

Chapter 42

UKRAINE

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I INTRODUCTION

Ukraine is a relatively new country, hence the imprint of international business generally is relatively new in Ukraine. In short, Ukraine is an emerging market for franchising.

Franchising started in Ukraine in the mid to late 90s, but did not start to develop significantly until the Ukrainian market generally picked up in 2003–2004.

An important legislative boost to the industry was the adoption of the Ukrainian Civil and Commercial Codes in January 2003, which, for the first time, actually statutorily defined and to some degree regulated the basics of ‘commercial concession’ (as franchising is legally understood in Ukraine). To date there is no other franchise-specific legislation in Ukraine, although regulations have been promised for around a decade.

McDonald’s opened its first restaurant in Kiev and in Ukraine in May 1997. This was a fairly late start bearing in mind that McDonald’s opened its first restaurant in Moscow still under the Soviet Union in January 1990. Nevertheless, McDonald’s currently has 76 outlets in Ukraine.

The market consists of many international brands (McDonald’s, Domino’s Pizza, Marks & Spencer, Basking & Robbins, Crocs, Mango, Mexx, and, as of 2013, KFC), Russian brands (McFoxy (fast food), Tez Tour) and a growing number of local brands (Novus supermarkets, Coffee Haus, Pan Pizza, Videnski Bulochky, Puzata Khata, etc.).

The Ukrainian Franchise Association was established in December 2001 when, according to the Association, there were fewer than 100 franchises in the country. Currently the Association claims its membership includes over 164 franchisers and over 2,300 companies as franchisees. The Association has a website, publishes, holds seminars and acts as a lobbyist for the industry.

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II MARKET ENTRY

i Restrictions

Foreign franchisors do not face any legal restrictions when entering the Ukrainian market. Market entry for foreign franchisors is, however, challenging because Ukraine is not a mature economy and is, quite frankly, a very difficult market in which to do business. The market is heavily regulated and quite bureaucratic. Market entry requires adequate preparation as well as adequate due diligence on potential franchisees.

ii Foreign exchange and tax

Ukraine is not a member of the EU and, as recent political developments have shown, will not sign its anticipated association agreement with the EU any time soon.

Bearing this in mind, foreign franchisors should appreciate that the currency of payment in Ukrainian domestic transactions is the Ukrainian hryvna, which is not a fully freely convertible currency. Although settlements between a Ukrainian franchisee and a foreign franchisor may be made in foreign currency, the foreign franchisor should appreciate that the franchisee's income is in hryvnas, which is set to slowly depreciate over the next year.

Many large foreign franchisors establish a Ukrainian subsidiary that acts as the local franchisor, in which case the local entity will have to pay Ukrainian corporate tax. For new market entrants that do not have a permanent establishment in Ukraine, it is important to consider the double taxation agreement (DTA) between Ukraine and the country where the franchisor is incorporated to establish whether withholding taxes apply (they typically do). For the purposes of applying withholding taxes, Ukraine would generally differentiate (if possible to so ascertain from the agreement) between the royalty part of the franchise fee (subject to withholding) and the service part of the franchise fee (subject to VAT).

III INTELLECTUAL PROPERTY

i Brand search

International trademark registrations are valid in Ukraine if the registration covers Ukraine. Many franchisors typically register additional Ukrainian language versions of their main trademarks in Ukraine. Searches against both the European and the Ukrainian Register are widely available through lawyers and trademark agents and can be performed online in a matter of minutes.

ii Brand protection

The process for copyright registration is simple and follows international norms. It is possible to register any distinctive word mark or logo with the Ukrainian Patent Office. In line with international practice, generic expressions cannot be protected. The problem is simply that the Patent Office is backlogged. A registration process may take two to three years.

Priority of Ukrainian marks is based on the date of the application for registration. Ukraine recognises unregistered marks that are acquired through use provided it can

also be shown that the mark or logo has achieved market recognition. Famous marks enjoy protection in Ukraine without evidence of use (see Article 6 of the Paris Protocol). Ukraine has implemented the Madrid Protocol so that foreign marks can be designated for local recognition.

iii Enforcement

Trademarks can be protected against infringement through court proceedings. Injunctions are available but specific performance is difficult to implement and enforce. Ukraine has a byzantine court system and specialist advice is indispensable when proceeding against infringements.

iv Data protection, cybercrime, social media and e-commerce

Similar to EU law, Ukraine also has laws and regulations governing the collection of personal data. Consent to personal data processing needs to be express. With very few exemptions this means that the owner of the personal data or data subject must 'opt in' by ticking a box or signing a document. If the personal data are passed on to other organisations this requires a separate consent. Franchisors need to carefully review their loyalty programmes and promotional campaigns to ensure that they comply with these requirements.

IV FRANCHISE LAW

i Legislation

Ukraine does not have a franchising law *per se*. However, Ukraine does have franchise-specific legislation, specifically, relevant provisions of its Civil Code and Commercial Code. Certain provisions of Ukrainian competition legislation also are relevant.

ii Pre-contractual disclosure

Ukrainian law expects the parties to treat each other fairly during contract negotiations. This being said, an obligation to voluntarily disclose material facts is relevant primarily for real property transactions only.

iii Registration

Article 1118.2 of the Civil Code of Ukraine and Article 367 of the Commercial Code of Ukraine require the registration of franchise agreements with the same registration authority that registered the franchisor or franchisee (provided that the franchisor is a foreign company and hence not registered in Ukraine). In other words, registration is contemplated at the national corporate registry. The language in both Codes is virtually identical and states that the parties to a franchise agreement cannot rely on their contract vis-à-vis third parties absent such registration.

Unfortunately, however, there is no regulation in place that allows for implementation of the contemplated national franchise registry. Hence, agreements that have not been properly registered (and in fact this means all such agreements) are generally deemed not valid as against third parties.

This being said, the relevant provisions of the two Codes as well as limited court practice indicates that the absence of registration should not affect the validity of the contract vis-à-vis the contracting parties themselves.

iv Mandatory clauses

Ukrainian law implies into the franchise agreement a number of provisions. These apply even where the contract is silent, so it would not be correct to speak of mandatory clauses. However, the practical effect is similar. The most important examples of prohibited clauses are listed below:

- a* The franchisor must provide certain services to the franchisee. A licence type franchise that does not oblige the franchisor to provide any training or support would not be enforceable.
- b* Price fixing or regulation of prices is prohibited.
- c* Upon expiry of the fixed term of a franchise agreement, the franchisee is entitled to renewal on the same terms (mandatory renewal).
- d* Interestingly, the renewal right does not apply if the franchise agreement is for an open-ended term. In those cases, either party has the right to terminate the agreement on six months' notice.
- e* Under Article 1123 of the Civil Code and Article 373 of the Commercial Code, the franchisor is jointly liable to the consumer for defective goods, works or services supplied by the franchisee. If it is a quality (warranty) claim the franchisee has primary liability, but the franchisor is jointly liable for manufacturer defect claims made against the franchisor as manufacturer. We are not aware of any court practice as to whether a franchisor can avoid liability if the franchisee was not following the guidelines established by the franchisor.

v Guarantees and protection

Ukrainian law recognises both bank guarantees and other forms of security such as suretyship. However, Ukrainian law insists that a Ukrainian entity can act only as a surety (not as a primary obligor – i.e., guarantor). Further Ukrainian currency regulations would require the Ukrainian surety to obtain a one-off licence to actually perform its payment obligation in foreign currency before a foreign party (the foreign franchisor would be unable to obtain the licence on behalf of a defaulting franchisee).

V TAX

i Franchisor tax liabilities

Domestic franchisors pay corporate profit tax at a flat rate of 19 per cent (16 per cent starting from 1 January 2014) unless such a franchisor opts to simplified taxation regime. Dividends are subject to income tax in the hands of the shareholders or withholding tax if payable to non-resident shareholders. Upon distribution of dividends the Ukrainian company should pay 19 per cent advance corporate profit tax (16 per cent starting from 1 January 2014), based on the amount of dividends payable to its shareholders. The payer of dividends is entitled to further reduce (credit) its corporate profits tax liability in

the period following the period when dividends were paid out, by the amount of advance tax remitted to the state.

Franchise fees are subject to VAT at 20 per cent (17 per cent starting from 1 January 2014). Domestic franchisors may have difficulties with tax deductibility of the initial or joining fee for corporate profit tax purposes. If part of the fee represents payment for initial services that part can be recognised in the first year of the term of the franchise. Problems can arise with marketing fees where the franchisor underspends. It is advisable to expressly state in the franchise agreement how monies underspent are returned or carried forward to avoid these being viewed as profit or gifts (non-repayable financial aid).

Foreign franchisors that have a local representative in Ukraine are likely to be treated as having a permanent establishment in Ukraine. Permanent establishment of a foreign franchisor is assessed for Ukrainian tax purposes on the income attributable to services delivered locally. For these reasons a local office or activities that lead to the creation of a permanent establishment are best avoided. Royalties are subject to withholding taxes.

Ukrainian tax legislation provides for different taxation regimes with respect to royalties and franchise fees. In short, payments of royalties will not be subject to Ukrainian VAT, whereas payments for services, goods and works will be subject to Ukrainian VAT at the current rate of 20 per cent (17 per cent starting from 1 January 2014) under a reverse charge procedure. Additionally, royalty payments will be subject to withholding tax at the rate of 15 per cent if not provided otherwise under the relevant DTA. Many DTAs exist and these often allow for exemptions from withholding tax to be applied for.

ii Franchisee tax liabilities

If the franchisee is a company it will pay corporate profit tax unless such a franchisee opts in to the simplified taxation regime. Otherwise, personal income tax will be payable. In addition, VAT is likely to apply as a franchise business is always presumed to involve a trading business. Alternatively, in certain cases for small and medium-sized businesses, the franchisee may choose to pay a 'unified' tax which can substitute for corporate profit tax and VAT.

The standard tax rates are:

- a* Personal tax rates: bands from 15 per cent and 17 per cent.
- b* Corporate profit: flat rate of 19 per cent (16 per cent starting from 1 January 2014).
- c* The VAT rate is 20 per cent (17 per cent starting from 1 January 2014).
- d* Unified tax: 3 per cent, 5 per cent or 7 per cent depending on turnover of a franchisee, number of employees and on whether such unified tax covers VAT or not.

Ukrainian transfer-pricing rules need to be considered in case a foreign franchisor comes from a jurisdiction in which the rate of the corporate profit tax is lower by 5 per cent or more than the Ukrainian corporate profit tax rate on the condition that the price of transactions between a foreign franchisor and a Ukrainian franchisee is at least

50 million hryvnas, net of VAT, which applies cumulatively for all transactions with one counterparty per calendar year.

Ukrainian tax legislation is very dynamic, there are number of changes being implemented starting from 1 January 2011, when the Tax Code of Ukraine entered into force. Although there are attempts to assess transactions on their substance, the 'form' of the transaction still dominates over its substance. Thus, careful attention shall be given to documentary support of each transaction.

iii Tax-efficient structures

Foreign franchisors should consider carefully the location of their franchisor company. Countries such as the UK and Cyprus are popular because of favourable DTAs. However, taking into account that the new DTA between Ukraine and Cyprus is entering into force from 1 January 2014, which provides for a less favourable tax regime than that enjoyed to date as well as due to the recent financial and banking crisis in Cyprus, alternative jurisdictions such as the Netherlands, Switzerland, etc. may be considered. Sometimes splitting the royalty income and the service income can be beneficial. Royalties can be paid to an offshore entity located in a country that has a DTA with Ukraine whereby withholding taxes are waived and service fees to a local service company. The best structure also depends on the home jurisdiction of the franchisor.

V IMPACT OF GENERAL LAW

i Competition law

As mentioned above, the Civil Code of Ukraine and the Commercial Code of Ukraine set forth principal requirements for 'commercial concession' arrangements which, by their essence, can be regarded as 'franchising' under applicable Ukrainian law.

Article 1122 of the Civil Code provides that the commercial concession agreements may establish specific provisions such as territorial exclusivity and non-compete clauses. In particular the franchisor may undertake not to grant similar rights to third parties on the territory in question or not to compete with the franchisee on this territory. The franchisee may undertake not to compete with the franchisor on the territory considered, as well as not to acquire similar rights from franchisor's competitors. It seems that the provisions limiting the operation of the franchisee to a certain area or to a specific category of customers are also permitted by Article 1122 (although its wording is quite vague). Article 1122 of the Civil Code expressly prohibits price fixing (including establishment of a minimum or maximum price by the franchisor).

The Ukrainian Competition Law (Law of Ukraine on Protection of Economic Competition No. 2210-III dated 11 January 2001) does not specifically regulate franchising or similar agreements. Franchising agreements, however, can be considered as 'concerted actions', which fall within jurisdiction of the Competition Law. Article 5 of the Competition Law describes 'concerted actions' as conclusion of agreements by business entities in any form as well as any other agreed behaviour of business entities. The Competition Law prohibits anti-competitive concerted actions, which are defined in Article 6 of the Law as 'concerted actions which have resulted or may result in prevention, elimination or restriction of competition'.

Article 6 of the Competition Law provides for an indicative list of actions to serve as a guide as to what may be treated as anti-competitive concerted actions. This list includes, among others, setting prices or other conditions for purchase or sale of goods, distribution of markets or sources of supply based on territorial principles, assortment of goods, range of customers, etc.

However, Article 8 of the Competition Law provides conditional exemption specifically with respect to vertical concerted actions. It states that the prohibitions of Article 6 are not applicable with respect to 'concerted actions' involving 'supply or use' of goods if a party (i.e., franchisor) to such a concerted action imposes restrictions on the other party (i.e., franchisee) relating to:

- a* use of the goods supplied by the party or by other suppliers;
- b* purchase from or sale to other business entities or customers of other goods;
- c* purchase of goods, which due to their nature or based on prevailing business practices in the relevant market segment do not relate to the subject of the agreement; and
- d* setting of prices or other conditions of the agreement for sale of the supplied goods to other business entities or customers.

The above exemptions are applicable if a particular form of concerted action does not: (1) result in substantial restriction of competition on the whole market or its significant part, including in monopolisation of the relevant markets; (2) restrict access to the market for other business entities; or (3) result in an economically unjustified increase in prices or in the goods' deficiency.

Further, we would add that under Article 1121 of the Civil Code, a franchisor may place restrictions on the behaviour and actions of a franchisee. The franchisee is in fact obliged to adhere to instructions of the franchisor 'directed at securing the appropriate character, methods and terms of use of the complex of the rights granted'. This provision as you can see is fairly broad. We are not aware of court practice on this point.

Although the vertical exemptions under Article 8 are formulated quite broadly and sometimes vaguely (e.g., it is unclear what the word 'use' means in the context of the Article 8 exemption), it appears that Article 8 is intended to protect quite a wide range of vertical restraints, including maintaining the retail price and exclusive dealing arrangements. Unfortunately, however, as of today there are neither official guidelines/interpretations of the AMC, nor reliable court practice of the application of those exemptions. It is also unclear whether such exemptions cover restrictions in franchising and similar contracts.

ii Restrictive covenants

Under Article 1122 of the Civil Code the franchisor may undertake not to compete with the franchisee on the territory covered by franchising agreement. The franchisee may undertake not to compete with the franchisor on the territory considered, as well as not to acquire similar rights from the franchisor's competitors.

iii Termination

A franchise agreement is a long-term contract requiring substantial investment on the part of the franchisee. This being said, Ukrainian law does not specify what constitutes a major or a minor breach of contract. However, a cure notice generally must be given.

Most legal practitioners will argue that restrictive covenants as to competition are enforceable in Ukraine provided the franchisor pays adequate compensation to the franchisee. This being said, this view is somewhat academic as we are not aware of any court practice on this issue. Further, since most franchisors do not wish to pay compensation, post-term restrictive covenants are rare.

Contractual penalties, on the other hand, are enforceable and can be used to effectively enforce the obligation to de-identify.

It is possible to provide that the franchisee must sell its business to the franchisor upon termination but the transfer of the lease would require the written consent of the landlord. This can be a major obstacle in practice. Further, as the parties must agree the price at the time of termination, the obligation to sell may be deemed simply as an agreement to agree.

Options over the shares of the Ukrainian franchisor are not enforceable and are not used in the market.

iv Anti-corruption and anti-terrorism regulation

Bribery and corruption are criminal offences in Ukraine. However, the franchisor would not normally be responsible for bribes paid by franchisees under Ukrainian law, although this may not be the case under the US Foreign Corrupt Practices Act or the UK Bribery Act (as examples).

v Dispute resolution

Ukraine's court system is widely condemned as corrupt and inefficient. This being said, international arbitration awards are generally fully recognised subject to the standard treaty exemptions. The Ukrainian International Commercial Arbitration Court of the Ukrainian Chamber of Commerce and Industry is an alternative to foreign arbitration.

As to the judgments of foreign national courts, Ukraine has recently subscribed to the reciprocity principle. To date, however, we are aware of only one court case where the judgment of a foreign court was enforced in Ukraine. The general practice is that these are not enforced.

Ukrainian courts will respect the choice of foreign law if the contract has sufficient connection to a foreign country. Usually this applies where the franchisor is incorporated abroad. Conversely, foreign franchisors that set up a Ukrainian subsidiary to deal with local franchisees are unable to contract out of Ukrainian law because the contracting parties are both located in Ukraine. Nevertheless, a foreign-owned Ukrainian company may contractually agree to foreign arbitration although under Ukrainian law as against a purely Ukrainian company.

As to Ukrainian court practice, injunctions are rare and require commencement of proceedings in order to implement.

Contractual penalties are enforceable and can be a remedy against franchisees that breach restrictive covenants.

Damages for certain breaches can be on an indemnity basis but the general principle is that damages are compensation for actual loss suffered as a result of the breach committed.

Moral damages are possible but are very much subject to the discretion of the judge.

VII CURRENT DEVELOPMENTS

Currently, we are not aware of any franchise-specific legislative developments in Ukraine, but market players generally will need to closely adhere to new Ukrainian tax guidelines as to transfer pricing between related entities. The market has recently (autumn 2013) welcomed the entry of KFC into Ukraine, with three outlets currently operating in Kiev.

Appendix 1

ABOUT THE AUTHORS

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Babette heads up the EMEA franchise group at Dentons. She has more than 20 years' experience in international franchising with a particular focus on emerging markets. Her work includes the creation and critique of franchise contracts and their customisation to local law. Babette has transactional experience in all 28 EU Member States. Babette is recognised as one of Europe's leading experts in hotel and leisure franchising with a particular emphasis on German-speaking Europe. Babette is ranked by *Chambers Global* as one of the top 10 franchise specialists in the world. She is also recommended by *The International Who's Who of Franchise Lawyers*, *Chambers UK* and *Legal 500* for her franchise expertise. Babette's research on the role of franchising in the European hospitality industry has attracted widespread media attention. Babette is the author of numerous publications on franchising. She also lectures widely on international franchise laws and her expertise is often sought by franchisors from common law countries that enter civil law jurisdictions. She is an associated editor of *The Franchise Law Review*. Babette is a member of the ABA Forum on Franchising, the IBA Franchise Committee and the IFA. She is dual-qualified in both Germany and the UK. She speaks English, German, French, Spanish and Russian.

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Myron is a global partner resident in Dentons' Kiev office. He has been representing international and Ukrainian clients for 21 years in complex negotiations of joint ventures, cross-border acquisitions, construction and development, hotel management and on general matters of Ukrainian corporate law. Myron is ranked as one of the leading lawyers in corporate/M&A in Ukraine by *Chambers Global* and *Chambers Europe 2013*. According to *Chambers Global 2013*, Myron is a 'veteran on the market: he has a very strong track record and is a high-quality lawyer'. He is also recognised as

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a leading individual for real estate in Ukraine by various international and Ukrainian legal directories, including *Legal 500 2013*, *PLC Which Lawyer?*, and *Chambers Europe 2013*. Myron regularly publishes articles in various legal and economic publications and participates as a speaker in conferences on Ukrainian corporate and real estate law issues. Myron is qualified in the United States. Myron speaks English, Ukrainian and Russian.

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