US Franchisors Expanding Abroad Must Consider FCPA Risks

Law360, New York (May 29, 2015, 8:35 AM ET) --

HL Rogers

Franchising has gained popularity as a form of international expansion, but it comes with some unusual Foreign Corrupt Practices Act risks. The government's enforcement of the FCPA focuses, in part, on a company's awareness of alleged misconduct and the degree of control a company exerts over intermediaries that act on its behalf. In franchising, a franchisor not only licenses the use of a trademark to an independent franchisee, but also continues to exert some degree of control over aspects of the franchisee's operations, such as advertising and training. Yet, despite the control a franchisor may exercise over its franchisee, and despite the FCPA's broad language, there has not been to date an FCPA enforcement action against a franchisor for franchisee-related conduct. Nevertheless, depending on the details of the franchising agreement and the degree of practical control over the franchisee, a franchisor may have potential FCPA exposure from the foreign operations of its franchisee. U.S. franchisors looking to expand their brand overseas need to be attentive to the risks in doing so.

The International Franchise Model: Benefits and Risks

For decades, the franchise model has been successful in the U.S., and now many companies are looking to use that model to expand operations into foreign markets. According to a 2008 survey by the International Franchise Association of almost 1,600 franchise systems, "nearly two-thirds (61 percent) of respondents currently franchise or operate in non-U.S. markets and three-fourths (74 percent) plan to begin international expansion efforts or accelerate their current ventures immediately."

Franchising has been an attractive model for international expansion for a number of reasons: It is relatively rapid and inexpensive when compared with other methods of expansion; the franchisee can provide knowledge and expertise of a local market; tariffs and restrictions on foreign investment can be avoided; and each franchisee typically handles its own day-to-day operations, so there is generally less risk of liability for the franchisor than if the company directly owned the foreign business.

But the franchise model still carries certain risks. The doctrine of vicarious liability — where a corporation can be held liable for the conduct of its agent — is routinely invoked in U.S.-based litigation involving franchises. Many courts have held that the franchise relationship becomes an agency relationship when the franchisor exerts significant control over the subject matter of the litigation. See, e.g., Wu v. Dunkin' Donuts Inc., 105 F. Supp. 2d 83, 87 (E.D.N.Y 2000). For its part, the FCPA expressly prohibits corrupt payments to foreign officials made by third parties or intermediaries, and the statute applies to any person who has knowledge of this conduct, whether directly or with a belief that circumstances exist such that the conduct is substantially certain to occur. Given the FCPA's broad language and long jurisdictional reach, it is possible for enforcement agencies to think, in some circumstances, that foreign franchisees could be "agents" of the franchisor for purposes of FCPA liability. As a result, franchisors looking to expand abroad should carefully consider how best to structure the franchise to avoid the risk of FCPA liability.

Applying FCPA Principles to the International Franchise

Although the FCPA has not yet been enforced in the franchise context, if the government did pursue an FCPA case against a franchisor, the government would likely focus on the degree of control the franchisor exercised over the foreign franchisee's practices and its knowledge of the alleged misconduct. Liability may therefore depend on the type of franchise being utilized.

There are various global franchising models available to a company considering foreign expansion. Master franchising — the most common method — gives the "master franchisee" the right to operate a specific number of units in a defined area. On the one hand, this model permits the master franchisee more flexibility in its operations, and less involvement by the franchisor, which may reduce the potential FCPA risks to the franchisor. On the other hand, less control means greater unpredictability, and the franchisee may have more incentives or opportunities to shirk its responsibilities toward the franchisor. This would certainly raise concerns from a business perspective and may also be an issue for FCPA compliance.

At the other end of the spectrum is the direct unit franchising model, in which the franchisor licenses to one franchise owner at a time. Here, the tradeoffs are reversed — the franchisor has more control over the franchisee's operations, which facilitates oversight and predictability, while at the same time increasing the likelihood of vicarious liability. Variations and hybrid arrangements also exist, and any company looking to expand its franchise abroad must consider which model works best for its business.

International franchisors must balance their interest in minimizing liability with their interest in ensuring that the franchisee adheres to uniform quality controls and standards. And while the risk of FCPA enforcement may be minimized through careful structuring of the franchised business, there is no way to eliminate the risks entirely. No matter which model is used, every franchisor should take specific measures to guarantee FCPA compliance.

How to Protect Your Brand

A franchisor's FCPA risks are related to the degree of control it has over the operations of its franchisees and the knowledge it has, or the knowledge it reasonably should have, of the franchisees' operations. When approaching FCPA compliance, franchisors have to balance maintaining enough control over the franchisee so that they can protect their brand, while at the same time reasonably keeping the franchisee at arm's length so that it is not considered an agent of the franchisor, understanding that, even at arm's length, the government has taken an increasingly expansive view of its jurisdiction under the FCPA.

With this understanding, franchisors doing business overseas can take a number of practical steps to limit the risk of FCPA violations. Most importantly, franchisors should have strong anti-corruption compliance language in their international franchise contracts. Also, franchisors should develop an effective compliance and training program for their own employees and should institute reporting obligations for these employees — including for issues that might arise with their franchisees. A franchisor cannot simply put its head in the sand if it learns of an issue with the franchisee, but must reasonably respond to potential misconduct.

And just as franchisors typically have thorough financial vetting requirements before allowing someone to become a franchisee, these companies should perform a robust FCPA compliance due diligence on any prospective overseas franchisee. Franchisors should consider whether franchise agreements that include audit rights will help reduce their overall potential FCPA liability. Finally, franchisors must evaluate the degree of control they have over their franchisees and modulate their compliance program as their degree of control increases.

Conclusion

Franchising can be a valuable method for expanding a business abroad, but in developing and overseeing their franchisees, franchisors must be aware of, and take active steps to protect against, the risks of FCPA enforcement, especially considering the lack of precedent on how the FCPA will be applied to international franchises.

—By HL Rogers and Ellen M. Crisham, Sidley Austin LLP

HL Rogers is a partner and Ellen Crisham is an associate in Sidley Austin's Washington, D.C., office.