

How to Sell a Franchise in Russia:

6 Legal and Business Aspects to Consider

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Good faith and fair dealing are the main principles of Russia's civil-law system and are enforced by Russian courts in all disputes. Franchising is not an exception.

Franchising has become an extremely popular and alluring business model in Russia. According to the official statistics cited by the Federal Service for Intellectual Property (Rospatent), there have been 2767 franchises involving national and international element recorded in 2016.

In fact, the Russian franchise-related laws and practice are based on the classic franchise concept developed and applied worldwide. More specifically, and as follows from the Russian Civil Code, a franchisor grants an exclusive or non-exclusive license to a franchisee for the use of the franchisor's system, including the right to do business under the franchisor's trademarks, operation manuals and standards, in a particular territory and within the terms and conditions set out by a contract: franchise agreement.

Generally, there are no legal restrictions for foreign companies to offer and sell franchises in Russia. In other words, there is no requirement to set up a local company as a pre-condition to perform franchising activities in the Russian territory. Therefore, all general forms of franchising are also used in Russia, including direct franchising and sub-franchising, area development and master franchising, multi-unit

franchising and joint ventures. Since franchisors quite rarely acquire stakes in franchisees, the latter are usually acting as independent contractors, and the franchisor's control is usually exercised over franchisees through the specific contractual provisions and further assurances (i.e. guarantees, options, supplemental agreements).

At the same time, foreign investors should always take into account the following six critical legal and business issues when franchising into Russia:

TRADEMARK AND IP RIGHTS

The key element of every franchise agreement targeted at Russia is a trademark, which must be registered or protected in Russia. In the absence of the national or international trademark registration the contract may not be classified or interpreted as a franchise agreement under the Russian law, whether it is governed locally or by any foreign law. In addition to the licensed (registered) trademark, the franchisor shall grant to the franchisee at least one additional and properly protected intellectual property subject matter, such as a trade name (e.g. logo), a copyrighted subject matter (e.g. operations manual), a know-how (i.e.

confidential information), or a patented subject matter (e.g. invention). If such (additional) IP-related element is missing, or has not been contracted to the franchisee, the agreement will not be treated as a franchise.

PRE-SALE DISCLOSURES

Pre-sale franchise disclosures are not stipulated by the Russian law. Nevertheless, pre-contractual disclosure obligations may be established on the basis of the civil-law doctrine of culpa in contrahendo and the principle of good faith at the time of corresponding contract negotiations. The format of disclosure is not adopted by Rospatent or any other governmental agency in Russia. Therefore, the parties are free to rely on the international franchise practice at that point.

On a separate note, franchisors are usually obliged to provide technical and commercial documentation, and any other information necessary for franchisees to be able to develop and operate the franchised business, as well as to instruct franchisees (their employees) on the related aspects associated with the relevant franchising operations.

Russia-related franchise grants, even if set out by the agreement governed by a foreign law, must be recorded with Rospatent. A franchise grant that is not recorded with Rospatent will be regarded as invalid. Therefore, in order to close the deal involving the Russian element, it is necessary to file and

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obtain the franchise registration upon the execution of the contract.

Rospatent will not accept the required documents if they are filed for the purposes of franchise recordal without a Russian translation. In practice, bilingual versions of the underlying franchise agreements, excerpts or notifications (as applicable) are usually prepared and filed in cross-border franchise deals. Alternatively, franchise documents, including the agreement, are produced in English and accompanied by certified Russian translations, if necessary.

Russian law does not provide for a specific period within which the franchise has to be filed and recorded. However, the sooner the franchise recordal is made after the signature, the better legal protection in terms of validity and enforcement will be achieved, especially against third parties. Depending on the transaction structure and parties' negotiations, the underlying franchise agreement may contain various terms and conditions. Russian contract law is primarily based on the principle of freedom of contract, meaning that the parties to a contract are generally free to agree on the provisions applicable to their agreement.

From the Russian law and registration perspective, the contract should address the following essential elements and provisions:

- parties (i.e., corporate names and addresses);
- subject matter (i.e., registration number of the licensed trademark and description of the other licensed IP rights);
- franchised products (i.e., goods or services as per the licensed trademark registration);
- scope of rights (i.e., permitted manners of trademark/IP use and description of business operations);
- consideration (i.e., franchise-entrance fee, franchise ongoing fees, etc.);
- type of franchise (i.e., sole, exclusive or non-exclusive franchise);
- term (i.e., term of protection of

the licensed IP rights or certain specific period);

- territory (i.e., whole of Russia or certain specific areas);
- sub-franchising (i.e., permitted or prohibited, within or without consent);
- termination (i.e., mutual or unilateral, for cause or convenience);
- signatures (i.e., names and titles of signees).

Of course, the franchise agreement will typically contain the other important clauses, including definitions and interpretation, the franchisor's and franchisee's duties and covenants, franchisee's training and education, franchisor's inspections and audits, product advertising and quality control, protection of franchised assets and confidential information, franchisee's default and post-termination, franchise transfer and assignment, franchise renewal, governing law and dispute resolution.

CURRENCY CONTROL

Generally, with regard to the currency control issue, there are no legal restrictions on the repatriation of franchise fees to foreign franchisors. Russian currency control laws do not prohibit the use of a foreign currency in the context of international franchising.

Russian franchisees are required though to open the so-called "transaction passports" with a local bank to have permission for payment of the contracted franchise fees to overseas franchisors. This particular rule especially applies to the franchise transaction with the contract price of \$50,000 USD (or more). Without the transaction passport, if required, the franchise fees cannot be remitted abroad. Also, there is no specific franchise-related tax in Russia.

In terms of franchisors' tax liabilities, foreign franchisors must add 18 percent value-added tax (VAT) on to franchise fees payable by Russian franchisees under franchise agreements. The licensing of patents, industrial designs, know-how, computer programs, databases and mask works have been exempt from VAT, while

trademark and copyright licenses are to be taxed according to the Russian tax law. In addition, franchise fees payable to foreign franchisors by local franchisees are subject to 20 percent corporate-income tax (CIT), unless there are special double tax treaties in place between Russia and foreign states where franchisors reside, as this may provide certain tax reliefs. In terms of franchisees' tax liabilities, if foreign franchisors do not have permanent establishment or representative offices in Russia, Russian franchisees act as respective tax agents for such foreign franchisors. Therefore, Russian franchisees must withhold the corresponding VAT amount from contracted franchise fees (related to trademark and copyright licenses), and remit that amount to the state budget. In addition, local franchisees, acting as tax agents for foreign franchisors, shall withhold the corresponding CIT amount from the contracted franchise fees and remit the same to the state budget, unless there are special double tax treaties in place between Russia and foreign states where franchisors reside, as this may grant certain tax benefits. Further, franchisees will be able to deduct the VAT-able amount as well as the amount of franchise fees when paying CIT to the government.

Finally, the parties should observe the applicable local transfer-pricing rules. In this regard, the amount of the contracted franchise fees should be equal to or in compliance with the level of the corresponding market price, as this might help to avoid additional taxes and penalties.

FAIR DEALING

The concepts of good faith and fair dealing are the main principles of Russian civil-law system. These important concepts are highly enforced by the Russian courts in all disputes involving domestic or international contracts and transactions. Franchising is not an exception. ■



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