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The Importance of Due Diligence on International Franchisees and Ways to Minimise Risk

TLT LLP

Pauline Cowie

The decision to franchise internationally can come about in a number of ways. An *ad hoc* enquiry may have been received from an overseas business wanting to take a franchise for a country or region, or a strategic decision may have been made to franchise internationally targeting certain countries and possibly potential franchisees.

Whichever route to international franchising is chosen, be it a direct, master or area development franchise, having made a decision to franchise internationally whether in a particular jurisdiction or generally, it is important to ensure that the franchisor complies with all compliance and legal requirements and that so far as possible, steps are taken to maximise the success both initially and for the longer term of the franchise.

One of the key areas to consider is the suitability of a prospective franchisee and this will need to take place on a number of levels. It is by the carrying out of an initial assessment and due diligence investigation that the franchisor will obtain sufficient information to enable a decision to be made in principle whether it has sufficient confidence to move forward to detailed discussions and the signing of a formal franchise agreement. It will also assist a franchisor in evaluating the strengths and weaknesses of a potential franchisee and inform how the franchise agreement may be structured. Franchisors that have already franchised their business whether domestically or internationally will already have an understanding and insight as to how critical it is to get the appointment of the franchisee right. If things go wrong domestically, problems and disputes with a franchisee are much easier to handle than a disruptive and non-compliant franchisee in an overseas jurisdiction.

Before starting the process, an understanding of culture and custom together with preliminary research on how familiar or prevalent franchising is in the target country will inform the approach to due diligence. In some countries, it is important to build the relationship with the prospective franchisee before any detailed due diligence information is requested. Good communications in the initial stages are a means of building rapport and can enable the franchisor to assess whether the parties are in fact able to communicate without a fundamental disagreement.

Whilst franchisors will already conduct due diligence on domestic franchisees, international due diligence will throw up a variety of additional challenges. Language may well be an issue as well as differences in how the parties like to communicate. There could also be cultural issues in that providing information to the level of detail required may be seen as damaging the potential relationship and a sign of mistrust or bad faith. In particular, the more detailed the information required, the more concerned the proposed franchisee may be and therefore reluctant to provide the level of detail required. Clearly, such an explanation could also be used to avoid making disclosures so a sensitive path will need to be taken. Local laws may also limit the availability of information but if this is the case, the franchisee should be upfront and fully transparent and if in doubt, checks should be made to ensure that the franchisee has correctly interpreted applicable rules.

First Steps

Although information under a due diligence exercise is being obtained about the prospective franchisee, this is likely to take place in the context of wider commercial discussions. The franchisor will need to protect the confidentiality of its commercially sensitive information having built up a substantial amount of know-how and brand awareness. Similarly, the franchisee may be concerned about protecting any non-publicly available information. It therefore makes sense that before either party discloses any non-publicly available information, a confidentiality or a non-disclosure agreement should be signed. The franchisor should send this at the earliest opportunity as at the beginning of any discussions, it may not be clear where they may lead and whether a franchise relationship may be established. Leaving it any later may mean that confidential information will be disclosed without a clear set of agreed rules regarding the use of that information. If there are any particular concerns over enforceability it may be wise to have the draft reviewed by local counsel, particularly regarding the duration of any restrictions.

In countries where there are formal disclosure requirements, local advice should be taken as to when disclosures need to be made and if they need to be made before the general due diligence exercise takes place.

Scope of Due Diligence Exercise

The due diligence exercise is not just about obtaining information on ownership structures, management and financial information, but also goes to a deeper level to find out:

- if there is a cultural fit;
- if the management team are easy to get along with and have the right skills and attributes;
- the respective strengths and vulnerabilities of the prospective franchisee;
- the prospective franchisee's level of sophistication (for example, they may already operate as a multi-brand franchisee). The practical skills needed by a master franchisee who will be sub-franchising will include recruiting franchisees, managing

sub-franchisees as well as enforcing the terms of the sub-franchise agreements. These skills are more difficult to assess but may be already in place with multi-brand franchisees;

- local market knowledge and contacts; and
- how the franchisee conducts itself throughout the due diligence process and negotiations.

The due diligence exercise will be a combination of business, financial and legal due diligence including verification against publicly available information and must be approached on a risk-sensitive basis. An important part of the process will also include meeting the owners and operational team. Meetings will need to take place both at the franchisors head office and at a local level with the franchisee. It is inevitable that at this stage the franchisee will be enthusiastic but the franchisor will need to be careful not to equate enthusiasm with competence.

It will also invariably be governed by practicalities such as how easy it is to obtain information, the timetable that the parties are working towards (and any particularly sensitive timelines), the willingness on the part of the proposed franchisee to provide the information which is requested in sufficient detail and in a timely fashion, and the costs and expense involved in verification. Industry knowledge may well also throw up valuable business intelligence.

On a practical level, the franchisor will need to assess the potential franchisee's financial position and obtain comfort that sufficient funds are available to develop the brand in the market in line with the franchisor's expectations. This will be particularly important where sub-franchising is not permitted and the franchisee will be an area developer, as the franchisee will need to use its own resources to open and expand the business. Where sub-franchising is permitted or required, the franchisee may need to open one or more pilot stores and will need to have the infrastructure in place to support the rollout of sub-franchises.

If the franchisee is a company with few assets or a poor credit risk, as well as concerns that it may not be able to maximise the potential of the franchise, there is also the risk that it may not have sufficient assets to meet a claim by the franchisor, in the event that the franchisee breaches the terms of the franchise agreement. The franchisor should therefore consider whether it is appropriate to take additional security such as a guarantee or bond to guarantee the franchisee's obligations from a parent company and/or key individuals who will be controlling and operating the franchise.

If supplies of products, equipment or raw materials are to be made by the franchisor or its suppliers to the franchisee, the franchisor will want to assess the ability of the franchisee to be able to pay for items supplied and consider how best to minimise risk, for example, through letters of credit, shortened payment terms, upfront payments and guarantees.

There may also be particular attributes which the franchisor regards as essential to success such as:

- Can the franchisor lever off the franchisee's existing supply chain and how might this work?
- For retail and leisure franchises, how good are the potential franchisee's contacts in the property market and does it have sufficient enough covenant strength?
- If local market knowledge is important to roll out the franchise does this need to be tested and how?
- If the potential franchisee has raised any particular issues of concern or local or regulatory hurdles how have they suggested that they will be able to overcome them to fit local market needs?

On some occasions the process may seem unnecessarily slow, but bearing in mind the potentially damaging effect on the franchisor's business as well as the disruption and time and expense in attempting to manage a non-compliant franchisee, this should put everything into perspective. In countries where there is a more formalised approach to disclosure and a franchise code of practice, franchisees will invariably be familiar with the process of due diligence without undue concern and have an awareness of what the parties must disclose to one another including an obligation to negotiate in good faith.

Franchise Questionnaire

In order to record and co-ordinate responses a questionnaire will be helpful particularly where information will be obtained from a number of sources. Whilst the amount of publicly available information has expanded, its reliability may be questionable and carrying out a due diligence exercise using traditional means is likely to be more reassuring. The franchisor should ask for the relevant information and consider whether verification is necessary. The franchisor should be aware that it may not be possible to obtain certain information on foreign companies without instructing specialist providers or local law firms.

Using a questionnaire has the advantage of creating a paper trail on the information provided by the franchisee and distinguishing it from information which may have been collated by the franchisor's internal business team. It will also test how serious the proposed franchisee is in proceeding beyond initial discussions.

At the very minimum it is likely to include the following:

- organisation background and registration particulars;
- evidence of necessary licences and registrations;
- group structure;
- details of the owners of the business including details of beneficial owners and anyone who has the ability to exercise any influence over the affairs of the business;
- details of any relationship with government officials;
- details of the management team and officers;
- disclosure of any criminal, regulatory or civil claims and proceedings both current and historic together with confirmation that none are pending;
- anti-bribery and anti-corruption compliance, policies and procedures;
- copies of statutory accounts and *pro forma* performance metrics as well as up to date financial information;
- details of other business activities and interests; and
- references.

When putting together a questionnaire, the franchisor should also consider how the structure of the proposed franchise and supply chain will operate and where it is appropriate to add to the information required.

Further information may also be required depending on the responses and information provided.

More problematic jurisdictions may mean that additional and more detailed due diligence should be undertaken overlaid with the checking against and awareness of sanctions against target countries, groups and individuals which if breached could mean that criminal offences are committed by the franchisor and its officers. The franchisor should take specialist advice on how it is able to meet its regulatory and compliance obligations.

The questionnaire should be completed and signed by an officer of the franchisee who should certify its completeness and accuracy.

Review of Information Received

When information is received, the franchisor should ensure it is properly reviewed and any areas of risk or uncertainty followed up. If there are any areas of concern it should consider how best to approach these and review carefully how the prospective franchisee handles any follow up requests. Verification from an independent source may also be advisable particularly in high-risk situations and where adverse information is received.

The franchisor will also need to bear in mind that the information provided will only be a snapshot at a particular time and may not necessarily remain completely up to date. If there is a long period between receiving replies to the original questionnaire and the signing of the franchise agreement, the franchisor should consider whether confirmation should be obtained that there have been no changes to the information originally provided before signature. Importantly, the due diligence exercise is an ongoing process and to the point of signature informs how the parties will communicate going forward.

The franchisor should usually obtain warranties and representations in the franchise agreement concerning the accuracy and completeness of the information provided and confirmation that there have been no material omissions. At the very least it reinforces the importance of the information provided and the reliance made.

The whole due diligence process is a combination of the franchisor taking a risk-based approach and also exercising judgment based on an assessment of the information received and the conduct of the prospective franchisee. In borderline situations where a potential franchisee falls short of minimum requirements and expectations, it may be tempting to proceed to the signing of the formal franchise agreement, but the better decision may be to walk away and learn from the experience.

Ongoing Due Diligence

In high-risk countries, due diligence will need to be an ongoing process to track changes in ownership structures. Therefore, even after the franchise agreement is signed, it may be necessary for the franchisor to ensure it obtains up to date information concerning the franchisee to comply with the franchisor's legal obligations. The franchisor will therefore need to ensure that it is entitled to require the franchisee to provide details of anticipated and ongoing changes and up to date information in the franchise agreement. This can be a complicated area and the franchisor will need to make sure that it keeps up to date with evolving requirements.

What Can Go Wrong?

In international franchising, it is usual for master franchise or area development agreements to be granted for a significantly longer period than domestic franchise agreements. This is in order to enable the franchisee to recover the benefit of the substantial investment required in setting up the franchise in an overseas territory and to allow enough time for the franchisee to maximise potential particularly where it is necessary for initial pilot operations to be launched to test the market and make any necessary adjustments to the business model. This, coupled with a potential grant of exclusivity means that the parties will be entering into a single substantial long-term franchise relationship.

There is also a not insignificant cost to the franchisor who will incur cost and expense in drawing up the franchise agreement and ancillary documents including the taking of local law advice. There will also be the cost of training, time spent with the franchisee and international travel. Some of these costs may be recouped but selecting the wrong franchisee may ultimately lead to reputational damage.

It will be expensive and time consuming to terminate a franchise agreement or remove a franchisee if things start to go wrong and the international element introduces a new level of complexity. In addition in certain jurisdictions, local laws may make it more difficult to terminate the franchise agreement and there may also be limitations on the enforcement of rights under the franchise agreement including potential difficulties in the enforcement of judgments and arbitration awards. Local counsel can assist in identifying particular issues and exit strategies as well as effective dispute resolution procedures. It may be preferable to have disputes resolved by arbitration but not all local courts will enforce overseas arbitration awards and in some countries the preferred route might be to use the local courts. Local counsel can also advise on how foreign courts approach litigation by foreign parties in the local courts. Failure to address these issues from the outset can result not only in issues in enforcement but also an inability to adequately reclaim the brand as well as fines or criminal convictions if applicable legislation has not been complied with.

The choice of law and jurisdiction will also need to be weighed up in the context of the location of where the franchisees assets are and the possibility of needing to take immediate action such as the obtaining of an injunction. It is unlikely that the franchisee will have significant (if any) assets in the country where the franchisor is based.

The franchisor should also be mindful of any potential liability in relation to the franchisee's employees and any particular consequences of termination such as rights of continued employment for the franchisee's employees where there is a transfer of an undertaking or service back to the franchisor. Other areas of concern include joint liability which is becoming an increasingly common concept depending on the degree of influence or control exercised by the franchisor over the franchisee as well as data protection and security breaches. This means that in some countries, where a franchisor exercises such control or influence, it may be treated as an employer of the franchisee's employees for social security purposes, or specific liabilities may be imposed on the franchisor in relation to the franchisee's treatment of its employees. In the latter scenario, the franchisor will need to put in place a system to prevent franchisees breaching certain local employment laws. It will be appropriate to obtain indemnities against the franchisee's breaches of its obligations and where liability is imposed on the franchisor, but ultimately they may be difficult to enforce and add another layer of complexity.

As with domestic franchising, side-stepping a thorough due diligence exercise could have particularly disastrous consequences and as much care should be taken by the franchisor as if it was establishing its own overseas operations. Having an understanding of how easy it may be to enforce or terminate the franchise agreement for breach and/or exercise step-in rights will inform the procedures which will need to be taken should things go wrong. The franchisor should also look at other ways of mitigating risks.

Business Planning

In a master franchise or area development relationship, it is important for the franchisee to be placed under an obligation to actually establish the franchise including any pilot operations, and for appropriate criteria to be set out for achieving this. It is also important to set out in writing the requirements and expectations for expansion. Usually, the franchisor will want the franchisee to expand quickly in order to obtain a flow of continuing fees. However, the franchisee may want to be sure of success before making a significant investment and may therefore be reluctant to agree to the setting of minimum targets until the viability of the franchise has been tested. This may be particularly an issue where the franchisor does not require one or more pilot operations and wants the franchisee to rely on the success of the franchise in other countries. Ultimately, this will be a matter for discussion between the franchisor and franchisee as to whether it is feasible or desirable to rely on the successful roll out of operations in other countries.

The potential franchisee should be required to prepare a business plan which will also give valuable insight into its plans and aspirations and whether this aligns with the franchisor's own views for the brand and its expansion. This will also allow further discussions to be held on the proposed franchisee's financial strength and available capital to fund growth as well as other resources necessary to support growth plans and to put in place the necessary infrastructure. These discussions will also assist in putting together minimum performance development criteria to maximise success and any controls which might be prudent to put in place to limit expansion if things are not going to plan with appropriate milestones.

A development schedule will set a target for the number of franchise outlets to be opened by specified dates by agreeing on the number of new outlets opened in each year potentially combined with the number of outlets which must be kept open on an ongoing basis. Failure to meet agreed targets could allow the franchisor to remove exclusivity and/or terminate the franchise agreement.

The franchisee may also need to put an agreed marketing plan in place and both the business plan and marketing plan will need to be updated annually and approved by the franchisor. It would be usual to assess performance against these plans to ensure that the franchisee keeps on track with discussions held with regard to any deviations.

Drafting Tips to Minimise Risk

The franchisor may also consider other controls to be put in place to minimise risk and exposure. Where sub-franchises are to be granted this may be by approval of sub-franchisees prior to the grant of sub-franchise agreements and the obtaining of approval prior to sub-franchise terminations. Where the franchisee has specific requirements regarding the opening of new outlets, the franchisor may require to approve the sites before fit out and opening.

In the event of a serious breach of the franchise agreement, the franchisor may require step-in rights allowing it to step in and operate the franchisee's business on a temporary basis. These can be useful, but in some countries may not be a viable option where it might therefore be better to terminate the franchise agreement. Obviously where the franchisee is not sub-franchising, the number of individual properties may make it an unattractive right. In any event, local advice should be sought to ensure that they cannot be circumvented by property holding requirements. It may also be necessary to obtain the consent of the landlord and so advice may be needed on how this might be best achieved and what documents should be signed to allow step-in rights to be exercised.

As with domestic franchising, the franchisor should also consider controls to be placed on the franchisee, its affiliates and potentially key individuals who will be controlling and operating the franchisee (subject to compliance with local applicable laws) to ensure that competitor concerns are addressed and that the proposed operational structure is maintained. In addition, guarantees and performance bonds where appropriate will all assist in keeping the franchisee on track.

The franchise agreement should also contain a number of specific obligations on the franchisee. In the context of a master franchise where sub-franchising is permitted and required, the franchisee should also be required to:

- comply with targets to develop the business;
- proactively recruit high quality franchisees;
- monitor and ensure compliance by franchisees with their sub-franchise agreements;
- provide support and guidance to franchisees;
- deal promptly with franchisee complaints; and
- comply with the manual and maintain standards.

Similar specific obligations appropriate to an area development agreement will also be required.

Termination

If things start to go wrong, it is important that the franchisor takes action to ensure that the franchisee stays on track. Regular communication and discussing issues before they escalate out of control are essential. However, in certain situations termination may be the only option although it is not a step to be taken lightly, particularly where there are a number of sub-franchisees who will continue to require support and supplies of products, equipment or raw materials. The franchisor will also be keen to ensure that it is able to exercise control over its brand and reputation but without necessarily taking on any liability for previous breaches of the franchise agreement by the franchisee.

The franchise agreement will therefore need to contain effective provisions to enable the franchisor to terminate the franchise agreement where it is necessary to protect the brand and to avoid the franchisor suffering significant damage. The grounds upon which the franchisor is entitled to terminate the contract will need to be clearly set out in the franchise agreement. If the breach is capable of remedy, then if the franchisee is able to remedy the breach it may avoid termination. But where there is a material breach of the agreement which cannot be remedied, then it is likely that local laws will allow immediate termination.

In a master franchise scenario, local advice should be taken when structuring the sub-franchise agreements to anticipate a termination of the franchise agreement with the master franchisee. The franchisor will need to assess how any rights which it may wish to exercise under the franchise agreement might affect the sub-franchise agreements and what its available options might be. In advance of any termination, a strategy to deal with sub-franchisees will need to be formulated as well as how to deal with communications.

The franchise agreement should set out the consequences of termination including the obligation to cease the business and cease continuing to operate as franchisee. Any separate licence to use any registered trademarks will also need to be terminated and the terminations recorded. It is usual to specify in detail exactly what the franchisee must do on termination including steps which must be taken to protect information and confidentiality. If the franchisee has not granted any sub-franchises, there may be a sell-off period for the sale of products purchased, but any orders in the course of being processed may, at the franchisor's discretion, be cancelled.

Any monies due will need to be paid and consideration will need to be given as to whether a claim for damages or other legal action should be taken. This may depend in part with compliance by the franchisee with post-termination obligations including any restrictive covenants. Any guarantees and performance bonds may also be called in.

Upon termination of a franchise agreement, the franchisee generally has no right to compensation. There are exceptions: for example, there could be circumstances which trigger the application of agency laws. Where these are applicable, consideration will need to be given as to their impact and whether a different tactical approach should be adopted.

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Pauline has over 30 years' experience in advising franchising clients with extensive international experience and leads TLT's Franchising team.

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