Franchising in Russia: practical aspects and legal basics

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Introduction

Franchising is an attractive contractual tool from a commercial perspective and has recently experienced a rapid boom in Russia. A number of foreign franchises are going global by entering the Russian market in order to develop their businesses, while many local companies are expanding within the country through application of the franchising model.

Generally, there are no statutory bans or legal restrictions against foreign companies offering or selling franchises in Russia. Thus, foreign business entities are free to franchise directly or indirectly to Russian business entities. In other words, a foreign company (franchisor) may conclude a franchise agreement with a Russian company (franchisee) or engage another foreign partner (franchisee) to sub-franchise in favour of the Russian company (sub-franchisee). There is no requirement to set up a local company as a pre-condition to undertaking franchising activities in Russia.

The principal rule of franchising is that the contracting parties must be commercial entities (ie, companies or individual entrepreneurs). Non-commercial companies and government agencies may not structure their relationships on the basis of the franchising model. As such, in most cases limited liability companies represent franchisors in regular deals and joint stock companies are used in complex transactions (eg, joint venture franchises).

Contract law and franchising concept

Russian contract law is primarily based on the principle of freedom of contract, meaning that the parties are generally free to agree on the terms and conditions of their agreement. This basic principle is limited by certain default franchising provisions and mandatory provisions of Russian contract law, which also apply to franchise agreements. Aspects not addressed by contracts must be resolved by applying the relevant mandatory provisions of contract law or the effective default rules on franchising.

In Russia, franchising is specifically regulated by the Civil Code (Chapter 54). Ongoing franchise relations may also be affected by the domestic legislation on intellectual property and information technology, consumer protection and data protection, advertising and promotion, competition and commercial law, labour and employment, real estate and property, taxation and currency control,

among others.

Russian law does not use the term 'franchise'. Instead, the term 'commercial concession' is used to define the franchise relationship between the contracting parties. According to Article 1027 of the Civil Code, under the contract of commercial concession (the franchise agreement), one party (the rights holder) grants the other party (the user) – for a consideration and for a definite or indefinite term – the right to use a combination of IP rights owned by the rights holder in the user's business, including trademarks and other rights such as trade names and trade secrets (know-how).

Disclosure and registration

Pre-franchising disclosures are not mandatory under Russian law; nor must the franchisor provide disclosure updates to the franchisee within the term of the franchise agreement. Russian franchising law states only that the franchisor shall provide technical and commercial documentation and any other information necessary for the franchisee to undertake franchising activities. This may not necessarily represent the duty to disclosure in the context of international law and practice.

At the same time, pre-franchising disclosure obligations may be established by the parties on an optional basis in order to comply with the general civil law principle of good faith, which applies to all commercial transactions. Further, the format of disclosure is not prescribed by Russian law. Thus, the parties are free to use and follow the documents applied in international franchise practice. The issue of disclosure updates may also be subject to contract.

All franchise agreements – even if governed by foreign law – must be made in writing. In addition, the grant of franchise contemplated by the franchise agreement must be registered with the Federal Service for Intellectual Property (Rospatent). A franchise not registered with Rospatent will be regarded as invalid (Article 1028(2) of the Civil Code). Thus, in order to conclude a franchise transaction involving a Russian element, it is imperative to register it with Rospatent, following execution of the underlying franchise agreement.

Brands and IP rights

The key element of every franchise agreement is a registered brand (ie, trademark). In the absence of a trademark registration, the contract may not be regarded as a franchise. Other elements – including trade names, copyrights, patents and trade secrets (know-how) – may also be included within the scope of the franchise agreement, provided that their ownership remains vested with the franchisor.

Trademarks

Trademarks are protected on a national basis following their registration with Rospatent. Russia is a signatory to the Madrid Agreement and Protocol; as such, international trademark registrations (designating Russia) are protected as well. Unregistered marks (or in-use marks) are not protected, unless they have obtained a special well-known status through Rospatent.

Words, pictures, three-dimensional configurations and other marks may be registered as trademarks. The registration of non-traditional marks (eg, sounds, colours and smells) is also possible. To obtain registration, the mark must be new and distinctive. Distinctiveness may be inherent or acquired.

Use of the mark need not be claimed before registration. Further, no proof of use need be submitted following the examination procedure. The owner should begin using the trademark within three years of registration; otherwise, it will risk losing its rights to the mark. If the trademark is not used during the three-year term following registration, any interested person may apply for cancellation of the trademark registration on the grounds of non-use.

Trademark registration is valid for 10 years and may be renewed indefinitely for subsequent 10-year terms.

Copyright

Franchisors often provide franchisees with operations manuals, proprietary software and databases

in the framework of franchise relations. As a result, copyrights vested in such works will usually be licensed by franchisors along with the registered trademarks.

Copyright subsists in scientific, literary and artistic works fixed in any tangible medium of expression, regardless of benefit, purpose or method of expression. To be copyrightable, a work of authorship must satisfy two fundamental criteria: it must be the result of personal/creative input and fixed in a tangible medium of expression.

According to Article 1259(1) of the Civil Code, the following are examples of works of authorship that are eligible for copyright protection:

- literary works;
- dramatic works;
- musical works;
- choreographic works and pantomimes;
- audio-visual works;
- sculptural, graphic and design works;
- photographic works;
- architectural works;
- pictorial works; and
- computer programs.

Copyright law also protects compilations (eg, databases) and derivative works (eg, translations).

Essentially, copyright vests in a work of authorship from the moment of its creation. There is no need to register or comply with any other formalities to acquire, exercise, transact or enforce copyright in Russia.

The general duration of copyright protection, which applies to all works of authorship, is the lifetime of the author plus 70 years following his or her death.

Know-how

Many franchise agreements provide for know-how licences (aside from trademark and copyright licences), as the transfer of certain confidential information will be inevitable and pertinent to any franchising deal. Any proprietary and confidential information may be protected as know-how in Russia.

Know-how shall not be registered. Nevertheless, the owner of the relevant information must undertake certain reasonable measures to maintain its confidentiality. If such measures are not implemented, know-how protection will not be afforded to the confidential information.

One legal way to acquire know-how protection is to implement a so-called 'trade secrets regime', as set out in the Law on Trade Secrets. In particular, the owner must:

- properly identify the confidential information;
- limit access to the confidential information (by establishing appropriate procedures for handling the information);
- affix the notice 'trade secret' to the medium in which the confidential information is stored (along with the owner's details); and
- follow other steps as required by the Law on Trade Secrets.

If one of these steps is ignored or omitted by the owner of the confidential information, the trade secrets regime will not be implemented, and as a result know-how protection will not be afforded.

Know-how will be protected for as long as it is kept secret by its owner. When the confidentiality of the information is lost, the exclusive rights to know-how lapse immediately.

Competition and antitrust covenants

Competition is mainly regulated by the Law on Protection of Competition. It prohibits monopolistic

(anti-competitive) activities, including cartels, abuse of dominance and unfair competition. The law essentially allows for the conclusion of vertical agreements – including franchise agreements – whether between foreign or domestic companies.

According to Article 1033 of the Civil Code, franchise agreements may impose different restrictions and covenants on the parties. In particular, the franchisor may be obliged not to offer or sell the same franchise to other persons in the territory licensed to the franchisee, or to refrain from carrying out similar activities (eg, relating to the use of the franchised system and IP rights) in the franchised territory. Conversely, the franchisor may impose the following conditions on the franchisee:

- a non-compete covenant which may be extended to the franchised territory and IP rights;
- an obligation to refuse to enter into similar franchise agreements with the franchisor's competitors;
- an obligation to sell goods or provide services at prices fixed by the franchisor and refrain from selling similar goods or providing similar services from the franchisor's competitors;
- an obligation to sell goods or provide services exclusively within certain contracted territory; and
- an obligation to obtain approval for the location and interior or exterior of the contracted commercial premises for undertaking franchising activities.

Theoretically, the restrictions and covenants that are incorporated into franchise agreements may be declared invalid by the Russian anti-monopoly authority (or another interested person) if they are found to conflict with the anti-monopoly legislation, subject to the relevant market conditions and economic status of the contracting parties. At present, the abovementioned covenants typically provided in franchise agreements are acceptable from an antitrust standpoint, and thus far no case or dispute has arisen in which a particular franchise agreement has been challenged for alleged breach of national competition laws.

As mentioned, the Law on Protection of Competition prohibits unfair competition. Thus, the dissemination of false or misleading information which may damage the operating business entity is not allowed. The law also prohibits the marketing of goods if intellectual property is affixed to them without the rights holder's authorisation. The law prohibits unfair competition in cases where other persons acquire and exploit IP rights in bad faith.

Taxation and currency issues

Corporate income tax

Foreign franchisors that generate income in Russia are subject to Russian corporate income tax. Royalties payable to a foreign franchisor – where they are not attributable to the franchisor's permanent Russian establishment – are subject to withholding tax, which must be remitted by the foreign franchisor's tax agent (ie, the Russian franchisee). The standard rate of corporate income tax is 20%. However, if the foreign franchisor is incorporated and does business under the laws of a jurisdiction that has signed a double tax treaty with Russia, a reduced (or even zero) corporate income tax rate may be applied accordingly. In order to avoid double taxation, the foreign franchisor must provide certified documentary evidence of its permanent establishment in the relevant contracted foreign jurisdiction.

Value added tax

Foreign franchisors must charge value added tax (VAT) on royalties or franchise fees payable by Russian franchisees. The standard rate of VAT is 18% and relates only to trademark and copyright licences in the context of franchise agreements. All other IP licences (eg, patent, know-how, software and database licences) are exempt from VAT. Where the foreign franchisor has no Russian permanent establishment or Russian branch/representative office, the Russian franchisee will act as its tax agent in order to withhold and remit the VAT (under the trademark and copyright licences contemplated in the franchise agreement) to the tax authorities. In such case, the amount of royalties payable to the foreign franchisor under the contract will usually be distinguished between trademark/copyright and other IP licences, and then grossed up by 18% (as applicable).

Currency controls

In terms of currency control, there are no legal restrictions on the repatriation of franchise fees to a foreign franchisor. The only requirement is that the franchisee have an appropriate currency account with the competent bank in order to transfer moneys overseas. Further, in certain instances the franchisee must meet a so-called 'passport of the deal' requirement. The passport of the deal is a mandatory document for all cross-border transactions amounting to or exceeding $50,000 (or the equivalent thereto), in the absence of which the contract price cannot be remitted. However, if the contract price is less than $50,000, the franchisee need not open the passport of the deal with a bank. In practice, it can take up to seven days to obtain the document in question.

Term and termination

There is no maximum permitted term within which a franchise agreement must be made effective. The franchise agreement may be concluded within a definite or indefinite term. In particular, the contract may provide for a specific term (eg, 10 years) or clearly state that it remains valid during the period of protection of the trademark(s) and other IP rights that are licensed under the franchise agreement. If the term of the franchise agreement is not stipulated in the contract, the franchise will be regarded as granted and effective for five years.

In order to include a valid termination clause in the franchise agreement, the parties are free to use the wording of Article 1037 of the Civil Code – which provides that any party may terminate a contract at any time – if the franchise agreement has been concluded for an indefinite term. Six months' prior written notice is required in this case, unless the contract indicates a different term for advance notice. If the contract provides for a specific period of validity, the parties shall be bound by the terms of the franchise agreement.

Either party to a contract concluded for a definite or indefinite term may repeal the franchise agreement by giving 30 days' advance written notice to the other party. This option is available only if the contract provides for payment of specific monetary compensation.

The franchisor may terminate the franchise agreement if the franchisee produces goods of inferior quality or the quality of its services does not correspond to what is set out in the contract. The franchisor may also repeal the franchise agreement if the franchisee does not follow the franchisor's instructions and guidance for compliance with the contractual terms relating to the use of the franchised system and licensed IP rights. Finally, the franchisor may cancel the franchise agreement if the franchisee fails to pay the franchise fees as set out in the contract.

Termination by the franchisor is also available if the franchisee has failed to remedy a contractual breach within a reasonable term, or has committed another breach within one year of receipt of written notice from the franchisor.

If the right to a franchised trademark or franchised trade name is lost for any reason, the franchise agreement will be terminated, unless any similar (effective) right is granted (or substituted) by the franchisor. If the franchisor or franchisee becomes insolvent (bankrupt), the franchise agreement will be terminated.

Franchise transfer and right of first refusal

The franchisee may transfer its franchise to a third party only at the franchisor's discretion. Permission to do so, if provided under the contract, will usually be with the franchisor's explicit consent. The franchisor may also restrict transfers of ownership interests in a franchisee's entity to a third party if the franchisor has acquired corporate control over the franchisee's business.

The franchisee has a right of first refusal under Russian law. If the franchisee has performed its contractual obligations in a timely and proper manner, it has a pre-emptive right to extend the term of the franchise agreement under the terms and conditions as agreed between the parties. If the franchisor ignores this overriding right – or refuses to re-enter into the agreement with the franchisee for a new period and instead concludes within one year a new franchise agreement granting the same rights to another (third) party – the former franchisee may demand that such rights be assigned in its favour and may also claim damages incurred as a result of the franchisor's refusal to renew the contract. Otherwise, the franchisee may claim damages.

Governing law and dispute resolution

There is no legal requirement for a franchise agreement to be governed by Russian law. Under the basic principle of international private law, the contracting parties are free to choose the relevant governing law when entering into a deal, or afterwards. Thus, the franchise agreement may be governed by the applicable foreign law.

In the absence of a choice of law provision in the contract, the law of the country where the franchisee has been authorised to use the franchised system and licensed IP rights will apply (Article 1211(6) of the Civil Code). In any event, the law of the country that is more bound up with the contract may be applicable where the nature and terms of the contract, or circumstances surrounding the transaction, clearly evidence as such (Article 1211(9) of the Civil Code).

In the event of dispute, the contracting parties reserve the right to choose between the local jurisdiction (courts), arbitral tribunals and mediation. Arbitration may be conducted in any jurisdiction and by any forum as chosen by the parties. If the contract contains no arbitration clause, it may not be submitted to arbitration.

A foreign court judgment on a dispute arising from the franchise agreement may be enforceable in Russia, provided that recognition and enforcement of the foreign judgment is stipulated by the relevant international treaty to which Russia is a party and the relevant federal law. Russia is a signatory to many multilateral and bilateral international treaties for recognition and enforcement of foreign judgments, including the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958 (the New York Convention). Thus, an arbitral award relating to a franchising dispute that is rendered in another New York Convention signatory state may be enforceable as well.

Good faith and fair dealing

The concepts of good faith and fair dealing are the basic principles of Russian civil law. These principles are usually supported and enforced by the Russian courts in all disputes involving various civil law contracts. Franchise agreements are no exception in this regard.

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