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International Franchising

Newsletter of the International Bar Association Legal Practice Division

Vol 18 No 2 OCTOBER 2014



**Nataliya
Mykolska**

Sayenko Kharenko,
Kiev
nmykolska@sk.ua

**Anzhela
Makhinova**

Sayenko Kharenko,
Kiev
amakhinova@sk.ua

Ukraine: recent case law on franchising (new developments and trends)

Franchising has been gradually capturing the Ukrainian market. According to the Franchising Association of Ukraine, as of today about 400 franchising chains operate in the Ukrainian market and this data demonstrates annual increase of about 20 per cent. Notwithstanding the substantial Ukrainian market potential for further franchising expansion, there are lots of pitfalls hindering successful franchising development in Ukraine, for example: (i) the equivocal legislative regulation; (ii) strict foreign currency regulation; (iii) misunderstanding by the franchisees of the nature of franchising; (iv) the franchisee's unwillingness to strictly follow the franchisor's standards; (v) 'historical' disrespect for the franchisor's intellectual property rights; and (vi) commercial secrets. The absence of well-established, firm practice in the ruling and interpretation of franchising related issues by the Ukrainian courts also pours oil on the flames. In view of the above, in this article we provide a general overview of a few judgments recently rendered by the Ukrainian courts to throw light on benchmark trends of franchising development in Ukraine without focusing on analysis of the legality and substantiation of the said judgments.

To register or not

The Civil Code of Ukraine and the Commercial Code of Ukraine, two principal legislative acts regulating franchising in Ukraine, require that the franchise agreement, amendments thereto as well as termination thereof shall be subject to the state registration. The state registration shall be carried out by the body that performed state registration of the franchisor as a legal entity or as an individual, that is, entrepreneur. If the franchisor is registered abroad, the franchise agreement shall be registered by the body that performed state registration of the franchisee.

Even though failure to register the franchise agreement does not entail either nullity or invalidity thereof, absence of the state registration results in the following negative consequences directly set forth by the Civil Code and the Commercial Code:

- the parties to the franchise agreement shall be entitled to refer to the said agreement as well as amendments thereto in their relations with the third party only after its state registration; and
- the parties are deprived of the right to refer to this agreement in case a dispute arises.

The major problem with the state registration of the franchise agreements in Ukraine is that the Ukrainian legislation does not stipulate a registration procedure, applicable terms or fees. Therefore, there is no uniform approach of the competent authorities, that is, some of them refuse to register franchise agreements in the absence of the relevant implementing legislation, some merely put on a relevant agreement stamp 'registered' which makes its legal status unclear. Therefore, it has become standard practice in Ukraine not to register the franchise agreement.

Generally the case law¹ confirms that non-registration of the franchise agreement shall not result in its invalidity/nullity as: (i) Ukrainian law does not stipulate a registration procedure and, thus, the relevant bodies have duly refused to register the franchise agreements; and (ii) pursuant to the Civil Code and the Commercial Code, failure to register the franchise agreement shall not result in its invalidity, that is, the parties are not entitled to refer thereto in relations with the third parties.

However, one of the cases² discusses the parties to the franchise agreement and scrutinises the registration issue.

Two companies concluded a franchise agreement. In order to duly perform the relevant registration requirement, the parties first tried to register the franchise agreement with Obolon District State Administration (the local body that performed state registration of

the franchisor as a legal entity). Having received an official refusal, the parties approached the State Service for Intellectual Property (the 'State Service') because the Draft Law,³ which was adopted by the Parliament of Ukraine in its first reading, states that the State Service shall be the responsible authority for the state registration of the franchise agreements. However, in the absence of the relevant registration procedure, the State Service also refused to register the franchise agreement.

Thereafter, the parties have duly performed under the franchise agreement. The franchisor granted the franchise, while the franchisee paid royalties and included their amounts into the deductible expenses for taxation purposes.

Further, the franchisee was subject to the tax audit. Following the results of the said audit, the tax service alleged that as the franchise agreement was not duly registered, it shall be regarded as un concluded and, thus, the parties shall not refer thereto in relations with any third parties, including tax authorities. Therefore, the tax service alleged that the franchisee unduly included royalties into the deductible expenses and, thus, undervalued its tax obligations. As a result, the tax service requested the franchisee to pay the tax obligations due and the relevant penalties.

The franchisee challenged the tax service's decision before the court. The court ruled that as the parties have not challenged before the court the above refusals of the Obolon District State Administration and the State Service, they have not duly performed their obligation as to state registration of the franchise agreement. Therefore, the agreement shall be regarded as un concluded and not vesting any rights or obligations on the parties. Thus, the tax service acted lawfully while declaring that the royalty related expenses should not have been included into the tax deductible expenses.

Thus, it goes without saying that the state registration issue shall be seriously considered by the parties, especially in view of the fact that under the existing case law, the third party are defined very broadly, that is, as any persons, except for the parties to the agreement, including other natural persons, legal entities or state agencies. Thus, it may well be that in addition to the tax authorities, the customs authorities and the banks may refuse to accept the franchise agreement in the absence of its due state registration. In view of the above risks of the non-registration

of a franchise agreement, it is highly advisable to apply to the competent authorities for the state registration thereof to at least receive an official refusal to perform such registration as this may act as a 'safe harbour' in case of disputes and will confirm the parties' intent to act in good faith.

Payment conditions

Quite often the parties do not pay attention to the payment conditions wording. At best, the franchise agreements stipulate a franchisee's general obligation to pay for the franchise, payment amounts and frequency. However, the franchise agreements are silent on 'procedural' issues, for example, who shall calculate amounts due, how invoices shall be issued, whether the parties shall issue acceptance acts and how they shall be executed, agreed, etc.

The *Euro Khata* case⁴ demonstrates that it is crucial to stipulate in the franchise agreement all payment terms and conditions as precisely as possible. The parties concluded a licence agreement in respect of the opening and operating of Euro Khata (*ЄвроХата*), a fast food restaurant. The court ruled that the said agreement was by its nature a franchise one and, thus, applied the respective provisions of the Ukrainian legislation. Under the franchise agreement, the franchisee shall pay franchise fees on a monthly basis within five working days after issuance of the relevant invoice by the franchisor. The act for acceptance of the services and works rendered by the franchisor shall be duly signed by both parties on a monthly basis. If the franchisee does not receive an invoice within the set term, the franchisee shall calculate on its own the amount due to the franchisor and shall pay it within the precisely identified period.

The franchisor duly granted to the franchisee the relevant franchise and according to the franchise agreement terms sent to the franchisee by post the invoices and draft acceptance acts executed on its behalf. However, the franchisee failed to take out the relevant documents from the post office and, thus, had never executed the acceptance acts from its side and failed to pay the amounts due. Due to this failure, the franchisor notified the franchisee on the franchise agreement termination and brought a claim before the court for franchise fees due for the whole period of franchise operation by the franchisee.

The court of the first instance ruled that the acceptance acts should be a ground for the invoice issuance and calculation of the franchise amounts due. Since there were no acceptance acts duly executed by both parties as set forth by the agreement, the franchisor was not entitled for any payments.

The appellate court did not follow the first instance court's approach. The appellate court ruled that the franchisor duly sent to the franchisee the relevant invoices and acceptance acts by post. Due to unknown reasons, the franchisee neither objected against the received invoices or acceptance acts nor paid the franchise related fees. Since the franchise agreement stipulated the franchisee's obligation to calculate the franchise fee due and to pay it (even in the absence of the invoice from the franchisor), the franchise agreement did not interrelate the payment of the franchise fees and execution of the relevant acceptance acts by the franchisee. In view of the above, the appellate court satisfied the franchisor's claims in full.

Verification issues

The *Chudo Pich* case⁵ demonstrates that unilateral documents on a franchisee's breach of the franchise agreement issued by the franchisor following the results of onsite inspections performed by the franchisor shall not be considered by the Ukrainian courts as legal and admissible evidence of the franchisee's breach.

The parties concluded four franchise agreements for setting up and operating four franchise bakeries under the *Chudo Pich* (Чудо Пич) brand. The franchise agreements stipulated, among other things, liability for the following franchisee's breaches: (i) usage of other trademarks in the franchise outlets; (ii) sale of freshly baked products, which were supplied by companies other than the franchisor; (iii) violation of sanitary and hygiene standards; (iv) utilisation of equipment supplied by the franchisor in violation of the franchise agreement; and (v) violation of maximum resale prices established by the franchisor, etc. Additionally, pursuant to the franchise agreement, the above breaches shall be confirmed by the relevant decision of the franchisor executed in writing and signed by its representative(s) providing the relevant evidence confirming occurrence of violation (eg, acts, photos) and sent to the franchisee.

The relevant franchisor's representatives conducted one-side onsite inspections of the franchise bakeries and identified the following breaches of the agreement:

- utilisation of the franchisor's equipment in violation of the franchise agreement;
- usage of other trademarks in the franchise outlets; and
- sale of freshly baked products, which were supplied by other companies than the franchisor.

According to the inspection results, the franchisor calculated penalties under the franchise agreement and demanded its payment by the franchisee. As the franchisee refused to pay the above penalties, the franchisor brought a claim before the court requesting, among other things, to oblige the franchisee to pay the penalties calculated. However, the court has not satisfied this franchisor's claim as the court considered the documents resulting from a one-side onsite inspection as not being legal and admissible evidence to confirm the franchisee's breach.

Trademarks to be licensed

Quite often unregistered trademarks or other intellectual property rights objects (the 'IP objects') are licensed under franchise agreements in Ukraine. According to the Civil Code of Ukraine, if certain IP objects are effective only after registration thereof (eg, trademarks, inventions, utility models, etc), the latter may be licensed only after such registration. Thus, all IP objects to be licensed under the franchise agreements should be duly registered in Ukraine under national or international procedures. Notably, as of today there is no case law addressing the legal consequences of licensing the unregistered IP objects under a franchise agreement, that is, whether they shall be regarded as invalid or even null and void. However, the major risk of use of unregistered IP objects is that neither the franchisor nor the franchisee will be able to fully protect and to prohibit unauthorised use of the IP objects by a third party. The recent case law⁶ revealed an additional risk of tax deductibility of the royalties paid for the unregistered IP objects use. The said case law confirmed the tax authorities' position that royalties paid for usage of the IP objects that are not duly registered shall not be tax deductible. Hence, franchisors and franchisees should make all efforts to protect the status of their IP objects in Ukraine.

Notes

- 1 The Decision of the Commercial Court of City of Kyiv of 14 March 2013 Case No 910/26026/13.
- 2 The Resolution of Ternopilskiy District Administrative Court dated 1 November 2011 Case No 2-a/1970/2606/11.
- 3 Draft Law 'On Amending the Civil and Commercial Codes of Ukraine (related to the franchise agreements)' No 8515 of 16 May 2011.
- 4 The Resolution of Zaporizhskiy Appellate Commercial Court dated 9 November 2011 Case No 4/381/09-13/33/10.
- 5 The Resolution of Lvivskiy Appellate Commercial Court of 3 June 2013 Case No 5015/3673/12.
- 6 The Resolution of Ternopilskiy District Administrative Court of 1 November 2011 Case No 2-a/1970/2606/11.