## CONTENTS

<table>
<thead>
<tr>
<th>Country</th>
<th>Authors</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The president of the company just left a message for you...</strong></td>
<td>Philip F Zeidman, DLA Piper LLP (US)</td>
<td>5</td>
</tr>
<tr>
<td><strong>Franchise M&amp;A</strong></td>
<td>Andrae J Marrocco, Dickinson Wright LLP</td>
<td>7</td>
</tr>
<tr>
<td><strong>Australia</strong></td>
<td>Alicia Hill and Raynia Theodore, MST Lawyers</td>
<td>11</td>
</tr>
<tr>
<td><strong>Brazil</strong></td>
<td>Paulo Shigueru Yamaguchi, Marco Mello Cunha and Victor Goulart Lazarini, Tess Advogados</td>
<td>20</td>
</tr>
<tr>
<td><strong>Canada</strong></td>
<td>Bruno Floriani and Marissa Carnevale, Lapointe Rosenstein Marchand Melançon LLP</td>
<td>25</td>
</tr>
<tr>
<td><strong>Chile</strong></td>
<td>Cristóbal Porzio, Porzio Rios Garcia</td>
<td>33</td>
</tr>
<tr>
<td><strong>China</strong></td>
<td>Claudio d’Agostino, DLA Piper UK LLP (Shanghai), Paula Cao, DLA Piper UK LLP (Beijing)</td>
<td>38</td>
</tr>
<tr>
<td><strong>Denmark</strong></td>
<td>Mikkel Friis Rossa and Dan Bjerg Geary, Bech-Bruun</td>
<td>46</td>
</tr>
<tr>
<td><strong>Finland</strong></td>
<td>Patrick Lindgren, Advocare Law Office</td>
<td>51</td>
</tr>
<tr>
<td><strong>France</strong></td>
<td>Emmanuel Schulte, Bersay &amp; Associés</td>
<td>57</td>
</tr>
<tr>
<td><strong>Germany</strong></td>
<td>Karsten Metzlaff and Tom Billing, Noerr LLP</td>
<td>64</td>
</tr>
<tr>
<td><strong>India</strong></td>
<td>Sharanya G Ranga, Laxmi Joshi and Aditi Rani, Advaya Legal</td>
<td>72</td>
</tr>
<tr>
<td><strong>Indonesia</strong></td>
<td>Norma Mutalib, Richard Cornwallis and Reagan Roy Teguh, Makarim &amp; Taira S</td>
<td>78</td>
</tr>
<tr>
<td><strong>Italy</strong></td>
<td>Roberto Pera and Irene Morgillo, Rodl &amp; Partner</td>
<td>85</td>
</tr>
<tr>
<td><strong>Japan</strong></td>
<td>Etsuko Hara, Anderson Mōri &amp; Tomotsune</td>
<td>93</td>
</tr>
<tr>
<td><strong>Korea</strong></td>
<td>Sun Chang and Terry Kim, Lee &amp; Ko</td>
<td>99</td>
</tr>
<tr>
<td><strong>Malaysia</strong></td>
<td>Jin Nee Wong, Wong Jin Nee &amp; Teo</td>
<td>106</td>
</tr>
<tr>
<td><strong>Mexico</strong></td>
<td>Jorge Mondragón, Gómez Calvillo SC</td>
<td>113</td>
</tr>
<tr>
<td><strong>New Zealand</strong></td>
<td>Stewart Germann, Stewart Germann Law Office</td>
<td>120</td>
</tr>
<tr>
<td><strong>Norway</strong></td>
<td>Kjetil Vågen and Eline Thorsrud, Advokatfirmaet CLP DA</td>
<td>125</td>
</tr>
<tr>
<td><strong>Russia</strong></td>
<td>Vladimir Biruliin and Sergey Medvedev, Gorodissky &amp; Partners</td>
<td>131</td>
</tr>
<tr>
<td><strong>South Africa</strong></td>
<td>Eugene Honey, Adams &amp; Adams</td>
<td>136</td>
</tr>
<tr>
<td><strong>Switzerland</strong></td>
<td>Martin Ammann, Christophe Rapin and Renato Bucher, Meyerlustenberger Lachen</td>
<td>143</td>
</tr>
<tr>
<td><strong>Thailand</strong></td>
<td>Chanvitaya Suvarnapunya and Pattama Jarupunphol, DLA Piper (Thailand) Limited</td>
<td>150</td>
</tr>
<tr>
<td><strong>Turkey</strong></td>
<td>Hikmet Koyuncuoğlu, Koyuncuoğlu &amp; Köksal Law Firm</td>
<td>155</td>
</tr>
<tr>
<td><strong>United Kingdom</strong></td>
<td>David Bond, Gordon Drakes and Vicky Reinhardt, Fieldfisher</td>
<td>160</td>
</tr>
<tr>
<td><strong>United States</strong></td>
<td>Richard Greenstein and Philip F Zeidman, DLA Piper LLP (US)</td>
<td>166</td>
</tr>
</tbody>
</table>

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GERMANY

Overview

1. What forms of business entities are relevant to the typical franchisor?

Franchisors wishing to set up business in Germany have a variety of legal forms (partnerships and limited liability companies) from which to choose. Nevertheless, the most common form of corporate vehicle to be established by a typical franchisor in Germany is a private limited liability company (GmbH). This corporate form requires a minimum amount of capital investment (at least €25,000) and offers limited liability, so only the company’s assets are liable to the company’s creditors. Furthermore, the GmbH offers a great deal of flexibility as regards internal structures and procedures. Other forms of corporation are the public limited company (AG) that requires a share capital of at least €50,000 and the recently introduced entrepreneurial company (limited liability). The latter is a version of the GmbH and to some extent resembles a private company limited by shares (Ltd) under common law – mostly through the abandonment of a minimum capital requirement.

Franchisors that operate in more than one member state of the European Union can also choose the Societas Europaea (SE) as their legal form. This is a public limited company still governed by the respective national law but with some special regulations provided by Regulation No. 2157/2001, simplifying European-wide operation. The minimum share capital for an SE is €120,000.

2. What laws and agencies govern the formation of business entities?

If the business entity is to be classified as a partnership, its formation is governed by the German Civil Code and the German Commercial Code. The incorporation of a private limited liability company is subject to the Limited Liability Company Act, and the formation of a public limited company is regulated by the Stock Corporation Act. Limited liability companies must be registered in the Commercial Register, which is maintained by the local courts.

3. Provide an overview of the requirements for forming and maintaining a business entity.

A GmbH is incorporated by a shareholder agreement that has to be certified by a notary and registered with the Commercial Register. The agreement, and therefore the registration, has to declare the name and registered office of the company, corporate objects, amount of share capital and individual contributions of the shareholders.

4. What restrictions apply to foreign business entities and foreign investment?

There are no restrictions on foreign business entities and foreign investment in Germany.

5. Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

A business entity that has its registered office or place of management in Germany is considered tax-resident in Germany. Unless otherwise provided for in an applicable double tax treaty, a tax-resident entity is subject to unlimited tax liability in Germany on its worldwide income.

The tax system for corporate entities can be characterised as a combination of corporate income tax and trade tax. Corporate income tax is payable at a rate of 15 per cent (plus a solidarity surcharge of 5.5 per cent of the corporate income tax, resulting in an aggregate corporate income tax rate of 15.825 per cent). Individuals who conduct business in Germany or are partners in a partnership in Germany are subject to progressive German income tax rates of up to 45 per cent (plus a solidarity surcharge of 5.5 per cent of income tax), depending on their income.

Trade tax is a municipal tax, individually imposed by local authorities at the company location, and varies between approximately 7 per cent and 18 per cent. The trade tax base is the taxable profit for income or corporate income tax purposes, modified by some add-backs and deductions. To mitigate the double burden of income tax and trade tax, income tax on business income is to a certain extent reduced by trade tax (trade tax rate relief allowance). Trade tax cannot, however, be deducted from the total corporate income tax amount.

Non-tax-resident business entities or entrepreneurs are subject to limited tax liability on their domestically sourced income. Income received from a permanent German establishment is regarded as domestically sourced income and is therefore subject to income tax (for individuals not tax-resident in Germany) or corporate income tax (for companies not tax-resident in Germany), as well as trade tax at the normal rate.

Income tax on domestic taxable income from the licensing of know-how or rights of use of non-tax-resident business entities or entrepreneurs not having a permanent establishment in Germany is levied at source by way of a withholding tax, unless otherwise provided for in an applicable double tax treaty. The withholding tax is normally paid by the debtor (the franchisee) on account of the creditor (the franchisor). The tax rate is 15 per cent. The solidarity surcharge amounts to 5.5 per cent of the income tax or the corporate income tax.

Deliveries and services supplied in Germany against consideration by an entrepreneur are generally subject to German value added tax (VAT). Services relating to licensing of rights or the provision of know-how supplied by an entrepreneur are generally subject to VAT, if the recipient of these services is situated in Germany. Deliveries of goods from abroad are either subject to German VAT on intra-Community acquisition of goods or to German import VAT. The standard rate is 19 per cent; however, some deliveries are taxed at the rate of 7 per cent and some supplies are tax exempt (for example, financial services).

6. Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Depending on the nature of the relationship between a franchisor and a franchisee, there may be a risk that the franchisee is considered as an employee or a quasi-employee of the franchisor, leading to the franchisee being confronted with employer obligations and employee rights of the franchisee. Whether a franchisee will be classified as an independent businessman or as an employee (or quasi-employee) depends on the scope of the control exercised by the franchisor, and on the extent of the entrepreneurial risk assumed by the franchisee.

In this respect, the courts rely on the criteria of personal dependency (employees) or economic dependency (quasi-employees).
Personal dependency will be assumed if the franchisee is excessively bound to the franchisor’s instructions regarding the subject matter, conduct, time, length and place of its activity. Self-employment on the other hand will be assumed where the franchisee is mainly free to determine its activity and bears the entrepreneurial risk. A franchisee organised in the form of a company limited by shares (for example, a limited liability company or a stock corporation) will not run the risk of being qualified as an employee (except for the particular case of a one-person company in which the characteristics of dependant employment prevail).

If the franchisee – in the case of self-employment – is considered as a quasi-employee, some employment law provisions are expressly declared applicable (no general application of employment law!). This requires, however, the franchisee’s economic dependency on the franchisor (ie, the franchisee’s basis of existence must arise out of the franchise business).

In order to avoid the risk of employment law being applicable, the franchisor has to make sure that there is no personal or economic dependency of the franchisee. This can be achieved by tailoring the contract and the corresponding execution of that contract.

7 How are trademarks and know-how protected?

Apart from well-known or famous brands, trademark protection in Germany requires registration either with the German Patent and Trademark Office or as a Community trademark with the European Trademark Office (Alicante, Spain) or a designation of international trademarks for Germany. Trademarks such as words, letters, numbers, pictures, sounds, colours and colour combinations are protected by the Trademark Act.

Although know-how is part of a franchisor’s intellectual property rights, the protection of know-how is not subject to specific statutes such as the Trademark Act or the Copyright Act. As a result there is no registration requirement for licensing know-how. Even so, franchisors’ know-how is confidential information under the franchise agreement or other confidentiality agreements. And the use of intellectual property rights and know-how is limited to the purpose of the franchise system. Breach of business confidentiality constitutes a breach of those agreements and, moreover, is punishable under the Act Against Unfair Competition.

8 What are the relevant aspects of the real estate market and real estate law?

German law does not provide for any special franchise-related regulations concerning the real estate market or real estate law. Thus, the general rules of the Civil Code apply. Commercial leases and subleases may be freely concluded between lessor and lessee. Any assignment of ownership must be notarised and registered in the land register.

Under German law subleasing requires the permission of the landlord. In case of commercial leases the lessee may neither be entitled to sublet, restrict the manner in which a franchisor recruits franchisees or selects its or its franchisees’ suppliers? or other confidentiality agreements. And the use of intellectual property rights is confidential information under the franchise agreement, concluded between the parties for this purpose.

In Germany, there are no specific laws or government agencies that regulate the offer and sale of franchises. Therefore, the offer and sale of franchises is only governed by the general provisions of contract law (the Civil Code), consumer law, commercial law (the Commercial Code), competition law and unfair trade law.

In particular, the provisions of the Civil Code concerning standard terms can be applied where the franchisor uses standard franchise agreements being signed by the franchisee on a take-it-or-leave-it basis (section 305 of the Civil Code). According to section 307 of the Civil Code, all standard-term provisions need to be reasonable and may not unduly disadvantage the other party contrary to the requirements of good faith, otherwise they are null and void (see also question 25).

According to German law the franchisor must disclose all necessary information to the franchisee (for details see question 15).

Further, according to German consumer credit law, a franchisee is entitled to withdraw from the franchise contract within a period of 14 days of its conclusion if it thereby establishes an independent business enterprise and the contract contains an obligation to repeatedly take supplies of goods (for details see question 37). But such right of withdrawal requires that the total value of the franchisee’s investments does not exceed an amount of €75,000.

Describe the relevant requirements of these laws and agencies.

See question 10.

12 What are the exemptions and exclusions from any franchise laws and regulations?

See question 10.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

German statutory law does not provide for special requirements that a franchisor must meet prior to offering franchises. Neither are there any specific government consents or official authorisations required to approve or perfect a franchise transaction with an overseas franchisor or enable it to operate through a franchisee in Germany.

Nevertheless, the GFA lists numerous guiding principles in its code of ethics. Inter alia:

• the franchisor must have successfully run a business concept for an appropriate period of time and with at least one pilot project before founding its franchise network;
• the franchisor must be the owner or legitimate user of the company name, trademark or any other special labelling of its network; and
• the franchisor must carry out initial training of the individual franchisee and must assure ongoing commercial and/or technical support to the franchisee during the entire term of the contract.

Observance of the stated principles is obligatory in order to become and remain a member of the GFA and to demonstrate fair business practices.

14 Are there any laws, regulations or government policies that restrict the manner in which a franchisor recruits franchisees or selects its or its franchisees’ suppliers?

There are no such laws, regulations or government policies in Germany.

Laws and agencies that regulate the offer and sale of franchises

There is no statutory definition of ‘franchise’ or ‘franchising’ in Germany. The German Franchise Association (GFA) (www.franchiseverband.com) provides a definition (recognised in parts by the courts) as follows:

Franchising is a sales and distribution system by means of which goods, services or technologies are marketed. It is based on a close and ongoing cooperation between legally and financially separate and independent companies, the franchisor and the franchisees. The franchisor grants its franchises the right, at the same time as imposing the obligation on them, to conduct a business in accordance with the franchisor’s concept. This right entitles and obliges the franchisee, in return for direct or indirect remuneration, to use the system’s name, trademark, service mark, copyright and/or other intellectual property rights, as well as know-how, economic and technical methods and the business system of the franchisor, under ongoing commercial and technical support by the franchisor, within the framework and for the term of a written franchise agreement, concluded between the parties for this purpose.

10 Which laws and government agencies regulate the offer and sale of franchises?

In Germany, there are no specific laws or government agencies that regulate the offer and sale of franchises. Therefore, the offer and sale of franchises is only governed by the general provisions of contract law (the Civil Code), consumer law, commercial law (the Commercial Code), competition law and unfair trade law.

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Observance of the stated principles is obligatory in order to become and remain a member of the GFA and to demonstrate fair business practices.

Are there any laws, regulations or government policies that restrict the manner in which a franchisor recruits franchisees or selects its or its franchisees’ suppliers?

There are no such laws, regulations or government policies in Germany.

www.gettingthedalesthrough.com
What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

Under German law, pre-contractual disclosure in connection with franchise contracts is not regulated by special statute or monitored by a specific agency. Only the general provisions regarding the opening of contractual negotiations apply, in particular the principle of culpa in contrahendo. This principle provides that before the conclusion of a franchise contract, the franchisor must ensure that all relevant facts have been clearly presented to the potential franchisee. In case of a violation of the franchisor’s duty to present the relevant facts, the franchisee has the right to claim damages. The scope and content of the duty depend on each individual case, taking the experience and knowledge of the franchisee into account.

German courts have stressed that, as a general rule, the franchisee is obliged to obtain information at its own initiative about the general market conditions and their impact on the prospective franchise business. Moreover, if there are particular circumstances of which only the franchisor is aware and which are recognisably of importance to the potential franchisee’s decision as to whether entering into the franchise contract or not, the franchisor must disclose such information. Thus, unlike common law countries, and contrary to the legal situation in, for example, France, Italy and Spain, there is no specific compliance procedure under German law or under German franchise practice. A written standard compliance procedure does not exist. Nevertheless, it would be advisable for franchisors to expressly disclose to their potential partners in writing all information that is deemed necessary according to German case law and to the non-binding GFA guideline on pre-contractual disclosure obligations (reflecting the actual constitution of the franchise system). German franchise lawyers have developed checklists to ensure such proper disclosure.

The pre-contractual information (see question 17) should be disclosed within a reasonable period prior to the conclusion of the franchise agreement. This applies also to any (preliminary) binding agreement between the parties. Conversely, the rules of pre-contractual disclosure in connection with franchise contracts shall not apply to reservation agreements between the franchisor and a potential franchisee. As the term of such agreements is shorter, there are minor economic consequences and usually no obligation to enter into a franchise agreement is provided.

In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

Master franchising seems to be still the preferred method for international franchisors who also wish to use the franchise concepts they have developed for their worldwide business in Germany. In case of a sub-franchising structure, it is up to the sub-franchisor to make pre-sale disclosures to sub-franchisees. As a result, the sub-franchisor must provide information about the way the franchise system works and its prospects of success.

However, as there are no statutory provisions with regard to pre-contractual disclosure obligations (see also question 15), the scope and content of disclosure requirements depends on the sub-franchisor’s need for information and its existing possibilities to obtain information. Therefore, the sub-franchisor must, at least, offer information about the master-franchise and the allocation of tasks between franchisor and sub-franchisor. Moreover, the sub-franchisor must show the extent of derivation of rights from the franchisor (particularly as to trademarks and know-how).

What information must the disclosure document contain?

There is no statutory requirement for specific items for pre-contractual disclosure. Even so, it may be derived from German case law and from the GFA guideline on pre-contractual disclosure obligations that at least the following items should be disclosed (see also question 15):

- information about the franchise concept, including in particular, date of the beginning of the franchise system and the actual number of franchisees, fluctuation rate;
- indication of people in charge to act on behalf of the franchisor;
- the franchise offer, including amongst others: location, performance and experience of the pilot business, required investment and manpower for the franchisee’s business;
- information that enables the franchisee to elaborate its own location analysis and profitability calculation of the franchise business;
- information about situations where compulsory statutory pension insurance for the franchisee applies;
- the franchise agreement and the franchise handbook (including all standard appendices);
- memberships in franchise associations;
- information on other distribution channels for the franchise product or service;
- pending lawsuits with a potential impact on the franchisee’s business.

Is there any obligation for continuing disclosure?

An obligation for continuing disclosure can follow from the principle of good faith that is a basic principle of German law (see question 36). By invoking good faith, a court may establish collateral obligations owed between contracting parties. This may include protective obligations, such as information (disclosure) about developments having an impact on the franchisee’s business or on the franchise system in general (for example, the franchisor’s trademark being challenged by a third party).

How do the relevant government agencies enforce the disclosure requirements?

This is not relevant in Germany (see question 15).

What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations?

If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

If the franchisor infringes its duty regarding disclosure, the franchisee is entitled to claim damages. The franchisor has to put the franchisee in the position it would have been in if the franchisor had fulfilled its disclosure obligation. As the franchisee may have not agreed to the franchise agreement under full disclosure, he or she may rescind the franchise agreement. The franchisor, therefore, can be ordered to consent to the cancellation of the franchise contract, to pay all obtained franchise fees back to the franchisee and to reimburse the franchisee for all expenses incurred in connection with the franchise business. But income the franchisee earned from the exercise of the franchise business has to be deducted.

In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

As sub-franchisors are usually self-employed entrepreneurs who are not allowed to act on behalf and for the account of the franchisor, there is no direct contractual relationship between the franchisor and the sub-franchisees. Sub-franchisees can therefore only claim damages against the franchisor by tort law or by product liability (e.g. a defect product manufactured by the franchisor causes a body injury). Consequently, a sub-franchisor is solely responsible for fulfilling the disclosure obligations with regard to the sub-franchisees (see question 16). Nevertheless, the sub-franchisor may have a right of recourse against the franchisor if the sub-franchisor has used and relied on the franchisor’s disclosure material containing misleading information (breach of duties by franchisor). Because of German law on standard
22 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

See question 10. For the principle of culpa in contrahendo, which establishes as an obligation of good faith to make pre-sale disclosure mandatory, see question 15.

23 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

See questions 15, 16 and 17.

24 What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under franchise sales disclosure laws?

If the franchisee has entered into the franchise agreement owing to a deception caused by fraudulent intent of the franchisor, the franchisee may initiate proceedings to have the franchise agreement declared invalid by a court. In the event that the franchise agreement is declared invalid, the franchisor must compensate the franchisee for the damage suffered. In comparison, see question 20 for the franchisee's possibilities to claim damages concerning a breach of faith (in particular disclosure obligations). Moreover, in case of severe fraudulent practices of the franchisor the franchisee may file a complaint with the competent public prosecutor's office.

Legal restrictions on the terms of franchise contracts and the relationship between parties in a franchise relationship

25 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

As well as the offer and sale of franchises, the ongoing relationship between franchisor and franchisee is only governed by the general provisions of the Civil Code, the Commercial Code, and competition and antitrust law (see question 10). In practice, the laws of the Civil Code concerning standard business conditions play an important role for the enforcement of standardised business conditions, for example, regarding franchisees' obligation to effect changes to the franchise system that are introduced by the franchisor during the term of the agreement. This law (in particular, section 307 of the Civil Code) provides that standard terms are null and void if they unduly prejudice the other party contrary to the requirements of good faith. In other words, the standard terms law addresses unfair contract terms that operate reasonably to the detriment of the other party.

26 Do other laws affect the franchise relationship?

Besides the general provisions of contract law, commercial law, competition and antitrust law, the franchise relationship can be affected in particular by laws regarding the protection of intellectual property, such as trademark law and the laws regarding patents.

27 Do other government or trade association policies affect the franchise relationship?

The GFA is a non-government body and membership is not compulsory. Nevertheless, the membership of the GFA is regarded as an indication of quality for a franchise system. Members must conduct a severe quality review before being admitted as a full member to the GFA.

In addition, franchisors as members of the GFA must comply with the GFA's code of ethics, which thereby influences franchise relationships at least to some extent. The GFA's code of ethics was adopted on the basis of the European Franchise Federation's code of ethics, which the GFA as a member must comply with.

28 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor’s ability to terminate a franchise relationship?

Franchise agreements can be entered into for a definite or an indefinite term. In both cases the franchise agreement can end by conclusion of an agreement to annul the franchise relationship.

Franchise agreement with a definite term

A franchise agreement with a definite term can end as a result of lapse of time or by termination for cause.

Under German law, a termination without notice requires good cause and a warning letter beforehand. That said, only major infringements of the duties of the franchise agreement constitute good cause in this respect, resulting in the right for termination even without notice. Since this right is considered as a last resort (ultima ratio), default of payment and the violation of certain contractual provisions alone do not make the continuation of a longstanding franchise relationship unreasonable for the franchisor (Kammergericht Berlin, judgment of 21 November 1997, file no. 5U 5398/97, Burger King). There may be circumstances that lead to sudden friction in the relationship between the franchisor and the franchisee, for example, the refusal to pay the franchise fees or the repeated breach of important rules of the franchise system (such as the prohibition on cooperating with competitors). To assess whether an action justifies the termination of the contract for good cause requires an overall evaluation of the circumstances of the individual case and weighing the interests of the franchisor and the franchisee. The termination declaration has to take place within a reasonable time after the occurrence of the activity that led to the friction in the relationship. It should be noted that according to German law on standard terms and conditions, neither the necessity nor the requirements for 'good cause' (including the warning letter) can be waived within a pre-formulated standard franchise agreement.

Franchise agreements with an indefinite term

Under German law, franchise agreements with an indefinite term can be terminated either for good cause (without notice, as specified above) or without cause. In case of termination without cause contractual or statutory periods of notice must be considered. German law provides for the following statutory notice periods depending on the duration of the contract: one month within the first year of the term, two months within the second year of the term, three months within the third to fifth year of the term, and five months after five years of the term. The parties may agree on a longer notice period as provided for by the Commercial Code but may not shorten it. Unless otherwise agreed by the parties, any termination is valid only to the end of a calendar month.

In the event of unjustified termination of the franchise agreement by the franchisor, the franchisee might be entitled to claim compensation for loss of income that might otherwise have been earned from further business. If so, the compensation can be as high as the average annual income (calculated on the basis of the past five years). However, compensation will not be paid if the contract was terminated by the franchisee or in case of termination without notice because of misbehaviour by the franchisor.

29 In what circumstances may a franchisee terminate a franchise relationship?

The franchisee may also terminate the franchise relationship if good cause arises. For example, good cause has been affirmed by German courts where a franchisor undertakes the contractual obligation to include the franchisee in purchase benefits (such as rebates) that the
franchisor receives from its suppliers, but then conceals that it has actually received such benefits.

30 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

According to German law, the renewal of a franchise contract is exclusively subject to agreement between the parties. Therefore, a franchisor may refuse to renew the franchise agreement without having to give reasons for its decision. Nevertheless, it should be noted that franchisors’ freedom to refuse the renewal of the franchise agreement may be limited under particular circumstances. From the principle of good faith derives a certain protection for investments made for the franchisee’s benefit. For this reason, a franchisor’s termination should be based on the legitimate interests of the franchise agreement. For example, if a franchisor has announced its intention to renew the franchise contract and thereby encouraged the franchisee to further investments on the verge of contract expiry, the refusal to renew the franchise contract without good reason may entitle the franchisee to claim damages.

31 May a franchisor restrict a franchisee’s ability to transfer its franchise or restrict transfers of ownership interests in a franchise entity?

Under German law, it is possible to regulate such restrictions within the franchise contract. Normally, the transfer of the franchise is subject to the franchisor’s prior written approval in order to protect the know-how and integrity of the franchise system and to prevent entry of the franchisor’s competitors. Likewise, it is possible (and enforceable) to make the franchisee’s transfer of ownership (including assignment or pledge) in the franchise entity subject to the prior approval of the franchisor.

32 Are there laws or regulations affecting the nature, amount or payment of fees?

There are no specific laws or regulations affecting the nature, amount or payment of fees. These issues are subject to negotiation between the parties. Nevertheless, the amount of fees should reflect the quality and value of the franchise system and franchisor’s services, given that fees that are conspicuously disproportionate to the franchisor’s performance are considered immoral and are therefore void (section 138 of the Civil Code).

33 Are there restrictions on the amount of interest that can be charged on overdue payments?

According to German law, the interest rate on overdue remuneration payments is 9 percentage points above the base interest rate (according to the European Central Bank) in case of legal transactions to which consumers are not involved (which is the case in franchise agreements, see question 37). It should be noted that the interest rate for other payment obligations among merchants (eg, compensation for damages) is only 5 percentage points above the base interest rate. Furthermore, the franchisor is entitled to charge a lump sum payment of €40 for overdue payments. These provisions are mandatory to some extent: while a total exclusion of interest on overdue remuneration payments cannot be agreed upon, its restriction must not be grossly unfair to the franchisor. The negotiation of higher interests on late payments or with regard to other payment obligations is possible, but in the case of standard terms and conditions the flat rate should be oriented towards the reasonable willingness pursuant to section 307 of the Civil Code (see also question 10). The principle of good faith requires that contractual rights are exercised in a manner consistent with good faith. However, the decision whether a certain behaviour violates the principle of good faith depends on the facts of the individual case. Courts make restrained use of the principle of good faith and refrain from introducing new contractual terms that might be regarded as more appropriate by means of this sweeping clause.

34 Are there laws or regulations restricting a franchisee’s ability to make payments to a foreign franchisor in the franchisee’s domestic currency?

No such laws or regulations exist in Germany.

35 Are confidentiality covenants in franchise agreements enforceable?

Yes, confidentiality covenants are enforceable. If a franchisee does not comply with its obligation to keep know-how, business or trade secrets confidential, the franchisor may apply for an injunction and claim damages from the franchisee. Moreover, such breach of contract can represent good cause for termination of the franchise agreement without notice. In addition, to secure confidentiality it is possible to agree on a contractual penalty.

36 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

German law stipulates that the parties to a contract effect performance according to the requirements of good faith (section 242 of the Civil Code). This is a basic principle of German law and a ‘general provision’, enabling a court to tailor its decision to the circumstances of the particular case. An implementation of this basic principle of good faith is the assessment of standard terms and conditions in terms of its reasonableness pursuant to section 307 of the Civil Code (see also question 10). The principle of good faith requires that contractual rights are exercised in a manner consistent with good faith. However, the decision whether a certain behaviour violates the principle of good faith depends on the facts of the individual case. Courts make restrained use of the principle of good faith and refrain from introducing new contractual terms that might be regarded as more appropriate by means of this sweeping clause.

37 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

As a general rule, franchisees are treated as entrepreneurs and not as consumers under German statutory law and jurisdiction. In that respect, the Federal Court of Justice decided on 24 February 2005 that potential franchisees are not to be treated like consumers in connection with the setting-up of the business (file No. III ZB 36/04). Nevertheless, even if a franchisee is not considered as a consumer it might be a ‘business founder’, with the right to withdraw from the contract under some conditions: in Germany the franchisee has a statutory right of withdrawal if the franchisee is subject to a procurement obligation within the meaning of section 510 of the Civil Code (ie, the franchisee is subject to a recurring purchase obligation in connection with the franchise agreement it has entered into). It is irrelevant in this respect whether the merchandise has to be purchased from the franchisor or from a third party designated by the franchisor (system supplier). An indirect supply agreement (eg, an obligation to purchase training materials or related PR products) is sufficient in this regard. A further prerequisite is that the franchisee is a business start-up investing an amount not exceeding €75,000 (generally referred to as the ‘right of withdrawal threshold’ pursuant to section 513 of the Civil Code). Since the entry fee upon conclusion of a franchise contract does not normally exceed €50,000, it can be assumed that in the case of a start-up franchisee entering into a franchise agreement with a procurement obligation, such right of withdrawal usually exists. It allows the franchisee to withdraw from the franchise contract within a period of 14 days. The withdrawal period will not start before the franchisee is provided with a written instruction on its right of withdrawal by the franchisor. If the franchisee has not or has not been properly advised, the withdrawal period is extended to one year and 14 days after conclusion of the contract.

38 Must disclosure documents and franchise agreements be in the language of your country?

German law does not require an international franchisor to provide the franchisee with pre-contractual information or a franchise agreement drafted in the German language. Nevertheless, in order to avoid misunderstandings and future disputes, it is advisable that the franchisee is at least provided with a translation of the franchise agreement for convenience, as long as it cannot be excluded that the franchisee might have difficulties with the interpretation of the franchise agreement. Moreover, if the franchise agreement provides for the jurisdiction of a German court, a translation of the agreement will become necessary if it is brought before a court, given that the language in court needs to be German (this applies to all documents involved).

39 What restrictions are there on provisions in franchise contracts?

German law is characterised by the principle of contractual freedom that allows the parties to agree on the provisions of a contract at their discretion. Therefore, restrictions on provisions in franchise contracts
are an exemption and mainly follow from antitrust law and the laws regarding conditions in standardised contracts (in particular section 307 of the Civil Code: see questions 10, 25 and 36).

No. The law regarding standard terms and conditions specifies the principle of good faith and bans standardised provisions that unreasonably disadvantage the franchisee in a manner contrary to the requirements of good faith. For example, a provision stipulating that the duration of the franchise agreement shall be 30 years would presumably be considered void, given that it unreasonably restricts a franchisee’s entrepreneurial freedom. On the other hand, a duration that is too short (for example, one year) could also be regarded as unreasonable, as it would be practically impossible for the franchisee to recover the costs of its investment in setting up the franchise business within the agreed term. In the context of standardised provisions in franchise contracts regarding their duration, a recent decision of the Higher Regional Court of Frankfurt should be noted: the agreed initial two-year period combined with multiple extensions of five years at a time unless terminated with 12 months’ notice of the expiry of the franchise contract was considered legally acceptable (see judgment of 8 October 2014, file No. 4 U 41/14).

The second source for legal restrictions on provisions in franchise contracts is antitrust (competition) law. In 2005, German antitrust law was completely harmonised with European antitrust law. All forms of competition restraints contained in distribution agreements, such as non-compete clauses, price-fixing, guaranteed exclusive areas and purchasing restrictions, are now treated in full compliance with European antitrust law. European antitrust law (article 101(1) of the Treaty on the Functioning of the European Union (TFEU)) prohibits agreements between undertakings that may affect trade between member states and that, as their object or effect, prevent the prevention, restriction or distortion of competition within the common market. Exemptions are made either on an individual basis, or, if applicable, under a block exemption. Vertical restraints such as those typically encountered in franchise agreements can be, to some extent, exempted under the EC Block Exemption Regulation No. 330/2010 (BER).

Non-compete clauses

Obligations not to compete during the term of the franchise agreement are subject to competition law, as they restrict the franchisee’s freedom of business activities and prevent other suppliers from distributing their products or services through the franchisee involved. Under competition law, non-compete obligations are treated like purchasing obligations. Consequently, they are lawful if they are essential for maintaining the identity and reputation of the franchise system or to protect the know-how transferred by the franchisor to the franchisee (European Court of Justice, judgment of 28 January 1986, case No. 165/84, ECR 1986, 353, Pronuptia). If a non-compete clause is not essential, the BER can still apply. According to the BER, non-compete clauses during the term of the agreement must not be agreed for more than five years (see below).

Under competition law, post-term non-compete clauses may fall under the ban on cartels (article 101(1) TFEU) if they have an appreciable impact on competition. Those post-term non-compete clauses are generally not exempted by the BER. Nevertheless, the BER states an exemption: non-compete clauses can be agreed for one year after termination of the agreement if they only apply to competing products or services, are essential for the protection of know-how and are restricted to the business location of the franchisee during the term of the agreement. Moreover, after the term of the agreement the franchisee can be prohibited from using and disclosing know-how provided by the franchisor that has not entered the public domain. There are no time restrictions for such clauses. Please note that the franchisee may claim reasonable compensation for a post-term non-compete obligation.

Purchasing restrictions, for example, of cross-supplies

It is often agreed in franchise agreements that the franchisee is only allowed to acquire goods from the franchisor and not from other sources, including other franchisees. The franchisee’s obligation to sell only the contract goods are lawful if they are essential for maintaining the identity and reputation of the franchise network (European Court of Justice, Pronuptia, see above). If a purchase obligation is not essential for the identity and reputation of the franchise network, the BER can still apply. According to article 5 BER, purchase obligations are exempted by the BER where the duration is neither indefinite nor exceeds five years. Contracts with purchase obligations that are tacitly renewable beyond a period of five years are therefore not exempted by the BER. However, if the goods or services are resold by the franchisee from premises and land owned by the franchisor or leased by the franchisor from third parties not connected with the franchisee, the non-compete obligation may be of the same duration as the period of occupancy of the point of sale by the franchisee. Again it is important to note that the BER only applies to franchise systems with a market share of less than 30 per cent. If the market share is higher than 30 per cent, the block exemption does not apply, but an individual exemption under article 101(3) TFEU might be possible.

However, the franchisee’s obligations to purchase the products from the franchisor or a third supplier designated by the franchisor can only be lawful if such a clause does not prevent the franchisee from obtaining the products from other franchisees of the network. Such an obligation is considered as a restraint of competition that can have negative effects on price competition. Article 4d BER prohibits restriction of cross-supplies between distributors within a selective distribution system. Under EU and German antitrust law, most franchise systems have to be considered as selective distribution systems. Therefore, franchisees have to be allowed to acquire cross-supplies from other franchisees.

40 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

See question 39.

Antitrust (competition) law is traditionally enforced by public authorities. The most important cartel authorities are the Federal Cartel Office (FCO) and the EU Commission. Public enforcement of antitrust law is mostly ensured by the imposition of sanctions (such as fines) as well as cease-and-desist orders. Private enforcement of antitrust law has become of greater importance as far as damage claims are concerned.
### Update and trends

There is an ongoing discussion in Germany about the necessity of specific statutory regulations on franchising. Recently, there seem to have been legislative attempts to codify German franchise law, in particular with regard to the requirements of pre-contractual disclosure. In 2015 the Federal Ministry of Justice and Consumer Protection tendered a research project regarding ‘Special Statutory Provisions about Franchise Agreements in International Comparison’, with a focus on ‘Pre-contractual Disclosure Obligations of the Franchisor’. This research was assigned to the Technical University of Chemnitz and is expected to be completed within the coming months.

In 2013 the Federal Ministry of Justice and Consumer Protection had already asked the Federal Chamber of Lawyers as well as several trade associations to submit their statements regarding specific regulations on franchise contracts and pre-contractual disclosure. Most associations spoke against specific statutory regulations on franchise contracts. The opponents argued that specific statutory regulations are not necessary in view of the many forms and the complexity of franchise systems, which can barely be reflected by specific regulations. There also believe that the existing case law and guidelines are sufficient to provide legal certainty, in particular with regard to specific disclosure regulations.

There are, however, voices in favour of specific franchise regulations. The proponents argue that specific regulations are necessary to provide legal certainty. The Federal Chamber of Lawyers, for example, submitted a statement to the Federal Ministry of Justice and Consumer Protection arguing for the necessity of such regulations, in particular with regard to disclosure requirements.

### E-commerce

In general, it should be noted that franchise systems face complex challenges with respect to ongoing digitisation. As e-commerce sales increase steadily, franchisors have to prepare themselves in the best possible way by pushing forward the digitisation of their business models. But can both the franchisor and the franchisee use the internet as a distribution channel? The franchisee, on the one hand, cannot be prohibited from establishing an internet home page, as this prohibition violates competition law (for details see question 39). Only regulation of the services provided is allowed, just as the presentation can be prescribed in regards to offline distribution (‘quality standards for the use of the internet site’, see point 54 of the European Commission’s Guidelines on Vertical Restraints). On the other hand, online shops run solely by the franchisor have been strongly challenged in litigation and are excluded.

A recent decision of the Higher Regional Court of Düsseldorf should have a positive effect on the competitiveness of franchise systems. Accordingly, a franchisor carrying out e-commerce is, in principle, not in breach of contract or antitrust law (judgment of 28 April 2016, file No. I ZR 194/14). The court thereby stressed that the franchisor’s obligation to protect the franchisee against competition is limited to the contractual arrangements unless the franchisee’s economic existence is permanently endangered.

### Consumer protection, in particular the imprint obligation

Recently, consumer protection law (more precisely, laws that are aimed at protecting the franchisee’s customers) has played an increasing role. Article 7 of the Directive on Unfair Commercial Practices (the UCP Directive) stipulates that misleading omissions in business practices are unlawful. Article 7 has been implemented in section 5a of the Act against Unfair Competition (AUC). According to section 5a(3) No. 2 AUC, an advertiser who offers a product for sale is obliged to indicate its identity and address and, where applicable, the identity and address of the person on whose behalf he or she is acting. Hence, if a company advertises not only its brand (pure image advertising) but concrete products and their prices, it must reveal itself and in an imprint state from what company the offer originates and where the company is based.

In a recent decision, the Federal Court of Justice applied this imprint obligation to franchise systems (judgment of 4 February 2016, file No. I ZR 194/14, Fressnapf). In this particular case, the franchisor had sent customers leaflets about a promotion containing the disclaimer ‘recommended retail prices, only in participating outlets’. This disclaimer is commonly used because of EU and German antitrust law prohibiting price-fixing (see question 39). Thereafter a price-based advertisement of the franchisor must not create pressure for uniformity on the franchisees to the effect that they are de facto compelled to charge the prices promoted in the advertisement. According to current decisions of the Federal Cartel Office (FCO), such a footnote is in line with antitrust law, provided that franchisors do not check with the franchisees whether they actually comply with the advertised pricing. But the court of appeal took the view that the franchisor was unable to notice the disclaimer and qualified the whole advertisement as a concrete offer to purchase triggering the imprint obligation (Higher Regional Court of Düsseldorf, judgment of 5 August 2014, file No. I ZR 140/10). Thus, according to the Higher Regional Court of Düsseldorf, the advertising franchisor was obliged to indicate the name and address of the franchisees located in the region and participating in the promotion. The court thereby rejected the up-to-now common practice of referring to the franchisor’s website where the consumer can find the required information (‘media disruption’). This practice has been established as it is almost impossible for franchisors to include in an advertisement the imprint information regarding all franchisees (see also European Court of Justice, judgment of 12 May 2011, case C-122/10, Konsumentombudsmannen/Ving Sverige regarding article 7 of the UCP Directive). In contrast, some former jurisprudence and prevailing opinion assume that – in the case of joint advertisements of large distribution systems such as franchising – the respective imprint information must be provided in the advertisement itself, but may be provided, on a case-by-case basis, on the franchisor’s website.

Additionally, the Higher Regional Court of Düsseldorf held that antitrust law was not decisive for the case as the franchisor could avoid the antitrust law problem by refraining from using this form of price-based advertisement in future.

The Federal Court of Justice confirmed the judgement of the Higher Regional Court of Düsseldorf, but clarified in a subsequent decision regarding the same legal case: section 5a AUC does not oblige the advertising franchisor to indicate all participating franchisees, but if the advertisement provides a list of franchisees, the indicated franchisee’s name must be limited to the participating ones (decision of 28 April 2016, file No. I ZR 194/14). Hence a decision of the Federal Court of Justice regarding the general legitimacy of the media disruption or providing another practical way in which franchisors can conduct price-based advertisements for participating franchisees is still outstanding.

### Compensation payment upon termination

As the franchisor or a replacement franchisee can continue to sell to the former franchisee’s customers, the franchisee may be entitled to a compensation payment.

A commercial agent is entitled to an indemnity at the end of the agreement pursuant to section 8b of the Commercial Code, if the commercial agent has generated new customers for the principal’s business, or has significantly increased the extent of business with already existing customers and the principal continues to derive substantial benefits from business with said customers. This right to claim indemnity cannot be waived in advance. German law provides some exemptions, for example, if the contract is terminated for cause owing to culpable conduct of the commercial agent. The amount of such compensation payment must be ‘reasonable’ and shall not amount to more than one year’s annual remuneration calculated on the basis of the commercial agent’s average earnings for its activities over the preceding five years. If the agreement goes back less than five years, the average for the period of activity shall be determinative. Section 8b of the Commercial Code may apply analogously in the case of termination of franchise agreements if two conditions are met:

- the franchisee needs to be included in the franchisor’s sales organisation to the extent that it has duties that to a considerable extent are financially comparable to those of a commercial agent; and
- the franchisee needs to be contractually obliged to (directly or indirectly) transfer its customer base to the franchisor no later than at the termination of the agreement.

Recently, the Federal Court of Justice has clarified that, for franchising, mere de facto customer continuity is not sufficient for the right to compensation by analogous application of section 8b of the Commercial Code (see judgment of 3 February 2015, file No. VII ZR 109/13). Thus, the fact that customers continue to walk into restaurants, filling stations or bakery shops does not fulfill the second precondition unless the franchisee is contractually obliged to transfer its customer base to the franchisor.
Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

Civil and commercial matters are dealt with by the civil courts. Unlike countries in which parallel court systems exist on both the federal and state levels, only one uniform court system is in place in Germany (consisting of the local courts, the regional courts, the higher regional courts and the Federal Court of Justice). Unless there is exclusive jurisdiction (such as for disputes relating to real property or antitrust law), German law acknowledges agreements on jurisdiction between the parties as to international and local jurisdiction. Franchisors and franchisees are also entitled to submit all or certain disputes to arbitration. Therefore, each of the parties may challenge the court’s jurisdiction by reference to a valid arbitration agreement. Mediation is also increasingly recognised as a form of joint dispute resolution. Nevertheless, given that mediation does not end with an enforceable judgment for one of the parties, franchisors and franchisees usually agree on mediation proceedings as only the first stage of dispute resolution.

Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Arbitration in Germany offers a number of advantages, such as significant flexibility (for example, number of arbitrators, place and language of the arbitration proceedings), potential cost and time efficiencies, greater confidentiality and a binding, enforceable and non-appealable resolution of the dispute. But arbitration proceedings may be more expensive than court proceedings, particularly if the matter in dispute is of relatively low value. In those cases, additionally, the parties may find it difficult to appoint their favoured (meaning highly specialised) arbitrators, given the relatively low arbitrators’ fees following on from the low value of the dispute.

In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Under German law there is no difference between franchisors from EU and non-EU member states.