>2</sup>

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<sup>2</sup> <http://www.coindesk.com/Bitcoin-crushes-mobile-payments-barriers/> last visited on 27 February 2014.

Naturally, as soon as something emerges that can be widely used in business the regulators become involved. A bill on alternative currency (AB 129) is currently under consideration at the California State Senate. If passed it would make Bitcoin a lawful currency in California. The state of New York is preparing to regulate Bitcoins by issuing "BitLicenses" for businesses that use Bitcoins. Perhaps this licensing criterion would be met by those who have adequate capital on their balance sheet to absorb unexpected losses and take the appropriate level of investment risk using consumer money.<sup>3</sup>

The U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) has declared Bitcoin exchanges to be money transmitters, requiring them to register, enact formal anti-money laundering programs, and report suspicious activity.<sup>4</sup>

In the UK, neither the Financial Conduct Authority (FCA) nor the European Banking Authority (EBA) currently regulate Bitcoin. In the east, the Monetary Authority of Singapore does not regulate Bitcoin yet. The Japanese Financial Services Agency and Finance Ministry are considering regulating Bitcoins after the recent MtGox crash.

In certain countries like Russia and Iceland Bitcoins are illegal. In China financial institutions are banned from doing business in Bitcoins. The Reserve Bank of India has issued a warning to domestic Bitcoin operators against dealing in Bitcoin due to various risks, including those related to money-laundering and cyber security. Over time however, it may well be that hostility to Bitcoins will abate. These are very real risks and operators must have in mind that all their know your client and other obligations as regards anti money laundering will also apply to payments made to them in Bitcoin.

<sup>3</sup> <http://www.cnbc.com/id/101408527> last visited on 27 February 2014.

<sup>4</sup> <http://uk.reuters.com/article/2014/02/28/us-Bitcoin-mtgox-insight-idUKBREAI1R06C20140228> last visited on 28 February 2014.

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All of these variances and potential volatility will impact upon the viability of Bitcoin as a method of paying international franchise fees and drive the development of appropriate language in the franchise agreements.

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### **Are Bitcoins taxable?**

Any that sell goods or services in exchange for their national currency, must accept that they will be subject to income tax on their Bitcoin income.

In the UK, HM Revenue & Customs (HMRC) has scrapped VAT on Bitcoin 'mining' and trading. Although for businesses accepting Bitcoin as payment of goods or services, VAT will be due in the normal way. The value of the supply of goods or services on which VAT is due will be the sterling value of Bitcoin at the point the transaction takes place. There will be no VAT due on the value of Bitcoins themselves when it is exchanged for sterling or any other foreign currency, like euros or dollars. HMRC's guidance stated that corporation tax, income tax and capital gains tax would continue to apply to businesses depending on the nature of activities involved.

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In the USA, the Internal Revenue Service (IRS) recently published guidance on tax issues concerning Bitcoin and other virtual currencies. Fundamentally, for federal tax purposes, as a virtual currency Bitcoin is treated as property and, as such, the general tax principles that apply to property transactions will apply to transactions using Bitcoin, meaning that it is not capable of generating foreign currency gain or loss for tax purposes. Additionally, the IRS has confirmed that employee wages paid by Bitcoin are taxable to the employee, and as a result are subject to federal income and payroll taxes, whilst self-employment tax rules will apply to payments made to independent contractors.<sup>5</sup>

Meanwhile, the Inland Revenue Authority of Singapore has clarified that a goods and services tax (GST) registered business has to charge GST to a customer if payment is made in Bitcoins.<sup>6</sup> Germany and Norway are levying capital gains tax on profit from Bitcoins.

Bitcoins bought for the purposes of appreciation and subsequently sold as an asset will incur a capital gains tax for individuals or corporation tax if it accrues to a company. The profits and losses of a non-incorporated business on Bitcoin transactions must be reflected in their accounts and will be taxable on normal income tax rules. HMRC pointed out that any profit or gain chargeable or any allowed loss will be looked at on a case-by-case basis taking into account the specific facts.<sup>7</sup>

In pure accounting terms Bitcoin transactions are similar to cash transactions. There may be commercial considerations in deciding how to account for the difference between the Bitcoin value when received or paid as it changes every day. Generally in accounting terms an average of the difference incurred (when it is exchanged for more traditional currency) is applicable, although for larger transactions a professional accountant's advice should be taken.

### **The commercial challenges presented by Bitcoin**

Franchise agreements will need to be amended to properly provide for the use of Bitcoins. Franchise networks accepting Bitcoins from customers and for franchisors accepting its franchise fees from its franchisees in Bitcoins will need to set an acceptable conversion rate that can be relied on every day. The franchise agreement will need to provide a mechanism for this. Hedging can help reduce this exchange rate risk and if used will also need to be referred to in the franchise agreement. There are a growing number of so-called “digital wallets”, like Coinbase which allow businesses to securely buy, use and accept Bitcoin. They profess to offer “bank level security” through high level encryption with off-line back up in bank vaults. The use of digital wallets will need to be dealt with in the franchise documentation.

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<sup>5</sup> IRS Notice 2014-21 - <http://www.irs.gov/pub/irs-drop/n-14-21.pdf> - 25 March 2014.

<sup>6</sup> Chee, Kenny, A taxing matter for Bitcoin, *The Strait Times*, 17 January 2014.

<sup>7</sup> <http://www.hmrc.gov.uk/briefs/vat/brief0914.htm> last visited on 12 March 2014.

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Businesses wanting to have a more long term and self-reliant arrangement, can enter into customised purchase agreements with individual miners or Bitcoin exchange houses, incorporating provisions to mitigate the currency conversion effect. This can be achieved by relying on prices based on the current market rate or on a weighted average basis. If a franchisor procures these services for its franchisees, there may be regulatory and contractual issues to be addressed in the franchise agreement.

Funds transfer confirmation, timings for completion and obligations for payment of any transaction fees levied by exchange houses could also be an issue, if Bitcoins are used to transfer substantial payments, such as franchise fees. However, for high priority transactions or a quick confirmation on transfer of funds transaction fees may be levied by these online exchange houses.

Money laundering remains a real risk with Bitcoin payments and so franchisors must ensure that their franchisees are vigilant and comply with their anti-money laundering obligations. Before using a Bitcoin exchange due diligence is essential. Franchisors must also ensure that they maintain secure systems to protect their franchisees against theft from hacking. For larger transactions, such as the transfer of franchise fees, a KYC exercise can help in identifying the real world identity of the persons involved.

The use of an escrow service to eliminate the risk of non-payment, dispute resolution and jurisdiction clauses will also need to be incorporated in operators Bitcoin agreements.

If franchisors are to accept payment of their franchise fees in Bitcoins their franchise agreements will need to be updated to provide for the appropriate procedures. It is unlikely that the current wording of their agreements will be sufficient. However, important though that is, it is likely to be the least of the franchisor’s challenges. The biggest challenge will be to educate the developers, master franchisees and franchisees in the benefits of Bitcoin, the creation of appropriate procedures within their business format and their roll out in the franchise network together with the introduction of appropriate secure technology.

### **Conclusion**

A currency loses value if its issuing government loses the ability to guarantee its value. In contrast Bitcoin is not backed by any treasury or central bank and therefore remains unaffected by government policies and politics. Unless declared illegal in a jurisdiction, Bitcoin can be used and exchanged for goods or services. It is likely that the use of Bitcoin will become more heavily regulated over time and operators must remember to exercise their usual caution in terms of their anti-money laundering obligations.

For Bitcoin to achieve its full potential the technology needs to evolve more. At the moment many franchised businesses may find it hard to overcome the technology gap and may not want to spend the time understanding or money in setting up cumbersome processes. To place Bitcoin in perspective it can be compared to the internet in the early 1990s. The internet then was expensive, slow, unreliable and inaccessible to non-technology savvy people but has today become indispensable to one and all. Proponents of Bitcoin believe that Bitcoin will turn out the same way. The impact of Bitcoin upon the drafting of franchise agreements is likely to follow the same developmental curve, as the full

implications of its use in franchising become more apparent and lawyers have the benefit of jurisprudence around the world to guide their word smithing.

Franchised and other businesses currently accepting Bitcoin may, in part, be using it as a PR gimmick to attract media coverage and inject some novelty into the customer experience. However, this will inevitably be short lived and longer term, more substantial criteria will determine its success. Even though there has been much drama and speculation around Bitcoin there is no denying that cryptocurrencies are the future. Volatile exchange rates and risks are issues but businesses are beginning to shed inhibitions about Bitcoin in recognition of its advantages surpassing the risks. As technology improves so Bitcoin may well become a part of everyday life in the franchise sector and the jurisprudence around its use will increase. The

questions for franchisors today are when they will decide to climb on the Bitcoin train and how they adapt their systems and franchise agreements to accommodate it.

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