UPDATE
FRANCHISING LAW

The impact of risk and compliance on cross border sales and franchising agreements

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THE IMPACT OF RISK AND COMPLIANCE TO a franchisor looking to expand and sell their brand/franchise overseas is seen in two ways:

1. A franchisor looking to expand into a foreign territory must conduct significant and thorough risk and compliance assessments. A franchisor cannot import the system they have into another country without looking at the following:
   - Assess your system and be clear on what it is and what it is offering.
   - Researching the country and its laws. Do not pick a country and then try to force the system through – ie, pushing a square peg through a round hole. Be careful about employment laws, privacy laws etc and local cultures.
   - Decide on the structure of the relationship – eg, area developer/master franchisor/joint venture.
   - Do you need to adapt your system including suppliers (look at the recipes, the brand, the methods, the whole system).
   - Check if the franchise agreement needs to be adapted for the target company.
   - Be realistic about the costs involved – it will not be cheap.
   - Engage expert counsel in the target country.

   A consequence of risk and compliance is that the franchisor will need to adapt the franchise system (including products and the name itself) in order to be successful in the other country.

2. If a franchisor does not conduct the due diligence and assess the impact of risk and compliance on their system and expanded too quickly into a country perceived to bring big rewards, the brand name has suffered and has cost the company significant amounts of money. There are many factors to be taken into account which include the following:
   - **Cultural:** name of franchise.
   - **Translation issues:** translations of agreements must be rendered by lawyers knowledgeable in the local law.
   - **Consumer preferences:** do you need to vary your system to address local preferences? For example, McDonald's offers menu items specific to the country.
   - **Sourcing:** availability of products, fixtures and *equipment.it* is not just about suppliers it is about the franchisors ability to protect the look and feel of the franchised business and the instant recognition of the brands.
   - **Products:** logistical issues. It is essential to ensure that the quality and availability of products is assured. McDonald's suffered brand damage in China when their meat supplier sold expired meat.
   - **Measurement:** you must adapt everything including unit measurement.
   - **Legal issues:** sanctions laws/anti bribery laws (cartels in New Zealand), dispute resolution, intellectual property issues.
   - **Knowledge/application of territorial preferences:** for example, ethnic and political make up. If it is important to observe the ethnic and cultural make up it may be better to have the local person be the face of the brand.

When a franchisor is looking to embark on cross border sales and franchising agreements, there will be considerable impact in relation to the risk and compliance to that franchisor.

Due diligence of business considerations

A franchisor may typically leave some business due diligence to its local partner, relying on the local partner's knowledge of the market and its industry expertise. If a franchise arrangement covers multiple jurisdictions, the due diligence conducted should cover each target market. The initial business due diligence on any new target market should, at a minimum, include the inquiries detailed below:

Composition of product or offering of service

Does the product sold require modification to make it locally compliant or culturally acceptable? For example, some jurisdictions regulate whether a product can be

labelled and sold as a particular type of food (ie, halal or kosher). Such required or desired adaptations may also affect a franchise's services as opposed to products. A franchise may need to inquire whether locally prescribed business hours or religious holidays or practices could impact the proposed operations of the franchised business.

Suitability of offering

How suitable is the product or service for the target market? Does the name of the brand translate poorly or is the product culturally insensitive or unpopular? How have competing brands in the marketplace performed? Is there adequate infrastructure to support the franchisor's business operations? Is there a demand for the product or service in the target market?

Import and local costs

Will certain supplies or products used or sold in the franchise need to be imported into the target market? Are there tariffs or other local taxes imposed? For those franchises that rely heavily on local supply chains, are affordable suppliers available? Moreover, are there rebates to local or offshore suppliers? Employment of workers, licences and permits, real estate costs and/or the cost of goods in the target market may lead to significantly higher cost of sales.

Political and social risks

A franchisor will need to analyse whether the target market presents significant risks, such as political threats or the threat of civil unrest or terrorism. It is also valuable for a franchisor to consider the reputational harm or social backlash it may face in its home country should it decide to expand into an unpopular country.

Payments

Will local exchange control regulations and/or tax laws restrict the repatriation of profits to the franchisor's home jurisdiction? Must payments be made in local currency of the target market?

Due diligence on legal matters

A franchisor must also conduct legal due diligence on the potential impact that local laws may have on the expansion of the franchise system to the target market. Often these issues are vetted with local counsel, who is familiar with the analysis needed to address the typical matters presented and is able to make the changes necessary to the franchisor's franchise agreement. Initial legal issues that should be investigated include the following:

Legality

Is it legal to sell the goods or services in the target market?

Trademarks

The franchisor must inquire whether the system's principal trademarks are registered or are available for registration. The franchisor must also inquire whether the franchisor's trademark must be registered before it is licensed to a third-party to avoid violating local law in the target market. A franchisor should investigate the typical duration of trademark registration in the target market, particularly if registration is required prior to the offer or sale of the franchise.

Disclosure or registration

The franchisor should know whether any local laws require disclosures before signing a letter of intent or before accepting any payment from a prospective local partner and whether disclosure is required before the franchise is advertised or before representatives of the franchisor speak to or meet with a prospective local partner candidate. A franchisor should also know whether local franchise laws require a regulatory filing or approval before a franchise agreement can be offered or executed or upon its execution.

Mandatory provisions

Jurisdictions that have franchise laws often require that certain provisions be included in franchise agreements. Some of these provisions impact the fundamental elements of the franchise offering, for example the term of agreement, a mandatory "cooling-off" period, a requirement that the agreement be written in the local language to be enforceable, or mandatory governance by local law.

Franchise structure

The franchisor should analyse whether the structure of the franchise violates any local laws, such as those related to pyramid selling.

Draft clauses and comments

Governing law

In a US agreement the Governing Law clause might read as follows:

> **3.1 Governing Law.** This Agreement shall be governed by the laws of New York and shall be subject to the jurisdiction of the New York Courts.
>
> **3.2 Waiver.**
>
> - **General.** Waiver of any default or breach of this Agreement shall not be interpreted as a waiver of any subsequent default or breach.
> - **Punitive Damages.** Except for Area Developer's obligation to indemnify [Subway] for third party claims under Section X.1, and except for punitive damages available to either party under the United States Trademark Act of 1946 (Lanham Act, 15 U.S.C., Sections 1051 et seq.), [Subway] and Area Developer (and Area Developer's owners) waive to the fullest extent permitted by law any right to or claim for any punitive, exemplary or consequential damages against the other and agree that in the event of a dispute between [Subway] and Area Developer, the party making a claim will be limited to equitable relief and recovery of any actual damages it sustains.
> - **Jury Trial.** [Subway] and Area Developer irrevocably waive trial by jury in any action, proceeding, or counterclaim, whether at law or in equity, brought by either of [Subway] or Area Developer.

In New Zealand the Governing Law clause could read as follows:

> This Agreement shall be governed by the laws of New Zealand and shall be subject to the jurisdiction of the New Zealand Courts.

It is important for due consideration to be undertaken in relation to governing law. In my opinion, it is often better to have the governing law in the jurisdiction of the master franchisee or area developer for if there is a breach and the franchisor needs to seek remedies in court, it is often easier and more expeditious to instruct local counsel to act on behalf of the US franchisor and to abide by the governing law in the local jurisdiction.

Social media

In New Zealand the Social Media clause might read as follows:

> The Franchisee acknowledges that in relation to the Business and the Franchisor's Intellectual Property it will act with care when using any social media and it shall always do its utmost to look after the best interests of the Franchisor and anything to be published, circulated, transmitted or disseminated in any way by or through social media shall be subject to the Franchisor's prior written approval.

In some international franchise agreements which I have seen, the website and social media clause might read as follows:

> **The Website and Social Media Pages**
>
> (a) The franchise system will be listed on our global website ("Website"). You will not have editorial access to the Website, but if you require changes and updates you must notify us in writing and we will implement such changes as soon as is reasonably practicable, subject to our prior approval, not to be unreasonably withheld or delayed. You will not advertise and promote via any other website featuring the Marks without our prior written consent.
>
> (b) You shall not advertise and promote your business via pages featuring the Marks on third party social media platforms ("Social Media Pages") without our prior written consent. The franchise system will be featured on our branded Social Media Pages. You will not have editorial access to our Social Media Pages, but if you require changes and updates you must notify us in writing and we will implement such changes as soon as is reasonably practicable, subject to our prior approval, not to be unreasonably withheld or delayed.
>
> (c) We will not use the Website or Social Media Pages to promote any marketing initiatives, promotions, discounts or loyalty schemes for your franchise system without your prior written consent.

It is important for all international franchisors or licensors to actively monitor their social media pages for otherwise a valuable brand could be destroyed while the parties are sleeping.

Local presence

The franchisor should know whether the target market requires it to establish a local subsidiary or branch in the jurisdiction or whether the franchisor must operate its own units of the franchise being offered for a certain period before it engages in franchising with other local parties. The franchisor should also determine whether foreign investment or ownership laws restrict the franchisor from establishing a presence or investing locally.

Industry regulations

Are there industry-specific regulations that could introduce additional costs or impractical requirements?

Travel restrictions

The franchisor should know what is required for the local partner's personnel to visit the franchisor's home country or the franchisor's personnel to visit the target market.

Compensation and competition

Are there local laws related to termination or non-renewal of franchises? Will the franchisor be required to compensate the local partner at the end of the franchise relationship? The franchisor should also investigate whether it will have the right to require non-competition covenants as they are not always permitted or may be heavily regulated in some countries.

Due diligence on the local partner

Because the local partner is the key to the ongoing success of the franchise in the target country, a background check on the individual local partner and the principal officers of any proposed franchisee entity is a critical part of the franchisor's due diligence. A background investigation or check delves into an individual's general reputation and history. When conducting an international background check, the franchisor must ensure that a potential local partner in a target market does not trigger certain national security and anti-bribery legislation. Some important aspects of a background check in the international context are:

United States Office of Foreign Assets Control

Americans are barred from engaging in transactions with individuals and entities that are listed on OFAC's Specially Designated Nationals and Blocked Persons (SDN) list. Franchisors based in the United States must conduct searches on the current SDN list to ensure that any potential franchise transaction does not involve these individuals and/or entities.

Third party

The third party relationships of local partner candidates could pose a risk for the franchisor. The US federal government is increasingly seeking to impose liability on corporations for the acts of third parties, such as distributors and subsidiaries in the Foreign Corrupt Practices Act and other contexts.

Anti-money laundering legislation

Many countries in the world including New Zealand have anti-money laundering legislation. In New Zealand we have the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (AML/CFT) legislation which requires lawyers to gather more information from clients. The information includes the following:

- Original passport
- Driver's licence
- Bank statement (or power/phone bill) with current address
- Details of directors/shareholders (if a company)
- Details of source of funds (if a company)
- IRD number.

Reputational due diligence

General business reputation

A franchisor should conduct a search of foreign news sources and media associated with the shareholders, principals and officers of a company under review.

Social media

Searches should be made of the social media accounts of the individual local partner or its franchisee entity as well as its principal shareholders and officers.

Criminal records and civil lawsuits

Each target country has varying laws about the type of criminal records that are publicly available, who is allowed to access them and how a third-party may use the information within a criminal record. To assist in reputational due diligence, a franchisor should be aware that the government of the United Kingdom has compiled a list of target countries and their processes for obtaining a criminal background check on someone who lives or has lived in the target country.

Reference checks

A franchisor should contact each reference that a franchise applicant has listed and ask questions about the applicant's background character and competency. The franchisor may need to use a translation service if the reference does not speak the same language as the franchisor.

Conducting cross-border due diligence on the business environment of the target market, the proposed local partner, area developer or joint venture partner, as well as the local legal issues remains a vital part of a franchisor's decision to enter a new jurisdiction. In conducting international due diligence, the franchisor will likely spend more, take longer and yield less information than desired. Given the scarcity of resources in many markets, it is prudent to allow for more time to complete the due diligence process and also be transparent with the prospects in regards to the process and the expectations of the prospects. To the extent that public sources are limited, the franchisor should be prepared to ask local partner candidates and local counsel to produce a number of documents related to the due diligence. To the extent a franchisor's inquiries do not reveal a depth of information, the franchisor may have to cover a broad range of topics in a shallow fashion and make the most of the information provided, recognising that cross-border due diligence is a difficult exercise that may not yield the same results as a domestic investigation.

Conclusion

When a franchisor is looking to embark on cross border sales and franchising agreements, there will be considerable impact in relation to the risk and compliance to that franchisor. There are many considerations to take into account including tax laws, dispute resolution and serious consideration of the governing law. When you embark upon cross border transactions great care must be taken in relation to the different jurisdictions, and expert legal advice should always be obtained in the local jurisdiction. ■

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