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LEGAL ADVISOR ROLE ON FRANCHISING PROJECT

GRATA International Mongolia

Legal advisor role on franchising project

People in the business world strive to be successful, profitable and most importantly not to go bankrupt. Nowadays, it is better idea to open a franchise rather than starting a new business. Franchising is a way of organizing a business, in which a business model has been already tested and proven to be effective in practice. Buying a franchise, not only receives a ready-made business plan, support in terms of advice, organization of supplies, but also the opportunity to work under a well-known brand that has already established itself and enjoys consumer loyalty. Also starting a new business from scratch, it is difficult to calculate the financial prospects for its development. Working on a franchise is much easier to plan future expenses and income based on the experience of other franchisees.

In order to implement a successful franchise business, the role of a legal advisor is crucial to several steps of the franchising project. It is important that legal advisor knows how to draw up a commercial agreement, license agreement in strict accordance with all existing requirements of the legislation as well as incorporation of legal entity to implement the franchising project and conduct due diligence of franchisee.

The franchising agreement is new in Mongolian practice and recognized by one of the most difficult agreement, so only an experienced and qualified specialist can lead to successful franchising project with professional support of the lawyer. This article is intended to address some of the key points of the franchising agreement, and the legal advisor role in franchising project.

There are several roles of legal advisor on Franchising:

1. Company set up

It is quite common for a franchise to be operated under a legal entity than a sole proprietorship in order to assess whether franchising project is profitable or efficient.

Mongolian legislation provides for a wide range of legal forms of commercial entities (Limited Liability Company or LLC, joint-stock company or JSC and joint venture), in practice, private businessmen and foreign investors mostly prefer with foreign invested LLC. According to the Company Law of Mongolia, a company may be established directly or by the reorganization of another legal person (merger, consolidation, division, separation, or transformation)

Limited Liability Company (LLC) with a foreign investment

According to the law, a foreign investd company is defined as “a business entity with an overall equity of US\$100,000 or more (or MNT equivalent), where not less than 25% must be owned by (a) foreign investor(s)”. Investments into Mongolia can be made in the following ways:

- By establishing a solely or jointly owned business entity;
- through the purchase of a Mongolian companies shares, bonds, and other types of securities;
- through merging or wholly acquiring Mongolian and foreign companies;
- through the establishment of franchises or financial leasing; and
- in other ways acceptable and not prohibited by law.

If two or more investors are planning to incorporate a foreign invested LLC in Mongolia, each investor must invest 100,000 USD or MNT equivalent.

An LLC is the most frequently used form of a legal entity established by one or more individuals or legal entities – founder/s/ or investor/s/ – who are not liable for its obligations while bearing the risk of losses related to the company’s activity to the extent of their personal contributions (participatory interests). The liability of the company is limited to its assets.

The bodies of a limited liability company are:

- a) the supreme body of a company shall be the Meeting of Shareholders(MoS).

LLC has exclusive powers with respect to the issues covering business, finance, management, and structure of the company.

- b) The executive body of a company (individual or collective).

The day-to-day management of the company is performed by the Director (individual executive body) or Board of Directors (collective executive body), who are elected at the MoS. Under Charter of the company, power of management or management team shall be defined clearly. The authorities entrusted to the Board of Directors shall be specified in the Charter of the company. The company may also have a Supervisory Board, which is, however, not mandatory.

Any amendment on Charter such as change of shareholder, address or business activity is required to be registered at the State Registration authority per relevant laws.

The state registration certificate of the LLC with foreign investment has a term of 1 or 2 years. Prior to expiry date of the state registration certificate, the representative of the LLC with foreign investment shall apply for extension.

State Registration

1. To establish an LLC in Mongolia, the founder(s) shall take the following steps in accordance with the relevant laws and regulations:

- a) Obtaining a company name: The founder(s) or an authorized representative acting under the Power of Attorney shall obtain the name of a LLC from the State Registration Authority. The company name shall meet the following requirements:

- not duplicate other companies’ name; and

- be in Cyrillic letters.

When an LLC obtains its name, the founders shall establish the company within 30 days. Otherwise, the verification sheet on the company name will expire in 30 days.

- b) Setting up temporary account of the company: Along with obtaining a company name, the founder shall get forms of opening current temporary account(s) for a new company with any commercial bank of Mongolia. This temporary current account is required to deposit for the paid capital of 100, 000 USD or MNT equivalent of a foreign invested company to develop one of the required documents referred to in section (c) below. Once the company is incorporated, with assistance of the founder or appointed Executive Director or any other representative, who is first signatory, the deposited amount can be withdrawn.
- c) Development of the documents required for establishment: Pursuant to the Law on State Registration of a Legal Entity, the founder(s) of the foreign invested limited liability company with foreign investments shall prepare the following documents. They are:
- Application form (UB-03 form);
 - Verification sheet on the company name;
 - Original decision for setting up a foreign invested company with official Mongolian translation;
 - founders' resolution;
 - if the founder is a foreign legal entity, it shall issue a separate resolution;
 - Charter and shareholders agreement of the company: charter – 2 copies in Mongolian and 1 copy of translation, shareholders agreement – 1 copy with official translation;
 - if a company consists of one investor, only the charter is required;
 - if a company consists of two or more investors, both charter and shareholders agreement are required and shall be drafted in Mongolian and any other foreign language chosen by investor, then printed in 2 copies each, where each copy of the shareholder agreement shall be notarized;
 - If the founder is a legal entity, a copy of the company incorporation/ registration certificate, charter and a brief company profile is required;
 - Bank remittance receipt/Start-up investment threshold, which is 100, 000 USD for each foreign investor;
 - Copy of the office lease agreement to confirm the company's address;
 - Copy of the Executive Director's passport;
 - Receipt of payment of the state stamp duty for establishment of a foreign invested LLC, which is 750,000 MNT (app 265USD);
 - Power of attorney (if applicable).

After 5 business days from submission of the above document, the state registration authority shall register a foreign invested limited liability company in Mongolia.

d) Obtaining the company seal

A foreign invested company shall provide an original copy of the company state registration certificate to order the company seal. This is the final step of the company incorporation.

The registration of a new foreign invested company in Mongolia takes place with three agencies:

- State Registration Authority;
- District Tax Office; and
- District Social Insurance Office.

2. Intellectual property registration

The franchising is entirely a form of use of intellectual property. Intellectual property rights are an important part of franchise agreements. These include the use of inventions, industrial designs, utility models, trademarks and legal entity's name and must be protected and registered to the State Administrative authority in charge of intellectual property in order to exercise such rights. Intellectual Property Rights may be put into economic circulation through several forms including the full or partial exercise of such rights by others upon the license, franchise, merchandising and other agreements or transactions, transfer of ownership rights, investment to legal entities by intellectual property and pledge.

Trademark are the most well-known intellectual property which will be used by the franchisee. Trademark is distinctive expression used by an individual or a legal entity, engaged in manufacturing of goods or the provision of services, in order to distinguish the goods or services from those of others. It may be expressed in words, figures, letters, numerals, three-dimensional configurations, colors, sounds, scents and/or any combinations thereof.

Trademark registration: For registering the trademark, the following documents are required:

1. Application form, which shall contain followings:
 - A request for registration of the trademark;
 - If the applicant is a legal person, then its official name and address, its organizational form, its seal or stamp, and a signature of a competent official;
 - If the applicant has an official representative (Power of attorney), then his/her surname, name of father /mother/, given name and address, and a signature of the applicant or his/her official representative;
 - If the applicant wishes to claim the priority date, then a declaration claiming the priority of an earlier application;
 - Trademark to be registered;

- Trademark description
 - If the applicant wishes to claim color or a trademark which is a three-dimension mark, then a statement to that effect;
 - If the trademark is a collective mark, then a statement to that effect;
 - If the trademark is a certification mark, then a statement to that effect;
 - In cases where the trade is expressed in characters other than Cyrillic or Latin script, or where it is in foreign language, a translation of the trademark into Cyrillic script or a translation thereof;
 - Classification of trademark and list of the names of goods and services pertaining to the trademark.
2. Receipt of state stamp duties payment.
 3. Other supporting documents related to collective trademark use, certification trademark use, documents related to priority date and POA.

Trademark registration process takes 9 months and can be extended for additional 6 months.

When the trademark is registered, its certificate shall be issued for 10 years term and can be extended for additional 10 years.

Then exclusive rights of the trademark holder shall be enforced within registered list of goods and services.

Under the Law on Trademark and Geographical Indications of Mongolia, the trademark and its holder right shall be protected under the license agreement.

A trademark holder may, under a license agreement, permit to use other person to use the trademark to all or some of the goods or services for which it is registered. License agreement shall be done in written form and will be effective after signed by two parties, and registered in the Intellectual property office.

The Intellectual property office inform registered license agreement by official publication to the public according to the Law on Trademark and Geographical Indications of Mongolia.

In accordance with Procedure on License agreement and intellectual property use for registration of other related contracts, the following shall be attached to the application for registration of a license agreement:

- Application form L-1, L-2;
- The original agreement or a notarized copy of the agreement related to the invention, product design or utility model;

- A notarized copy of the relevant part of the Agreement related to the trademark or a statement signed and certified by the licensor and licensee;
- Basic license agreement for a sub-license;
- If the original agreement of the invention, product design or utility model and a notarized copy of the relevant part of the agreement related to the trademark is executed in foreign language other than Mongolian, their Mongolian translation;
- If the licensor and the licensee have an authorized representative, a Power of attorney;
- A statement that each co-owner of the trademark, who is not a party of the license agreement, has agreed the license agreement;
- Receipt of state stamp duty and service fee.

After receiving the application form, the registration specialist will review within 10 working days. The registration specialist will digitalize the requested application, and shall inform the applicant in writing or by e-mail.

If the documents are incomplete, or does not meet the requirements the applicant shall eliminate incompleteness within 20 days.

3. Disclosure Documentation

An important part of setting up a franchise is a drafting franchise disclosure documents, often referred to as FDD. The franchise disclosure document is a legal document that the franchisor must disclose about franchise system and the agreements to be franchisee who sign to the franchise agreement prior to the franchise may be sold. Franchise disclosure documents have a very specific format divided into 23 “items” that cover all the information a potential Franchisee would need to make an informed decision and sign a contract.

In the below, there are provided the 23 items that are required for a Franchise Disclosure Document and a brief explanation of what each of those items covers.

- *Item 1- The Franchisor and Any Parents, Predecessors, and Affiliates*

Item 1 provides the history of the franchised business, any parent company or companies that existed prior to the current franchise. And an overview of business model, competition and franchise offer.

- *Item 2- Identity and Business experience of key person*

Item 2 provides information about the key directors, officers, managers and employees who played a large role in the sale and management of the franchise. This item is dedicated to introducing key franchise players and reviewing their past business experience.

- *Item 3- Litigation history*

Item 3 provides any past or current litigation of franchise has been involved in.

- Item 4- Bankruptcy

Item 4 provides any bankruptcy that has occurred in the company. This applies not only to bankruptcy that occurred within the company, but also to any of the key people involved in franchise.

- Item 5,6,7- Initial Franchise Fees, Other Fees, Initial Investment

Item 5,6,7 provide any deposits and fees that the Franchisee will have to pay in order to take ownership and start their franchise. For initial franchise fee, it may include a set fee, or a range depending on certain factors such as the number of territories purchased.

Other fees, this is where specifies the fee that franchisee may incur during the term of the franchise agreement.

Item 7 provide any costs that a franchisee will incur to start and run a franchise. This includes advertising, transaction costs, and any other expenses that may arise before the franchisee starts generating the income.

- Item 8- Restrictions on Sources of Products and Services

Item 8 provide any restrictions on the sources and types of products or services offered through franchise.

- Item 9- Obligations of Franchisee

Item 9 state all obligations that the Franchisee agrees to when signing franchising agreement.

- Item 10- Financing

Item 10 describe any funding options or programs available through the franchise,

- Item 11- Assistance from the Franchisor, advertising, computer systems and training.

Item 11 provide obligations that a Franchisor have when signing a franchise agreement with the Franchisee. Also, any advertising assistance that will be provided to the Franchisee, and information about training programs offered through the franchise.

- Item 12- Territory

Item 12 covers territory offered to the Franchisee, as well as whether the territory will be changed in connection with franchising agreement.

- Item 13 and 14- Trademarks, Patents, Copyrights and Proprietary information

Item 13 and 14 provide information about Franchise's trademark, patents, copyrights and other proprietary information on how the Franchisee may use these information.

- *Item 15- Obligation of the Franchisee to participate in the Actual Operation of the Franchise Business*

Item 15 provide the personal obligations of the franchisee in the actual conduct of the business.

- *Item 16- Restrictions on Goods and Services Offered by the Franchisee*

Item 16 conclude any products or services that the Franchisee cannot offer in their Affiliates. These restrictions will determine what Franchisees may or may not offer in their region.

- *Item 17- Renewal, Termination, Transfer and Dispute Resolution*

Item 17 deals with renewal, termination, transfer costs for Franchisee and dispute resolution. These disclosures are an extensive chart identifying main provisions in the franchise agreement.

- *Item 18- Public Figures*

Item 18 identifies any public figures (such as celebrities, entrepreneurs) for advertising or promotions.

- *Item 19- Financial Performance Representations*

Item 19 provide information about the financial performance of other franchised units.

- *Item 20-List of Outlets*

Item 20 provides chart information showing the number of outlets opened, transferred, terminated or cancelled during the past three years.

- *Item 21- Franchisor's Financial Statements*

Item 21 include audited financial statements for the last three years. The financial statements include a balance sheet, income statement and cash flow statement.

- *Item 22 and 23- Contracts, Receipt*

Item 22 lists the contract that a Franchisee will need to sign. These include confidentiality, non-competition agreement, territory agreement and etc.

Item 23 is receipt that a Franchisee must sign, providing notices and will be placed at the end of the FDD.¹

¹ <https://www.investopedia.com/terms/f/franchise-disclosure-document.asp>

The disclosure related regulation under the Civil code of Mongolia as follows: “The franchisor is obliged to provide the franchisee with the necessary information”. According to the general principles of Civil law, it is prohibited for one party to enter into an agreement by providing false information to the other party. If inaccurate information is provided, the other party has the right to terminate the agreement promptly upon reasonable justifications, moreover, to demand compensation for damages.

4. Due diligence

Prior to signing on the franchise agreement, it is helpful to discuss Due diligence is an important element of franchising, it is a necessary component of a franchise business, which is made up of an analysis of document and make assessment of current business of the franchisee. For successful implementation of the franchise project, the franchisor shall hire a legal advisor to conduct due diligence of the franchisee for making assessment of its current business scale. As mentions above, it is strongly recommendable to incorporate a new company for implementation of the franchise project. Otherwise, if the franchisee prefers to use its current company, it would be difficult to distinguish income and profit or expenditure of the franchise project by the franchisor.

Due diligence is common practice for the franchise project and the scope of the due diligence can be determined by the franchisor. For making decision on selling or collaborating with franchisee by the franchisor, the legal check or due diligence of the current business of the franchisee is crucial part of franchise project.

The complete or full due diligence of the current business of the franchisee shall identify whether all legal documents are in compliance with laws and legislations, whether any outstanding payments, levy, debt or fee to the government or private companies or individuals such as taxation, social insurance, customs etc and any party to the court or arbitration claim.

5. Drafting and execution of Franchise agreement

The most important role of legal advisor on franchise project is drafting and execution of franchise agreement on behalf of franchisor or franchisee. The both parties shall have a legal advisor and have a negotiation of contract with their legal advisor. The franchise agreement is important document between the parties to regulate all relations arisen from franchise project and shall cover all potential matters on regards with franchise project.

Franchise agreement is regulated in the article 333-336 of the Civil code of Mongolia. In the article 333.1 states that “Under the franchising contract a franchisor shall undertake to transfer a license, obtained according to established procedures and allow the use of nonmaterial property, conduct activities in accordance with the structures and cooperative program agreed with franchisor, as well

as to pay proper fees or certain part of revenues. Nonmaterial property shall design, packaging, planning, management and communication, main guidelines on goods and services procurement”.

Parties entering into a franchise agreement are advisable to set forth the terms and conditions in detail in their agreement, as the franchising is regulated under the Civil Code of Mongolia. For instance:

Payment.

When purchasing a franchise business, the Franchisee need to pay couples of fee in return for previous activities, as well as a regular franchise fee during the term of the agreement. The agreement clearly explain what payment is for and when the cost become payable. These include, initial fee, royalty fee and other payments.

- Initial fee is a fee paid to a franchisor in exchange for establishing a franchise relationship, along with the provision of some initial services.
- Royalty fee is an ongoing payment that a Franchisee must pay to Franchisor. A royalty fee is a recurring charge, usually on a weekly, monthly or quarterly basis, where the franchisee pays the franchisor for the continued use of the franchisor for the continued use of the franchisor's marks, systems, products, and services.

Fine and undue loss.

According to the Civil Code of Mongolia, a fine is a monetary payment to be paid by a party who has failed to perform or has improperly performed its obligation in the amount agreed in advance in the law and agreement or calculated on the basis of a fixed percentage of the value of the non-performed or improperly performed obligation. While the undue loss means a monetary payment to be paid by a party who has exceeded the deadline under the law or agreement in the amount not exceeding 0.5% of the outstanding value of the non-performed obligation per day. In practice, it is beneficial for the franchisee to set a low percentage of fines and penalties in the agreement.

Restrictions.

Upon the expiration of the franchising agreement, the Franchisor shall have the right to prohibit the Franchisee to compete in a specific territory for up to one year. Also it is prohibited to test and implement a new idea or transfer the franchise to a third party without the consent of the franchisor.

Termination.

Franchise agreements contain termination clauses that the agreement may be terminated upon expiration of the period agreed by the Parties. Furthermore, if the agreement is concluded for a period of more than ten years, it is possible to terminate the agreement within one year upon delivering a notice on termination of the agreement after the expiration of ten years. On the other hand, the franchise agreement is a long-term legal relation, therefore, can be terminated upon reasonable justifications. These include emergency circumstances of hardships and force majeure or circumstances where the continuation or extension of the agreement is impossible in order to protect

the rights and legitimate interests of the parties. It is also possible to terminate the agreement if the continuation or extension of the agreement may cause significant damage to one of the parties. In addition, if it is unable to perform the obligation due to one of the parties' fault, the agreement may be terminated by the other party.

Use of the intellectual property rights.

Intellectual property means all trademarks, copyrights, patent, and processes created by, owned by, or licensed for use by Franchisor in connection with Franchisee's operation of the Franchised business. The parties must set forth the ways and scope of the use of intellectual property rights and dispute resolution in detail in the agreement.

Indemnity.

According to the Civil law of Mongolia, the Franchisee shall be obliged to compensate damage and expenses caused to the Franchisor in relation to the obligations under franchising agreement. While the franchisor does not oblige to issue any guarantee as to possible revenues the Franchisee may earn under the franchising agreement. The franchisor is not responsible for the success of the franchise. In other words, the fact that the franchisee has not earned any income under the franchise activities does not constitute loss but a typical risk to the franchisee's business.

Applicable law.

Choice of law is crucial for the settlement of disputes arising out of the agreement. All claims, cases, disputes or other controversies arising from, under or with respect to the relationship between Parties are entitled to choose the applicable law as agreed upon.

Dispute Resolution.

Franchise agreements contain dispute resolution clauses that are designed to benefit the Franchisor at the Franchisee's expense. If the parties consider that they are unable to settle their disputes themselves, they may have the disputes settled by the court, mediation, and arbitration.

- Court – Disputes can be settled by three instance courts – the trial court, appellate court, and supreme court which is a time-consuming process.
- Mediation – Parties to any agreement should consider mediation, a method of alternative dispute resolution, aside from arbitration. Mediation is essentially a negotiation facilitated by a neutral third party. Unlike arbitration, which takes a form more similar to trial, mediation doesn't involve decision making by the neutral third party, but seeks to find a mutually acceptable resolution or compromise between the parties. The role of the mediator is to interpret concerns, relay information between the parties, frame issues, and define the problems. Any such mediation will be non-binding and will be conducted by the Mongolian International and National Arbitration Center in accordance with its then -current rules for mediation of commercial disputes.
- Arbitration – If the Parties cannot solve and settle a dispute, all dispute arising out of or in connection with franchise agreement shall be settled in the Mongolian International and

National Arbitration Center at the Mongolian National Chamber of Commerce and Industry in Mongolia under its Rules on Arbitration in Mongolia.

Source:

- <https://legalinfo.mn/mn/detail/299> - “Civil code of Mongolia”
- <https://legalinfo.mn/mn/detail/310> - “Law on Company of Mongolia”
- <https://legalinfo.mn/mn/detail/9491>- “Law on Investment of Mongolia”
- <https://legalinfo.mn/mn/detail/13591>- “On State registration of Legal entities”
- <https://legalinfo.mn/mn/detail/111> “Law of Mongolia on Trademarks and Geographical Indications”
- <https://legalinfo.mn/mn/detail/15356> - “The Intellectual Property law of Mongolia”
- <https://legalinfo.mn/mn/detail/515> - “Law on State Stamp duties of Mongolia”
- <https://www.ipom.gov.mn/source/IP%20License%20Registration%20Regulation.pdf> –
“Procedure on License agreement and intellectual property use for registration of other related contracts”

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