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International Trade Compliance Tips for Franchisors

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Although the Federal Trade Commission's franchise rule does not apply to international franchise development undertaken by U.S. franchisors, there are a number of other laws with which U.S. franchisors must comply when they seek to expand outside of the U.S. While a detailed description of these laws and their impact would fill many treatises, this article will highlight several of the more pertinent statutes and regulations.

Practice Areas

FCPA and Anti-Corruption
International Trade
Litigation

The Foreign Corrupt Practices Act

Under the FCPA, U.S. companies, their officers and employees, as well as third party representatives or persons acting on their behalf, may not give or offer to give anything of value to a foreign government official or employee of a state-owned enterprise for the purpose of influencing that individual in his or her official capacity, or causing that official to influence the foreign government, in order to obtain or retain business. The law also imposes certain accounting and internal controls requirements on "issuers" (corporations that have issued securities registered in the U.S. or that are required to file periodic reports with the U.S. Securities and Exchange Commission).

To violate the FCPA's anti-bribery provisions, an offer, promise, or authorization of a payment, or a payment, to a government official must be made "corruptly" — i.e., there must be an intent to induce the recipient to misuse his or her official position in order to obtain or retain business. The FCPA also prohibits corrupt payments to foreign officials through third-party intermediaries. Companies cannot avoid liability by remaining deliberately ignorant of the actions of third

parties that may violate the FCPA.

Like other covered companies, franchisors must abide by the FCPA's anti-bribery provisions. While there is no specific guidance on franchisor FCPA liability for franchisee actions, in light of the increased enforcement of the FCPA and the nature of the franchise relationship, franchisors could potentially be found liable under the FCPA for actions taken by franchisee, given franchisors' control over franchisees and possible benefit from franchisees' improper payments, particularly if there is a failure to exercise appropriate due diligence with respect to franchisees. Although the arm's-length nature of the relationship provides a franchisor with a measure of protection, several FCPA enforcement actions have been based on similar arrangements (such as corporate liability based on the actions of a distributor).

Although FCPA liability depends on a corrupt intent, a lack of knowledge may not be enough to avoid liability, because the FCPA can be enforced against entities that are "willfully blind" to violations, a concept that U.S. regulators interpret broadly. A claim of lack of knowledge (and, therefore, a lack of intent) may be strengthened where controls and policies are in place to deter and discover FCPA violations. The following steps should help minimize the potential risk of liability: an appropriate FCPA compliance program (including compliance manual, education, and internal enforcement to ensure corporate compliance with FCPA requirements); conducting due diligence prior to selecting business partners, whether agents, representatives or franchisees (particularly in jurisdictions where FCPA risks are heightened); inclusion of strong contractual language in franchise and other agreements regarding FCPA prohibitions and obligations; and implementation of an FCPA reporting and monitoring system.

Anti-Boycott Laws

Anti-boycott laws prohibit or penalize U.S. companies for participating in foreign-initiated boycotts and embargoes that the United States has not sanctioned. The main boycott that the laws are designed to counteract is the Arab League boycott of Israel. However, these laws extend beyond the boycott of Israel and apply to any boycott unapproved by the U.S. government. U.S. companies are subject to two anti-boycott laws, the Export Administration Act and the Ribicoff Amendment to the Tax Reform Act. The EAA and TRA are separate regulatory regimes which vary in their structure, application, penalties and prohibited activities. Generally, the following activities are prohibited: refusals to do business with a boycotted country or with a blacklisted United States person; discriminatory actions on the basis of race, religion, sex or national origin; furnishing information about race, religion, sex or national origin; and furnishing information about business relationships with boycotted countries or blacklisted persons.

Boycott requests can assume many forms — some of which may not be obvious. Training of relevant staff therefore is critical to help identify red flags. The EAA and TRA not only restrict compliance with boycott requests, they also require companies to report any request to support an unsanctioned boycott (even if there is no intent to comply with the request). Although countries that are members of the Arab League (Algeria, Lebanon, Syria, Bahrain, Libya, United Arab Emirates, Iraq, Oman, Yemen, Jordan, Qatar, Kuwait and Saudi

Arabia) are the predominant source of boycott requests, other countries have also asked U.S. companies to participate in a boycott (e.g., Bangladesh, Malaysia, Pakistan, Iran and Nigeria).

Franchisors, like other covered companies, must ensure that their direct actions do not run afoul of the U.S. anti-boycott regime. There is no direct statutory or regulatory language or agency guidance that addresses the liability of franchisors for franchisees' violations of anti-boycott laws. Franchisors seeking to avoid liability for franchisees' actions should focus on the fact that franchisees are independently owned and operated, and that franchisors do not exercise requisite control over franchisees' routine business activities — particularly those that may be implicated by boycott laws (e.g., franchisee purchase orders). Being able to document such separation, coupled with a strong compliance program tailored to the franchisor's own activities, would be the best approach for franchisors.

Franchisors may decrease their potential liability by implementing an appropriate compliance program designed to uncover any violations of anti-boycott laws; educating key employees; and making clear to franchisees, in franchise agreements and otherwise, that the franchisor cannot — and will not — take actions in violation of U.S. anti-boycott laws. Franchisors also should consider voluntarily disclosing any known violations.

Economic Sanctions Imposed by the U.S. Office of Foreign Assets Control

The U.S. Office of Foreign Assets Control administers and enforces economic sanctions, which are intended to deprive targeted countries, groups and individuals of access to their property in the United States, as well as the benefits of trading with the U.S. and using the U.S. banking system. OFAC administers two types of sanctions: (1) individual and (2) country-specific.

Individuals. OFAC maintains a list of Specially Designated Nationals with whom U.S. persons are prohibited from doing business. SDNs include terrorists, drug-traffickers, and entities associated with hostile governments. Transactions also are prohibited with SDN-owned or -controlled entities, which may not appear on OFAC's list of SDNs. OFAC frequently updates the SDN list.

Countries. OFAC maintains country-specific sanctions. Sanctions programs vary, but the broadest sanctions prohibit U.S. persons from engaging in nearly all business operations in or involving the sanctioned country. Countries subject to comprehensive sanctions are Iran, Syria, Cuba and Sudan. OFAC also employs country-specific sanctions that prohibit only certain transactions within the country – not all transactions. OFAC's website includes extensive information about country-specific sanctions, including a list of sanctioned countries and the specific prohibitions against doing business with such countries, which is periodically updated.

In conducting their direct business activities, U.S. franchisors are responsible for complying with the sanctions established by OFAC. In other words, franchisors should not engage in business with persons on the SDN list or in prohibited business with sanctioned jurisdictions. Further, U.S. franchisors face potential liability for transactions between a foreign franchisee and a sanctioned entity. OFAC has not issued guidance concerning

liability in the franchise context, but it is likely that, if the agency found that the franchisor had control over the franchisee, the franchisor would be liable for the franchisee's conduct in violation of OFAC sanctions. Risks are greater to the extent that the franchisee engaged in business with a sanctioned person or entity in furtherance of its franchised operations and/or if the franchisor controlled the actions, policies or personnel decisions of a franchisee. Franchisors could note the elements of the franchise relationship that make the franchisee independent of the franchisor, and further point to their own policies designed to comply with U.S. sanctions. Nonetheless, OFAC enforcement is aggressive, particularly in the case of dealings with Iran.

Because sanctions regulations create a strict liability regime, U.S. companies should consider conducting an assessment of their risk for violating sanctions and establishing appropriate compliance controls. Controls could appear in franchise agreements, screening programs, and processes for making goods, services and software available to franchisees. If franchisors provide any type of financing, guarantee, insurance or management service to a foreign franchisee, enhanced review and controls may be appropriate. Franchisors can consider taking steps to reduce potential liability, including performing due diligence on business partners; demanding compliance from franchisees and other partners; creating a compliance program; and responding promptly to suspicious activity.

Anti-Money Laundering

Money laundering is the process of disguising proceeds from illegal activities or funding illegal activities by mixing those proceeds with legal funds. In the United States, money laundering is investigated and prosecuted by several agencies, including the U.S. Department of Justice, the Internal Revenue Service, the Treasury Department's Financial Crimes Enforcement Networ and the U.S. Department of Homeland Security. Many of the anti-money laundering laws are collectively known as the Bank Secrecy Act and are administered and enforced through regulation by FinCEN. Violations can trigger civil and criminal penalties.

Generally applicable AML laws prohibit laundering money or aiding and abetting money laundering. Money laundering generally requires intent and knowledge of illegal activity, though willful blindness can suffice to show intent. These laws also require reporting certain activities, such as transactions of over $10,000, or bringing the same amount into or out of the United States. Generally applicable AML laws apply to franchisors, like other businesses. For example, a franchisor may not knowingly engage in financial transactions with funds of property acquired through illegal activities, or engage in financial transactions designed to avoid transaction reporting requirements. Franchisors could incur liability if they intentionally launder money, intentionally aid and abet a franchisee's money laundering, or are willfully blind to receipt of illegal proceeds. The more removed franchisors are from the illegal activity, the more attenuated liability is likely to be.

Because financial institutions will scrutinize franchise accounts and transactions for signs of money laundering, franchisors should consider implementing compliance programs to both govern their own business activities in compliance with AML laws and also minimize the risk of franchisee misconduct. Compliance measures to

consider include: identifying compliance officials; screening potential business partners; educating key personnel regarding AML laws and compliance requirements; conducting ongoing risk assessments, and identifying potential red flags in proposed and existing business relationships; requiring compliance from business partners and franchisees; and conducting internal audits.

Export Controls

Export controls regulate the transfer of certain U.S. goods, technology and services to particular foreign countries, entities and end users that are seen as a threat to U.S. national security and foreign policy. The U.S. limits the export of certain items, depending on the type of export and the identity of the recipient. Violation of export control rules could lead to civil and criminal penalties, as well as reputational injury.

The Export Administration Regulations govern the export of certain "dual use" items, technology and software that could be used for commercial as well as military purposes. In contrast, the International Traffic in Arms Regulations control the export of certain U.S. hardware, technical data and services that are "defense articles and services" appearing on the U.S. Munitions List. For restaurant franchisors, restaurant items and equipment, if governed by U.S. export laws, would very likely fall under the EAR and not the ITAR given the nonmilitary nature of such goods.

The EAR regulate exports and re-exports (the transmission of an item from one foreign country to another) of covered items, and apply to all items physically present in the U.S. or of U.S. origin, wherever located, and to certain foreign manufactured items. Further, any communication with a foreign national that transmits controlled information is considered a "deemed export" – for example, deemed exports could occur through proposals, emails or meetings with non-U.S. nationals.

The EAR contain a step-by-step guide for determining whether a specific export is subject to export control laws and whether licensing is required. There are four main factors that affect an export item's status: the item's classification (category of goods/products); the country of ultimate destination (the most restricted destinations are Cuba, Iraq, Iran, North Korea and Syria); the ultimate end user of the item (items may not be transmitted to certain prohibited users); and the ultimate end use of the item (certain uses – e.g., military uses – may be prohibited entirely). Most exports and re-exports of controlled items do not require a license, or are eligible for a license exception. If no license exception is available, the exporter must submit a written license application to the U.S. Bureau of Industry and Security within the U.S. Department of Commerce.

U.S. franchisors that export or re-export covered items, like all other companies, must comply with export control laws. These laws may apply to franchisors that are exporters or re-exporters. They do not apply to a franchisor where a third party exports equipment that the franchisor has approved, unless the franchisor somehow had knowledge that the export or re-export was unlawful. Franchisors should review their exports, re-exports and deemed exports of goods and software to ensure that they comply with the EAR and any licensing requirements. A franchisor should carefully examine whether the equipment it exports and any

software made available to foreign franchisees is consistent with the EAR. Even enterprise software that facilitates secure communications and transactions between a franchisor and its foreign franchisees could potentially raise EAR issues. Encrypted software is of particular concern, encryption embedded in software may be covered by the EAR, but would be subject to a general license. Ultimately, the applicability of export controls on encrypted software depends on the nature and extent of the encryption.

Where the EAR applies, franchisors may wish to consider developing a tailored compliance program to promote compliance and establish a strong mitigating factor in case of any violation.