VASIL KISIL & PARTNERS

ATTORNEYS & COUNSELLORS AT LAW

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FRANCHISING IN UKRAINE

This NEWSLETTER from the International Trade and International Arbitration Department of Vasil Kisil & Partners is dedicated to the analysis of legal regulation of franchising in Ukraine and offers you a brief overview of the issues of major legal concern while entering into international franchising agreements with Ukrainian counterpart.

1. Legislative framework of franchising in Ukraine

The institution of franchising is rather new for the Ukrainian legislation. For the first time franchising relations were specifically regulated in Ukraine only on 1 January 2004, when the *Civil Code of Ukraine* (the "**Civil Code**") and the *Commercial Code of Ukraine* (the "**Commercial Code**") came into effect[1].

According to the *Civil Code* under a *franchising agreement* one party (a franchisor) is obliged to grant to another party (a franchisee) a right to use a set of rights belonging to the franchisor for the production and/or sale of particular kinds of products and/or for rendering services under conditions set out by the franchisor for a fee. The said *set of rights* (i.e. franchise) shall comprise rights to franchisor's intellectual property objects (trademarks,

[1] The Ukrainian legislation operates not with the terms widely used in international trade i.e. "franchising", "franchising agreement", "franchisor", "franchisee", but with the terms "commercial concession", "commercial concession agreement", "title holder", "user" accordingly. In order to avoid any misunderstandings, herein we will use the terms "franchising", "franchising agreement", "franchisor", "franchisee".

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utility models, inventions, and property information etc.), commercial experience and goodwill/business reputation.

Besides, in order to make franchising agreements fully effective and operative in Ukraine, parties thereto shall take into account the relevant legislative requirements e.g. on competition, on quality, safety of products and consumers' rights protection in the sphere of intellectual property, advertising etc.

2. Issues to be taken into account by parties to franchising agreements related to Ukraine

Even though in Ukraine for international franchising agreements the choice of foreign law as the governing law is allowed and such agreed foreign law is fully applicable thereto, the standard franchising agreements used by the foreign franchisors to be fully effective and operative in Ukraine usually shall be adapted in view of certain mandatory provisions of Ukrainian law and for the sake of its fully enforceability in Ukraine.

Based on our experience in this field, the following provisions of the franchising agreement are of major concern:

(i) Essential provisions

We recommend providing clearly in franchising agreement for the essential conditions of the deal. The latter will exclude further disputes as to enforceability of the provisions of the franchising agreement from the side of the Ukrainian franchisee on the ground of their inconsistency with the mandatory provisions of the Ukrainian law. Under the Ukrainian legislation the provisions on the following issues shall be considered as essential for franchising agreements: (a) the *set of rights* transferred for use under the agreement (i.e. franchise), (b) amount and terms of *fees to be paid* as well as (c) any other terms and conditions that according to one of the parties to the agreement are essential and shall be agreed upon therein.

(ii) Form of agreement and its registration

According to the Ukrainian legislation, the franchising agreement shall be concluded in writing. Failure to comply with a written form of the franchising agreement entails its invalidity.

Furthermore, it is important to emphasize that Ukrainian law requires state registration of (a) franchising agreements, (b) amendments thereto as well as (c) termination thereof. Failure to register does not automatically entail the invalidity of franchising agreements. However, the parties to the franchising agreement shall be entitled to refer to the said agreement as well as amendments thereto in their relations with the third persons only after its state registration. Moreover, absence of the state registration of the franchising agreement shall divest the parties of the right to refer to this agreement in case a dispute arises. It is also worth noting that as of today the procedure of the state registration of the franchising agreement is not regulated by the law.

(iii) Parties

Under Ukrainian law only legal persons and natural persons - entrepreneurs may be parties to franchising agreements. Hence, prior to entering into the franchising agreement it is advisable to verify status of both the franchisor and the franchisee.

(iv) Payments

A person in the favor of which the franchisee is able to perform payments

Often international franchising agreements may require the franchisee purchasing certain items (e.g. equipment, signs, fittings etc.) from or apply for franchise related services to the third person (more often somehow connected with the franchisor), instead of the franchisor directly, and, of course, paying for such items to the said third persons. According to the Ukrainian foreign currency and customs clearance regulations the franchisee could provide the payment only to the party to the agreement. Therefore, if certain items are to be purchased not directly from the franchisor, but from any other companies, separate agreements shall be executed by the franchisee with the said companies.

Payment instruments / mechanisms

Usually, international franchising agreements stipulate *"comprehensive"* settlements mechanisms e.g. factoring, settlements by means of letters of credit, discounting of promissory notes or bills of exchange. It is worth noting that due to very strict bank regulations certain settlement mechanisms may lay a heavy burden on franchisees or even may be impossible to execute as: (a) the said *"comprehensive"* settlement mechanisms may currently be very expensive operations; (b) there are only a few banks in Ukraine entitling to perform the *"comprehensive"* settlement mechanisms, as in order to perform the said operations the banks need to comply with numerous mandatory requirements set forth by the National Bank of Ukraine (e.g. limits, reserves, regulations, instructions etc.); (c) banks in such cases establish very strict requirements to the franchisees (e.g. insurance requirements, security instruments, requirements to supply agreements, documents confirming actual supply of products, minimum amount of products to be supplied etc.). Currently due to financial situation using *"comprehensive"* settlement mechanisms in Ukraine became even more complicated and less attractive than previously.

Therefore, the practical enforceability and operation of each of the suggested settlement mechanisms as well as terms and conditions, under which such *"comprehensive"* settlement mechanism may be effected by the franchisee's bank, shall be discussed in details by the franchisor, franchisee and the franchisee's bank prior to entering into the franchising agreement.

(v) Obligations of franchisee's shareholders

Often international franchising agreements bind also the franchisee's shareholders being not parties to the franchising agreement (e.g. personal responsibility for the franchisee's activities, pre-emptive rights etc.). However, in order to ensure enforceability of such obligations and proper performance thereof, it is highly advisable to execute a separate agreement with the franchisee's shareholders (e.g. as an annex to the franchising agreement).

(vi) Dispute resolution

Sometimes international franchising agreements provide for exclusive competence of the foreign state courts as to any disputes occurred between the parties. However, the choice

of court agreement is generally inadmissible under Ukrainian law and the enforceability of such foreign court judgements is extremely low (if only provided by special bilateral international treaties). At the same time, there are no legal or formal obstacles for the the parties to cross-border commercial contracts to refer disputes to international arbitration both abroad or in Ukraine (either institutional or *ad hoc*). Ukraine is a party to the *New York Convention 1958* and foreign arbitral awards are subject to recognition and enforcement in Ukraine.

(vii) Product liability

Pursuant to the Ukrainian legislation, the franchisor and the franchisee bear *subsidiary liability* for consumers' claims related to quality of products manufactured and services provided by the franchisor and further resold by the franchisee. However, the franchisor and the franchisee bear *joint and several liability* for consumers' quality related claims with regard to the products manufactured by the franchisee.

(viii) Restrictions of the franchisee's activities

The Ukrainian legislation sets forth directly that conditions of the franchising agreement (a) entitling the franchisor to establish prices for products, works, services and/or maximum or minimum price rates; and (b) stipulating that the franchisee shall sell products, services only to certain kinds of consumers or exclusively to consumers located on the territory defined in the franchising agreement shall be regarded as null and void. Besides it is provided that any restrictive conditions of the franchising agreement, contradicting Ukrainian law, may be invalidated.

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Please, do not hesitate to contact us for any further information on the topic of this Newsletter or to address your other legal service needs.

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