



The first steps in a cross-border franchise transaction - international due diligence

By Kendal Tyre, Pierce Han and Nia Newton

When a franchise system expands internationally, due diligence that includes a thorough investigation of the business environment of the proposed target market, its legal landscape, and the proposed local master franchisee, area developer or joint venture partner will provide clues as to the likely success of the expansion.¹ Compared to a typical domestic franchise transaction in the United States, the amount of money invested in an international franchise transaction is generally higher, the time to recoup the investment is longer, the pool of viable candidates is smaller and the available resources to conduct any due diligence are often scarce. Regardless of these challenges, due diligence remains an essential and invaluable component of any cross-border transaction and some key considerations of that exercise are addressed here.

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 labeled and sold as a particular type of food (i.e., halal or kosher). Such required or desired adaptations may also affect a franchise's services as opposed to products. For example, hotels in Israel need to modify some services on the Sabbath, such as the operation of swimming pools and health clubs. A franchisor 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 off-shore suppliers? Employment of workers, licenses 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.** The franchisor will need to analyze 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? For example, pork products and alcoholic beverages cannot be sold in certain countries in the Middle East.
- **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.** A 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.ⁱⁱ 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,ⁱⁱⁱ a mandatory "cooling-off" period,^{iv} a requirement that the agreement be written in the local language to be enforceable^v or mandatory governance by local law.^{vi}

- **Franchise structure.** The franchisor should analyze whether the structure of the franchise violates any local laws, such as those related to pyramid selling.
- **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.^{vii} The franchisor should also determine whether foreign investment or ownership laws restrict the franchisor from establishing a presence or investing locally.
- **Industry regulation.** Are there industry-specific regulations that could introduce additional costs or impractical requirements?
- **Travel restrictions.** A 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

Given that the local partner is often the lynchpin to the ongoing success of the franchise in the target country, a background check on the individual local partner and/or 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 highlighted below:

- **United States Office of Foreign Assets Control.** U.S. persons 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 U.S. 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. As a result, it is important that when conducting background checks on potential local partners, the franchisor must investigate these third-party arrangements of any candidate.
- **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.** Fortunately, checking international references is more straight forward. A franchisor can 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.
- **Financial due diligence**
 - **Credit reports.** As with international criminal records, each target country has its own way of reporting credit, debt and responsibility. Many target countries have privacy laws about who can review credit reports. Franchisors will have to contact each credit reporting agency to determine whether they can access this information.
 - **Other information.** A franchisor should make an effort to review: personal financial statements; business financial records; bank statements; tax records; source of funds; capitalization of the franchisee entity; annual budgets, plans and projections; all auditor's and management letters; accounting policies; and receivables of the franchisee candidate.

Conclusion

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 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, recognizing that cross-border due diligence is a difficult exercise that may not yield the same results as a domestic investigation.

For more information on international franchising see *International Franchising 2016: Legal and Business Considerations*, a book edited and co-authored by Kendal H. Tyre, Executive Editor, Diana V. Vilmenay-Hammond and Keri A. McWilliams, Managing Editors, and Pierce Haesung Han and Nia D. Newton, Assistant Editors. To view a video book trailer of the book, [click here](#).

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

- Kendal H. Tyre, 202-585-8368, ktyre@nixonpeabody.com

- Pierce Haesung Han, 202-585-8139, phan@nixonpeabody.com
 - Nia D. Newton, 202-585-8700, nnewton@nixonpeabody.com
-

- ⁱ In this article, for ease of reference, the “local partner” will refer to the proposed local master franchisee, area developer or joint venture partner in the target country.
- ⁱⁱ Countries having disclosure laws in Europe include Belgium, France, Germany, Italy, Romania, Spain and Sweden; in the Asia Pacific, these include Australia, China, Indonesia, Japan, Macau, Malaysia, South Korea, Vietnam and Taiwan; in Africa, these include South Africa and Tunisia; and, in the Americas, Brazil, Canada, Mexico and the U.S. For more information, see *INTERNATIONAL FRANCHISING 2016: LEGAL AND BUSINESS CONSIDERATIONS* (Kendal H. Tyre, Jr, Diana Vilmenay-Hammond, Keri A. McWilliams, Pierce Haesung Han, and Nia D. Newton eds. LexNoir Foundation 2016) (hereinafter “*International Franchising*”).
- ⁱⁱⁱ For example, Argentina’s Civil and Commercial Code requires that the minimum term of a franchise agreement must be at least four years, with certain exceptions. See Mario Eduardo Castro Sammartino, Franchising in Argentina, in *International Franchising*.
- ^{iv} For example, Section 18 of the Franchise Act 1998 of Malaysia requires a cooling-off period, which shall not be less than seven working days, during which the franchisee has the option to terminate the agreement. See Wong Sai Fong and Michelle C.Y. Loi, Franchising in Malaysia, in *International Franchising*.
- ^v For example, Indonesia requires that if a franchise agreement is written in a foreign language, the agreement must be translated into the Indonesian language for registration. See Nurdin Adiwibowo, Freddy Karyadi, and Gustaaf Reerink, Franchising in Indonesia, in *International Franchising*.
- ^{vi} For example, Indonesia, Malaysia and the Philippines specifically require that local law govern the franchise agreement. See Kendal H. Tyre, Jr. and Diana Vilmenay-Hammond, International Franchising – An Overview of Legal and Business Issues, in *International Franchising*.
- ^{vii} In Vietnam, Decree No. 35-2006-ND-CP requires a Vietnamese sub-franchisor to operate the franchise for at least one year in Vietnam before sub-franchising.