COMMERCIAL LAW

BUSINESS LAW FOR ENTREPRENEURS

GUIDE Block 4.- Expanding and restructuring your business

4.1.- STRATEGIES FOR BUSINESS EXPANSION

When the business model is well settled and shows potential to grow, strategies for domestic and/or international expansion can be considered. The choice of the expansion model to deploy is a strategical decision that must be based on a serious analysis of costs and risks, expected aims, and market conditions. As it will be elaborated below, the expansion strategy is not only a business decision, but also a crucial legal choice whose consequences should be carefully considered.

Expansion strategies may be grouped in three categories:

1). Organic expansion that entails the opening of subsidiaries or branches or the acquisition of or merger with another company/ies operating in the target sector/territory.

2). Distribution-based expansion aimed to design and set up distribution channels for the distribution of products and services – agents, distributors, franchises.

3). Contract-based collaboration under joint ventures or strategical alliances.

4.2.- SUBSIDIARIES AND BRANCHES

The organic expansion model describes those strategies to make the business grow based on corporation/company instruments. It could entail creating a holding, acquiring other companies or merging.

Ex: Company X is located in Madrid and provides services to the entire Spanish market. Sound expectations for following years and regular expressions of interests from clients located in other European countries encourage the decision to expand the business in Europe in two phases: next year, Paris; in two years, Rome.

Under an organic expansion strategy, Company X may decide to incorporate a new company, first in Paris (Company Y), and subsequently, in Rome (Company Z) to manage the business growth in such markets.

A subsidiary is a new company, with distinct and separate legal personality, to be incorporated under the laws of France and Italy, respectively.

There are subsidiaries of Company X because they are participated by Company X as sole/majority partner or shareholder. Therefore, whereas the partners of Company X are A, B and C, the partner of Company Y and Company Z is primarily Company X. If Companies Y and Z are entirely participated subsidiaries, Company is the sole partner. Otherwise, these companies would be partially participated with Company X as a majority partner, together with other partners (normally, local partners). That means that all companies constitute a holding or group under Company X performing the role of holding company.

In practice, these companies (holding) tend to act in the market as an economic unit, insofar as they follow a common policy due to the existing economic bonds among the companies. Nonetheless, from a legal point of view, they are different companies with distinct and separate legal personality.

Alternatively, Company X may wish to consider the possibility of acquiring a local company or merge it. In that case, no new company must be incorporated in the target market.

Should an acquisition be planned, there are two options to articulate the closing: an asset deal and a share deal. Under an asset-deal acquisition, Company X purchase the asset/s, selected individually, of the target company. No liabilities of the target company are transferred to the acquiring company. In the case of a share deal, Company X purchases the shares of the target company. Consequently, assets and liabilities of the target company are passed on to the purchasing company. Unlike the asset deal, in a share deal the economic and financial situation of the target company is relevant, insofar as if it is in crisis, the purchase is riskier and potentially less attractive.

A merger entails a unification of two (or more) existing companies into a new one. Thus, it means a reduction in number of legal persons – several existing legal persons disappears, and a new one is set up. Reasons triggering mergers can be diverse. Commonly, it aims to expand the reach of the business, cover new business segments, or gain market share.

Finally, a distinction must be made between subsidiaries and branches. Whereas subsidiaries, as previously explained, have distinct and separate personality from the holding company, branches are part of the same company. That means that a branch has not separate legal personality. An illustrative example of branches are bank offices in a country.

Nowadays, expansion is mainly based on digital strategies. Hence, it might be worth wondering how digital expansion fits into the traditional concepts of subsidiaries and branches.

A). Is a website on a territorial domain name (amazon.es) a subsidiary?

No, unless the creation of the website entails the incorporation of a company (subsidiary) in the host country

B). Is a website on a territorial domain name a subsidiary subject to local legislation? Amazon.es to Spanish Law?

In general, it is not. Other factors should be considered, sole domain name is not enough to subject a business to the target legislation

C). Is a website hosted in a server to be subject to local legislation of the host country?

No, it is not. Merely hosting a website in a server located in a specific country does not mean that the business will be subject to its legislation

D). Which factors have to be considered to assess which legislation the business run through a website should be subject to?

- Language
- Accepted currency for transactions
- Contact information and customer services location
- Domain name
- Direct marketing strategies
- Stream of commerce
- Delivery policy and logistics
- Express exclusions or limitations based on territorial factors
- Technical measures: avoiding certain address or ZIP codes

4.3.- DISTRIBUTION CHANNELS

Expansion strategies based on distribution channels entail the conclusion of contractual relationships with independent collaborators: commission agents, commercial agents, distributors, or franchisees.

Unlike organic expansion, the establishment of distribution channels is based on the entering into collaboration contracts with other companies without modifying the corporative structure of our company (the principal).

The choice among agency, distribution and franchising must be carefully pondered on the basis of risk allocation, profit distribution, and market proximity - the presentation provides a comparative table among the main types of collaboration -. The comparison is based on four criteria. First, whether the contract concluded between the principal and the external collaborator is regulated by law or, contrariwise, its configuration is amply left to parties' autonomy to be set out by agreement. Second, whether the collaborator acts in the name of the principal and on his/her behalf, or in its own name. Third, whether the collaboration modality is designed to a durable and stable relationship or solely intended to assist in one or several spot transactions. Four, how the collaborated is retributed.

Combining the above-described criteria, the most distinctive features of collaboration variants in terms of risk allocation, profit distribution, and market proximity are explained below.

i) Risk allocation

Commission agents and commercial agents act always on behalf of the principal. Consequently, the risk of the business is naturally allocated to the principal, unless otherwise expressly provided by contract and retributed accordingly (risk commission).

On the contrary, the distributor is essentially a reseller. Hence, the distributor purchases from the principal, considering the market prospects, and re-sells to the clients in the market in its own name and on its own behalf. That means that the principal passes the risk of the expansion to the distributor who takes on the risks of overestimation, failures, or competition.

In case of franchising, the franchisee operates fundamentally as a distributor but the assumed risks is contained insofar as it is in the position of using a reputed trademark, receiving training from the franchisor, and implementing the know-how provided by the franchisor in the context of the franchising agreement. Whereas the franchisor contributes reputation, know-how, training, and common marketing strategies; the franchisee provides local knowledge, expertise in the target country, and proximity to the end user.

Given the different schemes of risk allocation articulated by the modalities of commercial collaboration, profit distribution models are aligned thereto accordingly.

ii) Profit distribution

The distributor is a reseller. Thus, the profit that the distribution makes is the margin of the resale price over the purchase price. The principal does not pay any commission to the distribution.

Unlike distributors, agents operate under commission. Commission is paid by the principal and is totally or partially based on the transactions promoted and concluded by the activity of the agents. Commissions can be fixed, variable, or hybrid combining a fixed component and a transaction-based one.

As a general rule, the agent does not take on the risk. However, if it so agreed by the parties, an extra risk commission is due.

Franchisees have to pay royalties to the franchisor for the license to use the trademark and other distinctive signs, for the training and/or for the transfer of know how. The possibility that the franchisor could fix or recommend sale prices to the franchisees (minimum price, maximum price, recommended price) is subject to scrutiny under competition laws as it may lead to price collusion.

iii) Market proximity

All models are intended to gain more proximity to local markets, by exploiting networking, contacts, knowledge or expertise of the local collaborator.

4.4.- JOINT VENTURES AND STRATEGICAL ALLIANCES

Companies can expand their business to other markets by creating strategical alliances with local companies. To penetrate certain markets, a partnership or alliance with a domestic company is not only advisable, but also a prerequisite to run business in that country.

Joint ventures and strategical alliances are contract-based commercial strategies aimed to create a collaboration framework, on short/medium/or long-term basis, between two or more companies. The agreement defines all aspects of the collaboration, milestones, goals, profit and cost distribution, decision making, applicable law, and conflict resolution.

Joint ventures can be divided in two categories. Unincorporated joint venture are contracts concluded between the collaborating companies without either transforming their structure or creating a new company. Companies members of the joint venture remain independent and separate and only collaborate with the extent and within the scope of the collaboration agreement. Corporate joint ventures do, however, entail the incorporation of the new company participated by the collaborating companies. In this latter case, the collaborating companies remain separate for the running of the respective business, but their collaboration crystalizes in a new company for such purposes.