

Chapter 22

GERMANY

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I INTRODUCTION

After a slow start, franchising evolved in Germany in the late 1960s when domestic franchise systems such as Nordsee (take away fish sandwiches), Ihr Platz (pharmacies) and OBI (DIY stores) started to use franchising to achieve rapid growth. Between 1975 and 1985 the number of franchise systems grew from 40 to 200.² German reunification resulted in a boom period, with many East German citizens looking to franchise systems as their route to self-employment. According to the German Franchise Association (DFV), there are currently more than 1,000 different franchisors active in Germany, with 50,000 franchisees. The franchise industry is dominated by the service sector, which accounts for 50 per cent of the active franchise systems, followed by retail (30 per cent) and food and beverages (15 per cent).

Germany has a mature franchise market, with a wide range of domestic and international franchise systems. McDonald's, Domino's Pizza, Burger King and Mailboxes etc are amongst the more prominent foreign franchisors in Germany. In addition there is a thriving domestic market with home-grown systems such as Schülerhilfe (tuition), Vom Fass (delicatessen), Joey's Pizza and Kamps (bakery). Every year, *Impulse* magazine carries out a market study and ranking and awards prizes to the top ten franchise systems in Germany. This year's winners were Miss Sporty (fitness studio), Backwerk (bakery) and Schülerhilfe. McDonald's ranked as fourth. Current trends show a fitness boom, while many other sectors have struggled to deliver significant growth.

There are two significant industry bodies: the German Franchise Association in Berlin and the German Franchisee Association. The German Franchise Association regularly publishes statistics and recommendations.

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II MARKET ENTRY

i Restrictions

Foreign franchisors do not face any legal restrictions when entering the German market. Market entry for foreign franchisors is, however, challenging because Germany is a mature western economy with a large number of successful local businesses in almost every industry sector. Many global brands have failed in Germany, not because of legal restrictions but because they have underestimated the competition from established local and regional players.

The requirement that certain service businesses must be operated by qualified members of trade guilds can restrict the growth of service franchises in sectors such as plumbing, leather and carpet cleaning and electricians. A list of regulated professions can be found in the Trade Act. Another sector restricted by similar laws is health care. A pharmacy needs to be owned by a qualified pharmacist, and a doctor's surgery or law firm can only be owned by doctors and lawyers respectively.

ii Foreign exchange and tax

As Germany is part of the eurozone, free trade exists with all other EU Member States and payment can be made in any lawful currency, although it is market practice for domestic franchisees to make payments in euros.

Many large foreign franchisors establish a German subsidiary that acts as the local franchisor, in which case the local entity will have to pay German corporation and trade tax. For new market entrants that do not have a permanent establishment in Germany, it is important to consider the DTA between Germany and the country where the franchisor is incorporated to establish if withholding taxes apply. For the purposes of applying withholding taxes, Germany differentiates between the royalty part of the franchise fee and the service part of the franchise fee. The Germany–USA DTA contains an exemption procedure for withholding taxes.

III INTELLECTUAL PROPERTY

i Brand search

European trademark registrations are valid in Germany. Many franchisors rely on their Community Trade Mark registrations. Others register additional German language versions of their trademarks in Germany. Searches against both the European and the German Register are widely available through lawyers and trademark agents, and can be performed online in a matter of minutes.

ii Brand protection

The process for registration is simple. It is possible to register any distinctive wordmark or logo with the German Patent and Trade Mark Office in Munich. In line with EU law, generic expressions cannot be protected. There is a fee of €300.

The priority of German marks is based on the date of the application for registration. Germany recognises unregistered marks which are acquired through use, provided it can also be shown that the mark or logo has achieved market recognition.

Famous marks enjoy protection in Germany without evidence of use (see article 6 of the Paris Protocol). Further protection against passing off is available under the Act against Unfair Competition. Germany has implemented the Madrid Protocol so that foreign marks can be designated for local recognition.

iii Enforcement

As is the case in all EU countries, trademarks can be protected against infringement through court proceedings. Injunctions are widely available but must be applied for within four weeks. Germany has a sophisticated court system and specialist advice is indispensable when proceeding against infringements.

iv Data protection, cybercrime, social media and e-commerce

Germany has wholeheartedly embraced privacy. In addition to the Federal Data Privacy Act, each German state has a regional privacy law. In addition, there are a growing number of sector-specific specialist regulations in areas such as protection of children and the media.

In line with EU law, the export of personal data collected by the franchisee is restricted. Export of data to the United States is subject to compliance with the safe harbour rules or other protection to ensure that the data is safe guarded. Consent to data processing needs to be express. With very few exemptions this means that the owner of the data or data subject must opt in by ticking a box or signing a document. If the data is passed on to other organisations, this requires a separate consent. Franchisors need to carefully review their loyalty programmes and promotional campaigns to ensure that they are compliant.

IV FRANCHISE LAW

i Legislation

Despite the fact that Germany does not have a franchise law, franchising is heavily regulated. Legislation that impacts on franchising includes:

- a* the common law principle of *culpa in contrahendo*, which gives rise to a pre-contractual duty of disclosure;
- b* the law of misrepresentation;
- c* agency laws including compensation;
- c* the Civil Code, particularly the principle of good faith, the rule that immoral contracts are void and the principle that a long-term contract can be terminated for important reasons;
- d* competition laws; and
- e* cooling off rights under the Consumer Credit Act, if the franchisee commits to the ongoing purchase of products and equipment.

It is the Unfair Contract Terms Act (UCTA) that has by far the biggest impact on franchise agreements. Under the UCTA, any provision in a standard form agreement that has not been negotiated between the parties is subject to a fairness test. If the provision deviates

to the detriment of the franchisee from the fallback position, as set out in the German Civil Code, a special justification will generally be needed. Franchisees are afforded the same protection as consumers for the purposes of the law. Fortunately, the UCTA is not regarded as internationally mandatory so it is possible to contract out of the Act provided that the franchisor is based in a foreign country. It should be noted that a franchise agreement between the German subsidiary of the franchisor and a local franchisee would not benefit from this exemption.

ii Pre-contractual disclosure

German law expects the parties to treat each other fairly during contract negotiations. This includes an obligation to voluntarily disclose material facts. The franchisor will usually have in its possession certain material facts that will impact the success of the franchisee, particularly as regards the success rate of other franchisees, choice of location and financial risk. The DFV recommends that franchisors should set out this important information, together with details of the franchisor and the system, in a disclosure document. It is important that franchisors ensure that disclosures are honest and fair. It can be tempting to emphasise examples of successful franchisees while remaining silent regarding those partners that 'left the system'. Litigation and damages claims relate mostly to franchise systems that over-emphasise examples of profitable franchise units while keeping silent about problem areas. In the *Aufina* case, the franchisor had claimed that success was guaranteed, although 20 per cent of Aufina franchisees were in financial difficulty. Personal Total was an employment agency franchise that provided information on average fees per placement and average number of placements to franchisees. The franchisor was unable to substantiate these statements. Both the franchisor and the directors were liable, including for fraudulent misrepresentation. Finally, in the case of Pizza Hut, the concept of personal liability was extended to third-party business consultants that provided unrealistic forecasts for the German market. Current legal thinking is based on the suggestion that the franchisor should use representative figures taken from real stores. The figures should reflect average performance. The temptation to provide illustrations of what can be achieved by top performers should be resisted.

If the franchisee succeeds with its claim the contract can be set aside, in which case a full refund of all fees paid and the wasted investment are payable in damages. The franchisee has three years to bring a claim.

The following disclosures are recommended by the DFV:

- a* description of the franchise system;
- b* information about the franchisor and key staff;
- c* summary of franchisor services;
- d* investments required; and
- e* financial outlook in the form of a prognosis.

It may not be wise to give a prognosis. If the franchisee does not achieve the projected revenue, it is likely that they will bring a claim. On the other hand, many franchisors provide financial illustrations to franchisees during the recruitment process, in which case it is generally preferable to formalise the approach. This avoids overstatements by enthusiastic sales staff. If the franchise system is new to the German market, it is

recommended to point this out. If the franchisee is to be a pioneer, they need to know this and understand the associated risks.

There has been no case law on the mandatory nature of disclosure. Mostly, the view is put forward that it is possible to contract out of the disclosure law by making the contract subject to English law. The opposing view would be that disclosure is pre-contractual, so that choice of law in a later contract cannot affect it.

iii Registration

There are no franchise registration laws.

iv Mandatory clauses

German law implies a number of provisions into the franchise agreement. These apply even where the contract is silent, so it would not be correct to speak of mandatory clauses. However, the practical effect is similar. The most important examples of prohibited clauses are listed below.

- a* the franchisee has an inalienable right to terminate for important reasons. This cannot be excluded from the contract;
- b* the franchisor must provide certain services to the franchisee. A licence type franchise that does not oblige the franchisor to provide any training or support is considered an immoral contract in German law and would not be enforceable;
- c* the franchisor must be the owner or licensee of a valid trademark. It is not possible to transfer the risk that the trademark is lost or challenged to the franchisee;
- d* it is not possible to reserve to the franchisor the unilateral right to make major changes to the system and the manual;
- e* it is not possible to impose a new franchisor on the franchisee without their consent. Assignment clauses that seek to anticipate this consent are not valid; and
- f* it is not possible for the franchisor to reserve the right to terminate for minor breach or without prior cure notice. Terminations must be reasonable, taking into account the long-term investment made by the franchisee.

v Guarantees and protection

German law recognises guarantees and other forms of security such as suretyship. Where the franchisee is a company, it is not uncommon to request a guarantee from the owner. However, German companies need to be properly capitalised as a matter of company law, so that the risk of contracting with a shell corporation is lower.

It should be noted that personal guarantees by individuals can be subject to the provisions of the Consumer Credit Act, in which case a separate cooling-off notice may have to be given.

V TAX

i Franchisor tax liabilities

Domestic franchisors in the legal form of a corporation pay corporate income tax at a flat rate of 15.8 per cent (including solidarity surcharge) and trade tax at a tax rate of 7 to

17 per cent, depending on their place of business. Dividends are subject to withholding tax at the time of the distribution, at a tax rate of 26.4 per cent (including solidarity surcharge).

Franchise fees are subject to VAT. If payment is for the use of intellectual property, the reduced rate of 7 per cent applies, while other fees are subject to VAT at a rate of 19 per cent.

For income tax purposes, the initial or joining fee is usually recognised over the term of the franchise. The part of the fee that represents payment for initial services can be recognised as a business expense in the first year. Problems can arise with marketing fees when the franchisor underspends. It is advisable to expressly state in the franchise agreement how monies underspent are returned or carried forward to avoid these being viewed as a profit; in this case the unspent funds can be netted with an accordant liability.

Foreign franchisors that have a local representative are assessed for tax on the income attributable to services delivered locally. For these reasons, a permanent establishment or representative should be avoided. Franchise fees and royalties are subject to withholding tax at a rate of 15 per cent. If the franchise agreement does not expressly stipulate which portion of the franchise fee is a payment for the use of intellectual property (royalty) and which part is paid for service (service fee), the tax authorities will assess the portions according to their experience. Germany has DTAs with a large number of countries, and these treaties often allow for exemptions to be applied for.

ii Franchisee tax liabilities

The franchisee is liable to corporate income tax if he is a corporation. If the franchisee is a natural person or a partnership, he is liable to income tax. In addition, trade tax will be levied as a franchise business is always presumed to involve a trading business. The tax rates are:

- a* income tax: bands from 14 to 45 per cent;
- b* corporate income tax: flat rate of 15.8 per cent;
- c* trade tax: flat rate of 7 to 17 per cent, depending on the municipality; and
- d* the standard VAT rate is 19 per cent and the reduced VAT rate is 7 per cent.

Franchisees often pay themselves a generous salary as directors of the franchisee company in order to pay income tax rather than corporate income tax and trade tax on revenues. Such salary needs to reflect the market rate. If the salary substantially strips out all profits or is otherwise unusual, this can lead to a challenge by the tax authorities.

Companies that voluntarily produce accounts, lose the benefit of small companies exemptions and cannot file simplified accounts. As most franchise agreements impose an obligation on the franchisee to produce accounts, this adds to the regulatory burden on the franchisee.

iii Tax-efficient structures

Foreign franchisors should carefully consider the location of their franchisor company. Countries such as Malta and Cyprus are popular because of favourable DTAs. Sometimes splitting the royalty income and the service income can be beneficial. Royalties can be paid to an offshore entity located in a country that has a DTA with Germany, whereby

withholding taxes are waived and service fees are paid to a local service company. The best structure also depends on the home jurisdiction of the franchisor and should reflect current developments on an international level, such as the new OECD approach on base erosion and profit shifting.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Good faith and fair dealing is central to German contract law. There is an implied obligation of good faith that applies to both parties. As a result, the franchisor needs to consider the impact on the franchisee before exercising a remedy or imposing a new system standard. The most prominent practical example of how good faith affects franchising is the requirement that changes to the manual are subject to the requirement of good faith. The franchisor may only impose changes while taking into account the reasonable interests of the franchisee.

ii Agency distributor model

Agency law is applied to franchise agreements. As a result, the franchisee enjoys similar protection to a commercial agent. This has two important consequences:

- a* the franchisee may be entitled to compensation upon termination; and
- b* the franchisee is entitled to payment of reasonable remuneration if they agree not to compete with the franchisor after termination of the franchise agreement.

iii Employment law

Franchisors that control every aspect of the business of the franchisee can find themselves treated as their employers. This applies particularly where the franchisee is an individual. The best known case is the *Iceman* decision of the Federal Labour Court. The franchisees were van drivers who delivered frozen food to customers in their allocated catchment area. They were subject to detailed control and supervision, and their entrepreneurial freedom was severely limited. The differences between the franchisee drivers and employed drivers were negligible. To avoid the *Iceman* trap, franchisors need to ensure that they do not try to legislate every aspect of the franchisee's business. Clauses to avoid include regulating opening hours and holidays.

iv Consumer protection

While franchisees are not consumers because they operate a commercial business, the German Consumer Credit Act extends protection to both consumers and business start-ups. As a result, franchisees that receive start-up loans from the franchisor, and franchisees that commit to a regular mandatory purchasing programme, must be given technical statutory notices setting out their right to cancel the contract.

The consequences of failure to give the statutory notice are so severe that most franchisors voluntarily give a cooling-off notice.

v **Competition law**

Germany is part of the EU, and as such European competition law principles apply. There are some local issues around interpretation of the Vertical Restraints Block Exemption and its impact on franchise agreements. Generally, it is thought that a purchase tie in a franchise system should not exceed the 80 per cent threshold set out in the Vertical Restraints Block Exemption. Less reliance is placed on European case law, and the standard for proving that a 100 per cent purchase tie is indispensable is set at the highest possible level. Most German authors recommend that the franchisee be permitted to purchase up to 20 per cent of complementary products from alternative suppliers. In the case of the Body Shop, it was decided that the franchisees must be permitted to purchase ancillary items such as brushes, hairbands and soap dishes from third-party suppliers.

The Vertical Restraints Block Exemption is taken more literally in Germany, and has been described as setting the standard for the purposes of good faith and fair dealing, so that restrictions that go beyond what is permitted under the Vertical Restraints Block Exemption are often considered unenforceable as a matter of contract law because they go beyond what is fair and reasonable.³

vi **Restrictive covenants**

During the term, the franchisor can insist that the franchisee should not compete. Even where the contract is silent, the implied duty of loyalty can give rise to an implied restriction on competition. Equally, the franchisor can be prevented from introducing a second competing brand to the catchment area of the franchisee.

vii **Termination**

A franchise agreement is a long-term contract requiring substantial investment on the part of the franchisee. Since the *Burger King* decision it has been clear law in Germany that the franchisor cannot terminate a long-term contract for minor breach. The breach needs to be substantial, and with very rare exceptions cure notice must first be given.

Restrictive covenants as to competition are enforceable in Germany provided the franchisor pays adequate compensation to the franchisee. Since most franchisors do not wish to pay compensation, post-term restrictive covenants are rare.

Contractual penalties, on the other hand, are enforceable and can be used to effectively enforce the obligation to de-identify.

It is possible to provide that the franchisee must sell his business to the franchisor upon termination, but the transfer of the lease would require the written consent of the landlord. This can be a major obstacle in practice.

An option over the shares would require a notarial deed, which is expensive and time consuming to obtain so is rarely used.

3 Leitfunktion – Modell function.

viii Anti-corruption and anti-terrorism regulation

Bribery and corruption are criminal offences in Germany. However, the franchisor would not normally be responsible for bribes paid by franchisees. It is rare for German franchisors to carry out background checks. German franchisees may take offence where this is suggested.

ix Dispute resolution

Germany has a well-developed court system. Judgments made in other EU countries are enforceable without a retrial, and arbitration awards are fully recognised. Mediation is recognised as a form of alternative dispute resolution.

German courts will respect the choice of foreign law if the contract has sufficient connection to a foreign country. Usually this applies where the franchisor is incorporated abroad. Conversely, foreign franchisors that set up a German subsidiary to deal with local franchisees are unable to contract out of German law because the contracting parties are both located in Germany.

Injunctions are widely available as a remedy in urgent cases. The courts take a strict view of 'urgency' and will not permit injunctions after four weeks. Typically, trademark infringements by former franchisees that continue to use the trade name of the franchisor can be prevented through interim injunctions.

Contractual penalties are enforceable and can be a powerful remedy against franchisees that breach restrictive covenants.

Damages for certain breaches can be on an indemnity basis, but the general principle is that damages are compensation for actual loss suffered as a result of the breach committed. Most commonly, franchisees claim a refund of all franchise fees paid and compensation for wasted investment. Not all breaches of contract result in termination, as termination before the expiry of the term is only permitted for major breaches. Damages can still be claimed for other breaches but the contract would continue. Enforcement is possible through a range of methods including confiscation of property and payment orders diverting salaries.

Germany has a lively franchise dispute market. Franchisees have access to quality legal advice, as most Germans carry legal expense insurance. Smaller German law firms will handle franchise disputes for a fixed fee. Specialist franchisee litigation firms exist. Only the statutory maximum fee (a percentage of the dispute value) is payable to the winning party by the party that has lost, making litigation risk manageable for franchisees.

Major landmark disputes relate to the following:

- a* *Apollo Optik* cases. These relate to the question of whether the franchisor can keep volume discounts and rebates paid by suppliers. Unless the franchisor openly discloses the discounts, it will be difficult for the franchisor to keep these payments;
- b* *Holiday Inn* cases. There are numerous cases relating to excessive fees and overcharging. Where the franchisee has no realistic prospect of earning back the fees and making a profit, the franchise agreement can be void;
- c* disclosure cases. Failure to disclose fully and fairly all key facts and misrepresentation (mainly by overstating positive factors) is a frequent reason for franchise disputes;

- d* agency compensation claims. Franchisees often claim compensation upon termination for loss of goodwill and customer base. Not all franchisees are entitled to compensation; and
- e* enforcement of post-term non-competition covenants. Monetary compensation is payable to franchisees that are subject to contractual restrictions on competition. It is not always possible to avoid these payments unless a written waiver of the non-compete is given six months before the end of the term.

VII CURRENT DEVELOPMENTS

Issues around cooling-off rights and the treatment of small franchisees as quasi employees remain topical:

- a* A statutory cooling-off right applies where the franchisee is under an obligation to make repeat purchases. This applies not only to retail franchising with a purchase tie, but also to service franchises where certain equipment must be bought from nominated suppliers. The application of the €50,000 loan exemption to franchising is the subject of much debate. If the value of the purchasing commitment exceeds this limit, arguably the cooling-off right does not apply. The debate affects both calculation of the limit (forecasting the value of a purchase tie over a five-year term) and the question of whether the initial franchise fee can be included in the calculation. It is important to notice that even minor purchase ties (towels for a sun studio, branded gifts for a fitness studio) can trigger the cooling-off right. Failure to give cooling-off notice can have disastrous consequences for the franchisor.
- b* The status of small 'man and a van' franchisees as employees has been topical for some years. The debate impacts both employment rights and tax treatment. If the franchisee is an employee, the franchisor is responsible for payroll taxes, social insurance and income tax deductions and for employer contributions to social insurance up to an extra 40 per cent. Furthermore, the franchisee enjoys protection against unfair dismissal under employment statutes. A range of reforms of the tax laws has set and reset the bar for quasi-employees, and great care needs to be taken to ensure that small franchisees are truly operating an independent business.

Appendix 1

ABOUT THE AUTHORS

BABETTE MÄRZHEUSER-WOOD

Dentons

Babette heads up the EMEA franchise group at Dentons. She has more than 20 years' experience in international franchising with a particular focus on emerging markets. Her work includes the creation and critique of franchise contracts and their customisation to local law. Babette has transactional experience in all 28 EU Member States. Babette is recognised as one of Europe's leading experts in hotel and leisure franchising with a particular emphasis on German-speaking Europe. Babette is ranked by *Chambers Global* as one of the top 10 franchise specialists in the world. She is also recommended by *The International Who's Who of Franchise Lawyers*, *Chambers UK* and *Legal 500* for her franchise expertise. Babette's research on the role of franchising in the European hospitality industry has attracted widespread media attention. Babette is the author of numerous publications on franchising. She also lectures widely on international franchise laws and her expertise is often sought by franchisors from common law countries that enter civil law jurisdictions. She is an associated editor of *The Franchise Law Review*. Babette is a member of the ABA Forum on Franchising, the IBA Franchise Committee and the IFA. She is dual-qualified in both Germany and the UK. She speaks English, German, French, Spanish and Russian.

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