Holmes & Lofstrom, LLP
FRANCHISE & BUSINESS COUNSEL

U.S. ANTI-TERRORISM MEASURES AND FRANCHISING The International and Domestic Effects

by

David E. Holmes

Northern California Office

555 Chorro Street, Suite D-2
San Luis Obispo, California 93405
Phone: 805.547.0697
Fax: 805.547.0716

Southern California Office

6621 Pacific Coast Hwy., Suite 250
Long Beach, California 90803
Phone: 562-596-0116
Fax: 562.596.0416

Please visit our website at www.HolmesLofstrom.com

U.S. ANTI-TERRORISM MEASURES AND FRANCHISING: THE INTERNATIONAL AND DOMESTIC EFFECTS

After the tragedies of September 11, 2001, the United States government responded in a number of ways, militarily, diplomatically and legally, each designed to enhance the ability of the United States and its allies to combat terrorism. Some aspects of the legal response have consequences for the way franchising is done, both within the United States and between United States companies and foreign enterprises.

For residents of Australia and New Zealand, those legal changes may affect them, whether they plan to "export" their concepts to the United States or if they plan to "import" U.S. concepts, by becoming Master or unit operating Franchisees in Australia or New Zealand. This article briefly covers some of the changes that have taken place within that legal framework and discusses some of the business consequences involved. Actual implementation of the matters considered here should, of course, be done only after discussion with sophisticated U.S. and international counsel experienced in franchising.

U.S. EXECUTIVE ORDER 13224

The first legal response by the United States government was President Bush's signing (within two weeks after the September 11 attacks) of Executive Order 13224, prohibiting transactions with suspected terrorists and those associated with suspected terrorists. For most companies involved in franchising, it's this order that will have the largest effect on their businesses.

Executive Order 13224 prohibits "any transaction or dealing by United States persons, or within the United States, in property or interests in property" of suspected terrorists, and persons or organizations associated with suspected terrorists. Clearly, the Order was intended to prevent U.S.-based support of terrorist organizations.

The Order applies to U.S. citizens, residents (including resident aliens – for example an Australia or New Zealand-based system with respect to its U.S. operations), companies, and foreign branches of U.S. companies and covers transactions with suspected terrorists and/or persons or companies

- Who assist in, sponsor or provide support for suspected terrorists.
- Associated with suspected terrorists.
- Owned or controlled by suspected terrorists.
- Who act on behalf of suspected terrorists.

Note two important things:

First, the Order applies to "suspected terrorists" – there is no requirement that the government prove that an organization or person actually is a terrorist.

Therefore, U.S Franchisors will be (and are) taking special steps to assure that they are not dealing with "suspected terrorists." The government

has compiled a list (found at www.ustreas.gov/terrorism.html) of suspected terrorists and organizations. Beginning with 27 names, the list has now grown to over 200; in addition the government maintains an even longer list of aliases. Anyone doing franchise business should check the names of those they plan to do business with against these lists, since doing business with such individuals or organizations would be a violation of the Order.

Second, a violation of the Order does not have to be purposeful to result in legal problems – under the Order even a non-willful violation may be subject to penalties. Willful violations of the Order can result in fines of up to $50,000 per instance and prison terms of up to 10 years, or both. Officers, directors and agents of a company in a prohibited transaction are personally subject to the same penalties.

Non-willful violations are subject to civil penalties of up to $10,000 each. According to a July 3 Wall Street Journal article, companies which have been sanctioned for related violations in dealing with nations on the Treasury Department's Office of Foreign Assets Control list have included such well know names as Goodyear Tire, the Los Angeles Dodgers, CNA Insurance and Ikea and we can assume that a claim that an organization was ignorant of the nature of those with whom it was dealing will not automatically assure freedom from legal sanctions.

For that reason, U.S. Franchisors are increasingly using various means to ensure that they can demonstrate they've taken reasonable steps to avoid prohibited dealings. These steps are concentrated in two areas: (1) receiving appropriate documentation from prospective Master Franchisees and Unit Franchisees, and (2) due diligence background checks relating to persons and organizations with whom the Franchisor plans to deal.

In the area of documentation, many U.S. Franchisors are requiring prospective Master Franchisees and Unit Franchisees to certify that neither their companies not any associated individuals have any connections with terrorist, or suspected terrorist, organizations. Therefore, persons and companies in Australia or New Zealand should not be surprised by clauses in agreements, or by certification papers, which require them to acknowledge their non-connection with terrorist, or suspected terrorist, organizations and our firm has already prepared such clauses for various U.S. and Australia-based systems.

In addition, many U.S. Franchisors have expanded the clauses, typically found in agreements relating to the obligations of Master Franchisees and Unit Franchisees to "obey all laws." These expanded clauses now include an obligation to assist the Franchisor in complying with all U.S. anti-terrorist legislation, including those relating to money laundering, etc. Prospective Australian or New Zealand franchisees should anticipate seeing such clauses in new contracts and should inform themselves in detail as to precisely what will be their obligations in this area. Sample clauses are available on request,

but should be reviewed with Australia or New Zealand counsel prior to implementation. Franchisors can be expected to require compliance with these and other restrictions even under existing agreements, based on the existence of the standard "obey all laws" clause.

As a matter of general interest, the Executive Order is **not** limited in its application to international transactions, although a risk of a violation is certainly greater there. U.S.-based Franchisors have the same obligations regarding with whom they deal with in domestic franchise relationships. Therefore, Australian and New Zealand companies planning to set up franchise organizations in North America, and award franchises to U.S. residents, should require similar certifications and may want to consider related background checks, as discussed below.

As to such background checks and related due diligence, an analysis begins with two facts the reader may have already noted: First, U.S.-based Franchisors have, as discussed, the obligation to not deal with suspected terrorists, and persons or organizations associated with suspected terrorists. Second, a realistic observer would comment that few, if any, terrorists would be reluctant to sign any certification placed in front of them!

Therefore, to minimize the possibility of liability under the Executive Order and related laws and regulations, a number of U.S.-based Franchisors are going beyond requiring such certifications and undertaking background checks regarding the persons and organizations applying for awards of Master and Unit Franchises, including especially awards to foreign-based persons and companies. Australia and New Zealand-based companies applying for such awards, then, may be asked to supply sufficient information to allow the U.S.-based Franchisor to fulfill this due diligence obligation.

Related to this obligation, U.S.-based Franchisors will now, at a minimum, often check the name of a prospective Master or Unit Franchisee against the lists of suspected terrorists maintained by the U.S. government. Note also that these screening procedures may extend to all business contacts, including owners, directors, officers, investors and lenders and (if goods are involved) major customers and others.

In addition, Australia and New Zealand-based companies may be required to perform similar background checks on their applicants for local franchises (for example, applicants in Perth or Palmerston North for operating unit franchises) on the basis that the Australian or New Zealand Master Franchisee is an agent of the U.S. Franchisor. Australia and New Zealand-based companies should discuss with their U.S. Franchisors and U.S. counsel details as to appropriate procedures and the impact of related costs on initial unit franchise fees charged, etc.

USA PATRIOT ACT REPORTING AND COMPLIANCE REQUIREMENTS

The USA Patriot Act (along with other provisions granting the U.S. government increased authority to intercept communications, etc.), in an effort to control funding of terrorist organizations and to disable certain of their operations, requires various entities to implement anti-money laundering procedures and to observe various reporting and record keeping requirements, some of which may apply to various franchise systems.

In general, these restrictions apply to "financial institutions," the definition of which has been expanded from prior U.S. law. Although franchise organizations are not automatically "financial institutions," some franchise systems would be, including those (1) engaged in vehicle sales (including automobiles, boats and aircraft) and (2) currency exchanges.

In addition, franchise systems and affiliates which conduct the following activities may also be deemed "financial institutions":

- Issuing, redeeming or cashing traveler's checks, checks, money orders, or similar instruments (including convenience stores that sell money orders or hotels that cash traveler's checks for a fee.)

- Loan and/or finance company functions (for example, an affiliate of a Franchisor that operates as a finance company.)

Be aware that the definition of "financial institutions" may be quite broad and that franchise organizations are well advised to review whether or not they are subject to these regulations.

If subject to the restrictions, franchise systems must, in various instances, develop and put into effect programs designed to thwart money laundering activities and to make appropriate reports to the U.S. government.

At the least, these programs (for franchise systems covered by the regulations) would include such elements as:

- Internal policies, procedures and controls.
- Designation of a compliance official.
- Ongoing Franchisee/employee training programs specific to the business.
- Independent audit functions to test the operation of the program.

EMBARGO REQUIREMENTS

Existing regulations regarding dealing with an embargoed or restricted countries remain in place and, in the current environment, can be expected to be vigorously enforced. These regulations vary in their effect by country (Cuba, Iran, Iraq, Libya, North Korea, Sudan and Syria are currently on the list, which may be found at www.treas.gov/ofac); with respect to some countries essentially all dealings are flatly prohibited, while in other cases the restrictions are significantly less severe.

U.S.-based Franchise systems concerned with complying with these restrictions can be expected to take the following steps:

- Inform all employees/Franchisees worldwide of the existence of the restrictions and how to comply with them.

- Before establishing or awarding international franchises, research applicable restrictions.

- Retain the right to modify territories/elements of the relationship to comply with changes in applicable law. In this connection, international Franchisors and Franchisees will want to consider provisions dealing with possible addition of a country to the restricted list and the related changes to their business deal.

- Implement appropriate restrictions on re-export of U.S. originated goods, etc. to countries on the restricted list.

CONCLUSION

The events of September 11 had many tragic consequences. Compared to the loss of life and property, new legal restrictions were among the least significant. Notwithstanding that, all of us involved in international franchising now live in a changed world and should be mindful of the restrictions and requirements with which we must now comply. Sophisticated Franchisors and Master Franchisees will be guided by experienced U.S. and international counsel to be sure that they are obeying the law.

Mr. Holmes is the Managing Partner of Holmes & Lofstrom, LLP, a U. S. -based law firm which is a member of the International Franchise Association, and specializes in international franchising transactions, including bringing Australian-based concepts to North America. He has been involved in the legal and business aspects of franchising for nearly 30 years and can be reached at D.Holmes@HolmesLofstrom.com or in the firm's Northern California office at 805-547-0697. Firm references and biographies are available on request.