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ADVOKATŲ KONTORA
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Specific Regulation of Franchising in Lithuania

Lithuanian business law topics

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Specific Regulation of Franchising in Lithuania

Until the adoption of the new Lithuanian Civil Code in 2000, franchising was generally governed by a considerable number of laws and regulations, in addition to those regulating contract, intellectual property and competition law, and no franchise-specific regulation existed in Lithuania.

Nevertheless, some of the general laws and regulations specifically addressed certain issues relevant to franchising; in particular, the Competition Law of 23 March 1999 and the former Block Exemption Regulation on the Application of Relevant Articles of Competition Law to Categories of Vertical Agreements of 27 December 1999. Due to the integration of the Republic of Lithuania into the European Union, local competition laws and other relevant legislation have been harmonized with the relevant EU competition laws and contain similar provisions.

To date, no pre-contractual disclosure legislation has been introduced in Lithuania, while specific regulation of franchising as a dynamic approach to the market was adopted on 18 July 2000. Provisions directly relating to franchising were introduced in Chapter XXXVII, Vol. 6 of the new Civil Code of the Republic of Lithuania. Notably, the provisions of the new Lithuanian Civil Code relating to franchising are very similar to those stipulated in the Russian Civil Code, which was used as a model when drafting the aforementioned chapter.

Since franchising was virtually non-existent in Lithuania until recently, and is fairly uncommon even now, there remain both practical and theoretical questions as to how the provisions of the new Lithuanian Civil Code (the 'LCC') will be applied and interpreted by the courts.

The concept of the franchise agreement

Article 6.766 of the LCC defines a franchise agreement as a contract in which one party (*the rightholder*) undertakes to grant the other party (*the user*), for a specified or unspecified period of time, the right to use in the course of the user's entrepreneurial activity a complex of exclusive rights belonging to the rightholder (the right to use the firm name, the trademark, the service mark, protected commercial information, and the like), and in return the other party undertakes to pay remuneration as stipulated in the contract.

Although the LCC gives a definition of *franchise agreements*, it follows the pattern of the Russian Civil Code where the parties to a franchise agreement are named as rightholder and user rather than *franchisor* and *franchisee* – evidently a direct reflection of its origins in Russian legislation.

As may be observed from the analysis of the concept of franchise agreements determined in the LCC, this definition is rather ambiguous. On the one hand, a franchisor, for instance, may not have any exclusive rights, but may simply have a licence from any third party that owns exclusive rights, and that permits the franchisor to use them; and therefore such relationships formally should not come within the purview of the article in question. On the other hand, it might be possible to argue that, where the exclusive rights do not belong to the franchisor, then a particular franchise agreement may not be covered by the law because formally it is not in line with the definition set forth in the LCC.

In fact, greater certainty as to the scope of the relevant article should arrive when the official commentary to Volume 6 of the LCC is published by the drafters of the LCC, or when relevant case law is established by the Lithuanian courts.

It is further provided in the LCC that franchise agreements shall provide for the use of a complex of exclusive rights, and the business reputation and commercial expertise of the franchisor to a specified extent (establishing the minimum or maximum method or other form of use). Franchise agreements may also stipulate the territory for the application of such exclusive rights, business reputation or commercial expertise, or the field of entrepreneurial activity to which the relevant agreement shall be applied (sales of goods, provision of services, etc).

Pre-contractual franchise disclosure

The LCC does not lay down any specific obligations for the franchisor in respect of pre-contractual disclosure. It restricts itself to regulation of specific terms of the franchise relationship only.

However, the following statutory regulation in connection with the pre-contractual relationship is determined in the LCC:

- (1) The parties must disclose to each other the information they have which is of essential importance for the conclusion of a contract. In essence, this is only a general provision, and no indication is given as to what specific information must be disclosed before entering into a franchise agreement and what specific disclosures a franchisor would have to make to a prospective franchisee in order to permit the prospective franchisee to make an informed decision as to acquiring the appropriate franchise.
- (2) In the course of pre-contractual relationships, the parties must conduct themselves in accordance with the requirements of *good faith*.

- (3) The parties shall be free to begin negotiations and to negotiate, and shall not be subject to any liability in respect of failure to reach an agreement.
- (4) A party who begins negotiations or negotiates in *bad faith* shall be liable in damages for harm caused to the other party. It shall be considered as being in bad faith for a party to enter into negotiations or continue them without intending to reach an agreement with the other party; likewise any other actions that do not conform with the requirements of *good faith*.
- (5) Where in the course of negotiations one party furnishes the other with confidential information, the party that has learned or received such information shall be under a duty not to disclose it, or use it unlawfully for his or her own purposes, irrespective of whether a contract is subsequently concluded or not. Where breach of confidentiality occurs, the breaching party is liable in damages in compensation for the harm suffered by the aggrieved party. In such cases, the minimum amount of recoverable damages equates to the monetary value of the benefit received.

Form and registration of franchise agreements

Article 6.767 of the LCC provides that franchise agreements must be concluded in written form. Failure to observe this requirement invalidates the agreement.

The LCC then provides that franchise agreements may be used against third persons only after having been registered, pursuant to the procedure established by law, in the register of legal entities where the franchisor is registered. If the franchisor is registered in a foreign state, the registration of the franchise agreement shall be made in the register of legal entities that registered the franchisee.

This article also contains a provision relating to the effect of registration of a franchise agreement. It stipulates that in relations with third persons the parties to the franchise agreement may refer to the agreement only if it has been registered.

As distinct from the practice in some other jurisdictions, the Lithuanian Register of Legal Entities is not a special *Franchisors' Register* but a uniform state register of all types (forms) of legal entities. Pursuant to the aforementioned requirement established by the LCC, the following data relating to the facts of entry, amendment, and termination of the franchise or sub-franchise agreements shall be registered with the Lithuanian register:

- (1) the dates of such entry, amendment, or termination;
- (2) the data about the parties to the agreement; and
- (3) the subject of the agreement.

Both the application and the copy of the agreement or its amendments must be submitted to the Register

of Legal Entities. In this connection, it is important to note that, pursuant to article 4 of the Law on Register of Legal Entities of 12 June 2001, all data submitted to this register will be public and accessible in accordance with the procedure established in Lithuanian law. There is much confusion over the nature of such statutory provisions laid down by legislation, due to the lack of argumentation as to why contractual information of a confidential nature should be made available to the public.

Sub-franchise

Article 6.768 of the LCC attempts to legislate for sub-franchising techniques. It states that franchise agreements may grant the franchisee the right to permit the use of the complex of the exclusive rights granted to him or her – or the use of some of those rights – by other persons on sub-franchise terms. The terms of the sub-franchise agreement must be stipulated beforehand in the franchise agreement or agreed upon with the franchisor at a later stage. The franchise agreement may also oblige the franchisee to grant to other persons, for a specified period of time, the right to use the exclusive rights on sub-franchise terms after conclusion of the agreement.

This article also stipulates that sub-franchise agreements may not be concluded for a term longer than the term of the franchise agreement. Moreover, should the franchise agreement be deemed invalid, the sub-franchise agreement shall also be deemed invalid. It is further provided that if a franchise agreement concluded for a specified term is terminated early, the rights and obligations of the franchisee under the sub-franchise agreement shall revert to the franchisor, provided that the latter consents to assuming the rights and obligations under the sub-franchise agreement.

An article on the sub-franchise issue contains an additional provision imposing subsidiary liability on the franchisor, on the part of the sub-franchisor, for the sub-franchisee's acts. However, such liability may be excluded if the parties so agree in the franchise agreement. This issue, of course, may give rise to the question of how that could affect a third party who might make a claim without having knowledge of the exclusion of liability. The main intention when drafting this provision, probably, was to make a main franchisee liable to the franchisor for losses incurred as a result of a sub-franchisee's actions. The term *subsidiary liability* leads to these conclusions:

- (1) the sub-franchisor is not liable unless the sub-franchisee has defaulted; and
- (2) no joint and several liability in this respect is provided for in the LCC.

Royalties

Article 6.769 of the LCC outlines how fees are to be arranged under the franchise agreement. It provides that remuneration may be paid in the form of a fixed lump

sum and/or periodical payments, deductions from the franchisee's proceeds, or in any other form stipulated in the agreement. In this connection, the LCC confers the possibility to use a combination of different methods of fee or remuneration payments under the franchise agreement, which seem to be similar to those paid in transactions of international franchising.

Franchisor's obligations

Article 6.770 of the LCC defines the franchisor's obligations, and provides a list of obligations in this regard. These appear to be intended as minimum rather than maximum requirements, although this is not specifically stated. It is provided that franchisor is obliged to:

- (1) transfer technical and commercial documentation to the franchisee, and provide other information necessary for the franchisee to exercise the rights granted to him or her under the franchise agreement, as well as instruct the franchisee and his or her employees on all issues related to the execution of granted rights; and
- (2) issue the licences stipulated in the agreement to the franchisee and ensure the formalization thereof in accordance with the established procedure.

In addition, unless provided otherwise by the franchise agreement, the franchisor shall be obliged to:

- (1) ensure the registration of the franchise agreement;
- (2) render continuous technical and consultancy assistance to the franchisee and assist in training his or her employees;
- (3) supervise the quality of goods manufactured, work performed, or services rendered by the franchisee in compliance with the franchise agreement.

In particular, it should be noted that many of the franchisor's obligations under this article must be met unless stipulated otherwise in the franchise agreement. From a practical point of view, it is likely that in a number of cases there would be attempts by the franchisor to contract out of certain of the obligations provided for in the LCC.

Franchisee's obligations

Article 6.771 of the LCC provides a non-exhaustive list of the franchisee's obligations, all of which are common in franchise agreements. In particular, the franchisee is obliged:

- (1) to use the franchisor's firm name, trademark, and service mark;
- (2) to ensure the proper quality of goods manufactured, work performed, or services rendered;
- (3) to observe the franchisor's directions and instructions concerning the use of rights, and the ex-

terior and interior decoration of the commercial premises used by the franchisee;

- (4) to render to customers such additional services as they could reasonably count on when purchasing goods or services directly from the franchisor;
- (5) not to disclose the franchisor's know-how or any other confidential information received from him or her to other persons;
- (6) to conclude a sub-franchise agreement, should the franchise agreement stipulate this obligation;
- (7) to inform customers by the means most obvious for them that he or she is operating under the franchise agreement and using the franchisor's firm name, trademark, service mark or any other symbol that identifies the franchisor.

Although these are listed obligations, it should be borne in mind that they should not be interpreted as the minimum of obligations laid upon the franchisee, and that obviously others could be added to the agreement if the parties so wished.

Limitations on stipulating certain terms

When drafting franchise agreements under the laws of Lithuania, or where the laws of Lithuania are applicable to the agreement, the following general rules must be observed, in the light of competition law. As is generally provided in the LCC, the parties to the franchise agreement may stipulate in the agreement only such terms and conditions restraining competition as are not prohibited by competition law. Although it is subject to competition issues and virtually falls within the purview of competition law, the LCC provides for some exceptions and includes a permissive list of restrictions where the franchise agreement may stipulate various limitations on the rights of the parties to the franchise agreement, and this will not be deemed as restraining competition. Pursuant to article 6.772 of the LCC franchise agreements may stipulate the following restraints:

- (1) The franchisor's obligation not to grant other persons similar complexes of exclusive rights to be used in the territory assigned to the franchisee or to desist from performing on his or her own account a similar activity in this territory.
- (2) The franchisee's obligation not to compete against the franchisor in the territory covered by the franchise agreement, with respect to the entrepreneurial activity performed by the franchisee, by using the exclusive rights belonging to the franchisor.
- (3) A prohibition imposed upon the franchisee to enter into franchise agreements, involving similar rights, with the franchisor's competitors (potential competitors).
- (4) The franchisee's obligation to coordinate with the franchisor the location of commercial premises defined in the agreement, as well as the exterior and interior decoration thereof.

The article also contains a statement to the effect that where the terms of a franchise agreement restrict the rights of the parties to that agreement, these may be deemed invalid, upon the bases and procedure established by competition law, if they restrict competition. In particular, it is provided that terms prohibited by competition law shall be deemed void. Specifically, these are:

- (1) terms that entitle the franchisor to fix prices or establish the minimum level of such prices; and
- (2) terms that entitle the franchisee to sell goods, perform work, or render services exclusively to a specific group of customers or exclusively to customers residing in the territory defined in the agreement.

The LCC provides that both these prohibitions are mandatory; and therefore such terms, if included in an agreement, shall be automatically void. On the matter of fixed prices, although prices cannot be fixed, it is clear that price recommendations are permissible.

Franchisor's liability for claims filed against franchisee

Article 6.773 of the LCC, which deals with this issue, provides that the franchisor shall have subsidiary liability for claims filed against the franchisee in relation to lack of conformity, in terms of quality, of the goods sold, work performed, or services rendered by the franchisee under the franchise agreement. It also provides that, with respect to claims filed against the franchisee as the manufacturer of the franchisor's products, the franchisor shall be held jointly and severally liable with the franchisee. These provisions are somewhat controversial, since they render the franchisor liable for the acts, deeds, and misdeeds of the franchisees.

Moreover, the franchisor's liability issue gives rise to further questions in connection with article 6.771 of the LCC (as already discussed) which contains one of the obligations on the part of the franchisee and requires him or her to inform customers that he or she is operating under a franchise agreement and that customers are dealing not with the franchisor, but with the franchisee.

There is also a question mark over whether or not an indemnity provided by the franchisee to the franchisor, in the franchise agreement, against any claim which might be made, would be legally valid. Most anticipate that interpretation of this issue will depend on the official commentary to be published by the drafters of the LCC as well as on appropriate case law established by the Lithuanian courts.

Franchisee's right to renew franchise agreement

The provisions of article 6.774 of the LCC appear much more questionable than those of the article dealing with franchisor's liability. This article provides that:

- (1) the franchisee who has been properly performing his or her obligations under the franchise agreement shall have the right on the expiry of the term of the agreement to renew the agreement on the same terms and conditions; and
- (2) the franchisor shall have the right to refuse to renew the agreement, provided that within three years after the end of the agreement term he or she will not conclude with other persons a similar franchise agreement to cover the same territory previously covered by the terminated agreement. Should the franchisor, before the three year period is up, wish to grant to another person the same rights as those granted to the franchisee under the terminated agreement, he or she shall be obliged to offer the franchisee the possibility to conclude a new agreement, or compensate the latter for losses incurred. The new agreement must be concluded on terms no less advantageous for the franchisee than those contained in the terminated agreement.

In regulating franchise relationships, the LCC takes an unusual and rather impractical approach in connection with the issue of renewal by determining an automatic right of renewal on the same terms for any franchisee who has not been in breach of his or her obligations under the franchise agreement during the term of the agreement. This clearly raises a considerable number of problems for any franchisor who, due to the changes which may have taken place during the term of franchise agreement (either in the market, business environment, or in the applicable legislation), or as a result of his or her experiences over the course of the agreement, wishes to adjust the new terms of their franchise agreements.

In this respect, some could argue that the franchisee is the weaker party and that therefore the appropriate instruments providing for relevant protection have been introduced in the legislation. However, it also has to be admitted that the drafters of Chapter XXXVII, Vol. 6 of the LCC simply followed the model provided by the Russian Civil Code, and stipulated the same provisions, without giving thorough consideration to the question of what practice exists internationally to deal with such cases.

Termination of franchise agreements

Article 6.775 of the LCC – which deals with termination of franchise agreements – lays down certain rules and specifies certain events in respect of termination. It provides that a franchise agreement must be terminated if:

- (1) the franchisor forfeits his or her rights to the firm name or trade (service) mark and these rights remain unreplaced by new and similar rights; and
- (2) bankruptcy proceedings are instituted against the franchisor or the franchisee.

It also provides that where a franchise agreement is concluded for an unspecified term, either party shall have the right to terminate the agreement on six months' notice, unless the agreement stipulates a longer notice period. Termination of the franchise agreement must be registered in accordance with the procedure prescribed in the LCC (specifically, article 6.767, which has been already discussed).

Change of contractual parties

Article 6.777 of the LCC provides that should any of the exclusive rights which constitute the object of the franchise agreement be transferred to another person, the franchise agreement shall remain valid. The new franchisor shall become a party to the franchise agreement in respect of the rights and obligations relating to the exclusive rights transferred. It further provides that in the event of the franchisor's or franchisee's death, his or her rights and obligations under the franchise agreement shall be transferred to his or her heir, provided the latter is an entrepreneur and continues or undertakes a entrepreneurial activity within six months of the date of the inheritance. Otherwise, the agreement shall be terminated. The performance of the rights and obligations of the deceased franchisor under the agreement until the heir has assumed the inheritance and has undertaken an entrepreneurial activity shall be carried out by an administrator of the assets appointed by the court.

Consequences of changes in franchisor's trademark and termination of exclusive right

Articles 6.778 and 6.779 of the LCC provide that should the franchisor's firm name or trademark which constitutes the object of the franchise agreement change, the franchise agreement shall remain valid with respect to the franchisor's new firm name or trade (service) mark, unless the franchisee demands termination of the agreement and compensation in respect of losses. Should the agreement remain in force, the franchisee shall have the right to demand a commensurate decrease of remuneration due to the franchisor, unless the agreement provides otherwise.

It is further provided that should the term of an exclusive right which constitutes the object of the franchise

agreement expire, or should such right terminate on any other grounds, the franchise agreement shall remain valid, save for the provisions relating to the terminated right, while the franchisee, unless the agreement provides otherwise, shall have the right to demand a commensurate decrease of remuneration due to the franchisor. This provision also appears questionable, because it is rather difficult to see how in practice the contract could survive the loss of exclusive rights, since such rights are essential to the franchisee. It is highly probable that without these rights the franchisee would never have entered into the agreement at all.

The article also stipulates that unless the franchisee demands the termination of the agreement and compensation of losses, in the event of expiration of exclusive right, the franchise agreement must be re-registered.

The Lithuanian model of franchise regulation

As regards the domestic regulation of franchising, research shows that the states which introduced legislation on franchising, adopted either:

- (1) disclosure legislation, limited to regulation of the information that a franchisor must provide to a prospective franchisee in order to permit the prospective franchisee to make an informed decision as to whether or not to acquire the franchise; or
- (2) legislation known as relationship laws regulating specific terms of the franchise relationship (such as renewal and termination of the franchise agreement, registration requirements, limitation of liability, etc).

Since no disclosure legislation has yet been introduced in Lithuania, the adoption of the new LCC containing so-called relationship provisions has placed the Republic of Lithuania in the second category of states that attempt to regulate franchising by specific statutory laws.

In the meantime, since very little franchising occurs in Lithuania at present, a number of questions arise regarding the manner in which the provisions of the LCC specifically regulating franchise relationship will be applied in practice.

Paulius Gruodis
tel. +370 5 2690 700, email: p.gruodis@glimstedt.lt

This briefing constitutes a general guide only. It is not intended to contain legal advice: this should be sought as appropriate in relation to the particular matter in hand. If you would like further information on the issues outlined in this briefing, please contact Bernotas & Dominas Glimstedt: tel: +370 5 2690 700, fax. +370 5 2690 701, vilnius@glimstedt.lt



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Contact details:

Bernotas ir Dominas Glimstedt
Jogailos g. 4
LT-01116 Vilnius, Lithuania
Tel. +370 5 269 0700
Fax. +370 5 269 0701
email: vilnius@glimstedt.lt
www.glimstedt.lt

Riga Office

Glimstedt & Partners
Gertrudes Street 10-12,
Riga LV-1010, Latvia
Tel.: +371 780 33 80
Fax.: +371 780 33 81
email: riga@glimstedt.lv
www.glimstedt.lv

Tallinn Office

Glimstedt Straus & Partners
Ravala pst 5,
10145 Tallinn Estonia
Tel: +372 630 91 70
Fax: +372 630 91 71
email: tallinn@glimstedt.ee
www.glimstedt.ee

Minsk Office

Glimstedt
Pobediteley ave. 59-103
Minsk, Belarus
Tel: +375 447 179179
email: minsk@glimstedt.by
www.glimstedt.by

Stockholm Office

Advokatfirman Glimstedt
Strandvagen 7A
Box 5244 102 45 Stockholm, Sweden
Tel. +46 8 566 119 00
Fax. +46 8 566 119 49
email: stockholm@glimstedt.se
www.glimstedt.se

Other offices:

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