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## **INTERNATIONAL OPPORTUNITIES FROM FRANCHISES**

As marketing systems, franchises depend on growth and expansion. Most successful nationally operating franchisors are eventually faced with the issue of expanding their franchise internationally. Such cross-border expansion offers considerable new opportunities for growth, which should be seized.

The term “franchising” has a consistent international definition: the franchisor licences its know-how and business concept to a franchisee by way of a franchising agreement. The franchisor permits the franchisee to use its trade name and brand and undertakes to continue to develop the concept and support the franchisee. In return, the franchisee usually pays the franchisor a one-off franchise fee for inclusion in the franchise and an ongoing fee for regular provision of services from the franchisor. The franchisee must set up its business in line with corporate identity and the stipulations of the franchise and provide marketing in line with franchise requirements.

The opportunity to extend its sales should be of great interest to every business. The possibility of securing business growth using the funds of business partners is a globally successful marketing concept. Franchises are one of the fastest growing business areas but often the opportunities of internationalisation are missed out of fear of the challenges of a foreign market. The following is designed to outline the opportunities, risks and legal basis of internationalisation.

### **1. Adapting concept to target market**

International expansion requires the involvement of tax, legal and business consultants from the target country. Naturally, this also requires a substantial financial investment. International networks such as the Alliance of Business Lawyers (ABL) and INTEGRA permit a relatively quick identification and clarification of the relevant issues. However, it is also necessary to address other issues and the following matters are often neglected and can turn into expensive barriers to progress:

- the need to adapt to a foreign language
- different social, cultural, societal and religious conditions can result in differing expectations, wishes and preferences of customers and may require a revision of marketing concepts
- a different legal environment, perhaps including government regulation
- restraint on the importation of business equipment and goods into the target country along with relevant customs, import duties and transportation costs, which might have a negative impact on the competitiveness of the products in the target country
- protection of intellectual property rights in the target country.

The extent of adaption required can vary greatly between franchise concepts. Advanced globalisation is leading to increased standardisation of national customs, practices and

markets and is making it easier to transfer business ideas to other countries. Some concepts and brands have turned out to have international application and the main issues in this respect are mainly adaptation for language purposes and the different legal system. Other concepts purposely retain the foreign characteristics in the target market in order to attract the interest of customers with these characteristics. There are also franchises that deliberately promote foreign characteristics of a concept even though they have been developed domestically. In order to avoid expensive bad investments, it is necessary to make a careful preliminary determination of whether it is possible to retain most elements of a concept during expansion plans.

As there are extreme differences between different countries as to the extent to which consumers are open to foreign products and companies, each expansion decision should be preceded by an intensive analysis of the target country. It makes sense to begin to expand in those countries that are closest geographically and culturally to the country of origin. In any case, there should be an analysis of the competition and a study should explore whether there is a market in the target country for the products or services.

Before expansion, research should also be carried out into protection of intellectual property rights in the target country. The extent of intellectual property rights that may be protected in addition to the trade name depends on the relevant franchise concept and registration possibilities in the target country. If the adaptation of the franchise concept in the target country involves third parties such as a joint venture partner or a master franchisee, contractual arrangements should determine the entitlement of the franchisor to any new intellectual property rights which may be created, such as copyright in a new or amended handbook.

## **2. Legal framework**

The legal relationship between the contractual parties for cross-border franchise agreements and other international agreements intended to expand a franchise are subject to national laws. There is no international franchise law. Where no individual valid agreement has been drawn up between the parties that determines which national legal system is applicable, this is determined in accordance with the provisions of private international law, which contains just national conflict of law provisions. The legal relationship between the parties is also significantly affected by the relevant applicable competition laws, by European competition law within the European Union. Competition law provisions apply regardless of national legal systems, as they are state market regulatory regulations that cannot be excluded by private agreement between market participants. Special attention should be paid to possible competition law limitations in the target country, which can have a significant impact on how agreements are drafted.

This memorandum is intended only to provide an overview. It should not replace professional legal advice and the authors accept no liability for any claims based on this information. It is recommended that legal advice be sought from specialist lawyers and tax experts in individual cases.

## **3. Models of international expansion**

The principle of freedom of contract offers the franchisor various models to achieve international expansion. The advantages and disadvantages of the different models should be considered before deciding on which path of internationalisation to follow. In particular, there are the following possibilities:

- foundation of a dependent branch office, subsidiary or joint venture
- direct franchising
- master franchising

- area development.

### **3.1 Establishment of a dependent branch office, subsidiary or joint venture**

Regardless of which franchising expansion model is selected, the franchisor can start by establishing a dependent branch office or subsidiary in the target country. This can represent the franchisor and be used as a basis to build up a national franchise system.

It is also possible to establish a joint venture with a company registered in the target country. This enables the involvement of persons who are familiar with conditions and markets in the target country and who can take over local management. As the franchisor includes the joint venture partner as an outsider in the marketing organisation in the target country, the franchisor should ensure that it secures contractual protection for its own know-how.

### **3.2 Direct franchising**

The simplest model of expansion is direct franchising – the conclusion of individual franchise agreements with franchisees in the target country. In practice, such international franchising agreements arise “randomly”, such as when a franchisor is approached out of the blue by an interested party in another country that wishes to acquire a franchise without the franchisor having planned a systematic expansion. In order to avoid problems with which legal system is applicable, choice of legal system should be determined as a matter of urgency. The place of jurisdiction should also be agreed. Expansion by way of direct franchising should be discouraged if the relevant countries are a long distance apart, as this often causes regular difficulties with regard to support, control and management. This model can at best be considered as an interim solution between neighbouring countries. There are numerous examples of such agreements for cross-border expansion between Germany and Austria or Germany and The Netherlands. However, if the target country is a great distance away, it is normally better for a company to set up its own branch office or its own company or to have its own local representative.

### **3.3 Master franchising**

One widespread model of expansion of franchising systems is master franchising. This model sees the establishment of a franchise system on several levels. The franchisor concludes a master agreement with a company (master franchisee) in the target country. The master franchise agreement allows the master franchisee to act as franchisor within the target country and to build up its own national franchise system with sub-franchisees. These sub-franchisees become contractual partners of the master franchisee.

Depending on contractual arrangements, the master franchisee undertakes to adapt the franchise concept to the target market at its own cost and to establish marketability. If the master franchisee undertakes this responsibility, the franchisor normally demands a lower master-franchising fee for the master franchise licence than it would normally required to be paid. If the agreement does not specifically regulate this matter, the master franchisee should not automatically expect that the franchisor has carried out market testing in the target country. This applies in particular if the franchisor has carried out sufficient testing in the country of origin and the concept has been proven successful there and if there are no significant differences to the planned operation of the franchise system in the target country. However, in line with relevant applicable laws, as part of its pre-contractual duty of disclosure the master franchisee must advise the first sub-franchisees that no market testing has yet been carried out in the target country.

The multiple levels of master franchising can have a negative effect, as the franchisor has only an indirect influence on sub-franchisees, as they are contractual partners of the master franchisee. The franchisor must therefore ensure that the quality of products and services, image and reputation of the franchise is maintained in the relationship between the master

franchisee and the sub-franchisees and that know-how is kept confidential.

### **3.4 Area development**

The area development model is another widely used model for international expansion of franchise systems. This form of expansion is particularly common in the USA and Canada. With area development, the franchisor concludes an area development agreement with an area developer. The area developer then assumes responsibility for seeking franchisees in the target country to invest in the franchise. Individual franchise agreements are then concluded directly between franchisor and franchisees. Area developers are not contractual partners of the franchisees. In the target country, the area developer assumes the responsibilities of the franchisor in the target country as its representative and also provides ongoing advice, support and control of the franchisee as well as market observation and the organisation of marketing measures.

The duties of the area developer differ according to the various agreements concluded. If the responsibilities of the area developer are limited to the expansion of the franchise in the target country, it normally receives only a commission fee for the conclusion of new franchise agreements. The area developer role is then similar to that of a franchise broker. However, sometimes the focus of the duties of the area developer is on the permanent support provided to franchisees, which requires ongoing remuneration. Occasionally, there is agreement that the area developer is responsible for adapting the franchise to the target country at its own cost.

The advantage of area development over master franchising is that the franchisor retains control over franchising agreements and direct influence over the franchisees. This may turn out in practice to be only a theoretical advantage if language barriers or great geographical distance mean that the franchisor remains largely dependant on the area developer.

If you are interested in further information do not hesitate to get into contact with one of the authors ([info@jacobsen-confurius.de](mailto:info@jacobsen-confurius.de)).