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Gary W. Vanderhoof & Michael Amies

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**Sibley International specializes in the
application of franchising as a development
tool for the small and medium enterprise
sector in developing economies.**

1990 M Street,

NW, Suite 680,

Washington, DC 20036

Phone: (202) 833-9588

Fax: (202) 775-9416

E-mail: sibleyi@aol.com

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Management and Development Issues facing Franchise Businesses in the Republic of Kazakstan

Introduction

Measuring statistics and assessing contracts does not adequately reveal the level of franchising in Kazakstan. Severe economic crisis and poor business performance of the population, suppressed with excessive taxes, corrupted officials and other adversities not at all made for the rise and development of one of one of the most rapidly evolving and dynamic markets in the 80s and 90s.

Currently a USAID project, aimed at establishing a number of pilot franchising systems in Kazakstan, is under implementation. *Sibley International, Ltd.* in common with CARANA Corporation (both US consulting companies) intend to focus on developing franchising strategies under local conditions by both foreign experts and indigenous businesses and consultants.

Management and Development Issues facing Franchise Businesses in the Republic of Kazakhstan

Consistency of Terms and Degree of Knowledge

There are no experts in franchising in Kazakhstan. At the present moment it seems premature to set long-term goals, aimed to take over any sectors of the domestic market for consumer goods and services.

One of the hardships for franchisors will be almost absolute lack of reliable companies, which could help a franchisor with supplies, should it be equipment, machinery, agricultural products, scarce raw materials.

Also a difficulty will be the lack of qualified support service providers who can help a franchisor to develop. Franchisors will find it difficult to locate legal counsel who understand current and pending legislation relating to franchising. It is also difficult to locate translators who have a previous knowledge of franchising terminology. Franchisors will also find that franchise related terminology exists for accounting but there are numerous tax implications related to choice of terms for expenses. In relation to executing franchise agreements, franchisors will find only a very small number of prospective applicants who know and understand franchising.

From a practical perspective, franchisors entering the Kazakhstan market, should not try to develop new terminology for their franchise business. The word “franchisor” and “franchisee” do not translate in Russian. The words are most often transliterated (spelling “franchisor” in Cyrillic without any attempt to create a new Russian word). Time should be spent with new translators to explain and discuss this terminology.

The same principle of explanation and discussion applies to working with Kazakhstan legal counsel. Before selection, franchisors should read thoroughly the section entitled Legal Issues for Franchising (Section 4 of the four sections of this Manual) that follows in this text. Basically, the difficulty for franchisors is that the legal framework is rapidly evolving and new terms are being added almost daily.

Managerial accounting terminology in Kazakhstan has not yet developed. Choice of terminology on official documents may be based on already existing terms, accepted in the financial reports. For instance, one Western consultant who had already developed a successful master franchise in another East European country commented that the first assignment for their build-out management team was to thoroughly understand the Russia’s accounting and taxation systems. With a detailed understanding of tax and accounting terminology they were later able to alter their standard financial reporting.

Management and Development Issues facing Franchise Businesses in the Republic of Kazakhstan

Before beginning the process of franchisee development, it is prudent for the franchisor to test a Kazakhstan applicant's knowledge of free market policies and his/her understanding of the investment required. These applicants should be referred to seminars in franchising strategies development that are conducted under enterprise and private businesses support projects by the World Bank, USAID, TACIS and regional offices of the World Bank.

Management and Development Issues facing Franchise Businesses in the Republic of Kazakhstan

Peculiarities of the Kazakhstan Business Environment Noted by Foreign Businesses

In 1992, the inflow of foreign businesses to Kazakhstan began in earnest. Prior to making a formal commitment to developing a franchise business in Kazakhstan foreign companies overlook the realities of the market and operations requirements. In the early 1990s many foreign businesses saw the market potential but failed to see the operating difficulties. Nevertheless, these businesses came to Kazakhstan and began investing very rapidly. When problems subsequently developed, the level of financial and emotional investment made it impossible for them to withdraw. The meaning is that only highly profile and purposeful businesses are in capacity to do a success in such an unsteady market as Kazakhstan.

Franchisors considering entering the Kazakhstan market should first evaluate their overall position in international markets. Are there good opportunities in other foreign markets which present fewer obstacles? Do these markets offer a more immediate return on investment? Do these markets provide a more favorable environment for franchising? Do these markets provide existing businesses which can be easily converted to franchising?

Though there is the potential for a significant return on a franchise investment in Kazakhstan, in making a commitment to the Kazakhstan market, a franchisor must recognize the time that is required for that investment to be realized. In staking an early claim, a franchisor has established a market presence. There is name recognition and possibly immediate brand recognition.

To date most franchises in Russia, where franchising successfully expands, represent the fast food industry. However, performance results of these franchises have been mixed. Apart from a use of a popular brand name other factors, such as the nature of the franchisor/franchisee relationship, site acquisition and identification of reliable local partners have each contributed to the slow development of these franchises.

Types of Contracts Used to Establish Franchise Relationships

As there are no international franchises operating in Kazakhstan at this time, it is worth of addressing experience and knowledge of the Russian neighbor. No one

Management and Development Issues facing Franchise Businesses in the Republic of Kazakhstan

agreement, legally recognized and executed between a franchisor and a franchisee. Some international franchisors utilized a standard Master Franchise Agreement.

It makes sense to mention a number of reasons why some franchising systems in Russia failed to achieve set tasks. In one sense both franchisors and franchisees are to blame for these poor results. In one case the franchisor could not appreciate the difficulty of site acquisition and actual store development. On the other hand, many franchisees seriously underestimated the financial and human resource commitments required to meet their development schedules. Besides, franchisors have not reviewed agreements and support mechanisms that properly address issues specific to Russia. Because of the uniqueness of franchising as a business concept in this country, the goals of these franchisors are unrealistic.

One should refer to successful franchising initiatives. Of the three Russia's franchise businesses interviewed, none of the businesses used an all-encompassing franchise agreement. Instead they are developing the practice of using three separate agreements to define the franchisor/franchisee relationship.

The first of these incorporated by all three businesses is a trademark license agreement. This agreement authorizes the licensee to operate the business under the trademark of the license holder. Trademarks in Russia extend over names, designs, technical specifications and logos. More information on the topic of trademark law may be found in the Legal Issues section of this manual.

The second agreement used by all three businesses is the equipment and build-out service contract. This agreement provides the franchisee with the necessary design, architectural and engineering support necessary to construct a site. The agreement may also include the sale, delivery and installation of specific equipment necessary for operations. What is less common in the post-Soviet environment than in the West is franchisor equipment leasing agreements. Details of leasing arrangements that are occurring can be found in another section of this manual, Leasing Issues.

By separating one general franchise agreement into separate agreements, these franchisors have found that it is easier to control their franchisees. When the contract is narrowly defined, these franchisors are better able to protect their legal rights in the courts. As more narrowly defined contracts are easier to enforce.

Management and Development Issues facing Franchise Businesses in the Republic of Kazakhstan

Difficulties To Be Avoided

Foreign media has done a thorough job of negative depicting of investment opportunities to the Russian economy, citing a number of collapsed western investments in the Russian businesses. What has not been adequately covered are the well-working partnerships. Of particular note are the successful franchising projects.

Franchisors seeking to establish a presence in Kazakhstan have to identify a Kazakhstan company as a business partner which can determine the success of the venture. In selecting this company, it is important that the franchisor closely investigate their background and affiliations with other Kazakhstan companies. The first company interviewed may not be the best suited for this association. Check any available references including banking relationships, and other professional service providers such as accounting firms and legal counsel.

Management and Development Issues facing Franchise Businesses in the Republic of Kazakhstan

The Question of Operational Control vs. Equity Control

In establishing a relationship with a local Kazakhstan company, every franchisor must address the issue of operational versus equity control of the business. Operational control grants the franchisor the ability to establish and effectively monitor the day-to-day operations of each franchise unit. In accepting responsibility for operational control, the franchisor is prepared to provide on-going support to the management of the franchise in an attempt to maintain product and service standards. Usually in these situations, where the franchisor maintains operational control the local Kazakhstan partner is still involved in management but to a lesser degree.

In Kazakhstan, the party that controls the operations of the company controls the company. Too often the franchisor relies on their equity control of the company to ensure their rights as owners. In those situations where equity control is granted to the local Kazakhstan company it is extremely important that the franchisor know their partner.

Opportunities for the Conversion of Existing Businesses to Franchises

Currently there are a significant number of retail and service businesses operating in Kazakhstan. As the free market economy continues to expand, it is anticipated that these opportunities will increase.



Franchise Financing in Kazakhstan

Part 2 of 4 Parts

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Franchise Financing in the Republic of Kazakhstan

Introduction

This part is a practical manual for organizations offering their trademark to other enterprises (hereinafter referred to as “Franchisor”) which analyses issues of financing franchisees in the Republic of Kazakhstan.

It has to be mentioned that financing environment in Kazakhstan is changing rapidly and that the programs and policies described below are subject to constant changes and improvements. Due to this fact, some points contained in this document may have drastically changed by the time the Franchisor gets acquainted with it. Therefore, the Franchisor has to be prepared to quickly adjust to all changes in order to be able to participate in credit program structuring.

Franchise Financing in the Republic of Kazakhstan

Present Environment

Fast Changing Business Environment

Giving an overall evaluation, it has to be noted that franchise relations have not been well known in the Republic of Kazakhstan. At present, there are no normative acts which would regulate financing conditions for franchisees using debts from such institutions as banks or leasing companies.

Long term financing program plays an important role in the franchise development, however, under the economic conditions existing in Kazakhstan at present, the share of long term loans in the market is only 5-6%. It is worth mentioning that not all Kazak banks understand the concept of franchise, or are familiar with the possibility of reduction of risks connected with loan repayment, which become available through franchising. Apart from this, banks lack necessary experience in loan provision to not only franchised small sized enterprises, but also to non-franchised businesses. This is because of the present condition of the banking system of Kazakhstan, which is characterized by inefficient capitalization of some banks that prevents them from being able to finance medium and long term investment projects independently. A big share of banks is represented by small banks, a lot of which experience difficulties at the moment, most of their income is derived from transaction fees charged on deposits, withdrawals, foreign exchange, and interest rate spread between deposits and low risk investments in money market instruments (various types of securities).

Long term loans issued for leasing activities on medium and long term lease of main production facilities are also very important. Long term leasing requires about 75% of long-term bank loans. As was mentioned above, Kazak commercial banks prefer working with short term loans (90-96%), therefore, there have been no cases of serious leasing deals.

At the same time, lease financing which becomes available on an domestic and international levels, can very soon become available for franchisees under the condition of introducing amendments into the Legislation and taxation laws.

Early Steps

Franchisees which have a low level of expenditures during an initial period (about \$25,000 - 50,000), can be financed only by means of either equity capital of

Franchise Financing in the Republic of Kazakhstan

franchisees or as a combination of bank loans with a 3 to 9 month maturity with a real interest rate of 20-40% (i.e. an interest rate adjusted according to the inflation rate).

In some cases, the Franchisor provides a part of financing of their franchisees by issuing promissory notes to conduct initial training and franchise fees, as well as for purchase of start-up inventory.

As a rule, any bank debt is treated as a prior one in respect to any debt liabilities. In cases when a short-term banking financing is required, all economic activities of the enterprise have to be structured in a way which would allow to generate large amounts of cash to rapidly repay the loan.

In this case, the Franchisor has an opportunity to show to the bank financial statements of franchisees who have already been in operation for some time. Bankers use financial documents of already existing franchisees as a proof of the ability of owners of these new enterprises to service their debt liabilities. At the same time, in the United States and United Kingdom, provision of such financial statements is avoided because it can represent "earnings claim", which can later be used by an unsuccessful franchisee to sue the Franchisor for making false promises about the earnings potential of the franchise.

International Financial Institutions

A number of foreign countries and some economic circles use the policy which fosters the development of democracy and capitalism in Kazakhstan through economic programs similar to those used to reconstruct Western Europe after World War II, such as the Marshall Plan.

Some of the governmental organizations and semi-private institutions responsible for implementation of such programs, are:

- a) International Finance Corporation (IFC);
- b) Kazakhstan Post-Privatization Fund;
- c) Overseas Private Investment Corporation (OPIC);
- d) Central Asian American Enterprise Fund (CAAEF);
- e) European Bank for Reconstruction and Development (EBRD);
- f) Asian Development Bank (ADB).

Kazak Intermediate Bank

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Some of these organizations, the Central Asian American Enterprise Fund (CAAEF) in particular, conduct programs with the help of which they demonstrate to the Kazak banks (Kazkommertsbank, Igilik Bank, Tsesna Bank, etc.) how to generate profits by offering loans to small enterprises. At the same time, they also offer a certain part or the whole debt capital required for issuing of loans, which comes from a western organization to a certain small enterprise in Kazakhstan through a Kazak intermediate bank.

This framework allows international financial institutions to participate in financing without using banking license to operate in Kazakhstan, which is very expensive and the process of obtaining of which is very time consuming. Most likely, the most important thing is that this framework offers to intermediate partner-banks an excellent opportunity to obtain practical experience.

“back-to-back” lending programs

Loan applications are accepted by partner banks. A Kazak bank which is able to issue a loan, then appraises and approves (or does not approve) this possibility together with its western partner. If a loan is approved, the western organization can offer 100% of borrowed funds, the Kazak bank, however, takes at least 50% of the risk of arrears. An interest rate ranging from 12% to 18% can be distributed as 50% to the bank and 50% to the western organization.

Such banking programs are known as loan “compensation” programs. They are not yet known to Kazak leasing companies, their use, however, is possible in the future.

Sometimes, a western company’s consultant and a credit supervisor from the Kazak partner bank work jointly for a specific period of time; each potential loan goes through a thorough evaluation of a borrowers ability to pay off the principal and interest rate on the loan on time; responsibilities of the consultant include training its Kazak colleagues on how to appraise a loan and issue loans to small enterprises.

Decision Makers

In spite of the fact that the Kazakhstan intermediate bank is in some sense a student of the western financial institution, which actually provides a loan, it will make a final decision on its interest in establishing relations with the Franchisor and in financing its franchisees.

Franchise Financing in the Republic of Kazakhstan

Because of this, the Franchisor sets a goal to make arrangements with two decision making organizations: the Kazak intermediate bank and the western financial institution, each of which is able to “strangle a deal”.

It is important to mention that as a rule the intermediate bank is more conservative, and setting up good and stable relations with it requires a lot of time and effort. The Franchisor making a presentation to representatives of the intermediate bank and the western financial institution, has to think of where to channel its arguments and attention in dealing with the local banker.

Immediate Credit Benefits

As a rule, evaluation costs for each loan are higher in comparison with those usually incurred by western banks. This is explained by the fact that local bankers and their western colleagues spend a considerable amount of time on preparation of documents, obtaining of loan guarantees, and training. Beside this, each deal is usually unique in its nature and is known among bankers as a “one time deal”, because it is difficult to use the experience, obtained after the loan is provided, and to shorten the time spent on preparation and appraisal of the next loan.

On the other hand, franchising offers a better chance to provide Kazak banks with numerous loan possibilities all of which have almost identical economic characteristics. The franchise does not only allow to reduce the risk of arrears, but also permits to save the time on preparing a deal and obtaining a loan guarantee.

Franchise Financing in the Republic of Kazakhstan

Taking Advantage of the Current Opportunities

When an entry cost of a franchise is more than the ability of the majority of local citizens to finance its purchases by means of private capital and loans of local bank (the cost of one enterprise is over \$75,000), then the Franchisor may consider establishing a franchise program together with loan compensation institutions to finance its potential franchisees.

The term “program” means that participating financial institutions thoroughly understand and agree with economic principles of the franchise organization, and are willing to finance those franchise enterprises which comply with their other selection criteria. Furthermore, they can obtain certain Franchisor’ concessions which provide them with guarantees in the event the franchisee fails to pay off its loan.

Track Record

Loan institutions can express interest in setting up such a program if the Franchisor is able to demonstrate its ability to overcome as many conceptual, production, and administrative risks as possible.

a) *Availability of Operating Enterprises.* The best way for the Franchisor to set up relations with a financial institution is to have several profitable franchisees already operating in Kazakhstan. This is how it will be able to prove to financial institutions that it has had successful experience in the past.

b) *Newly Independent States’ Experience.* It would also be useful to demonstrate that a specific franchise enterprise operates successfully in other N.I.States such as Poland, Czech Republic, or Hungary.

c) *Experienced International Managers.* In conclusion, it has to be mentioned that the management team of a Kazakstani enterprise has to include one (or more) professionally trained specialist with international franchising experience.

Franchise Financing in the Republic of Kazakhstan

Presentation to Leading Foreign Investors

To start, all Franchisors should know how to present themselves to representatives of the mentioned above organizations and how to determine their level of interest in the overall concept of financing their franchisees.

One of the best locations to have meetings with creditors on an initial stage is an operating franchise unit. It is also very useful to have at these meetings a local intermediate bank representative who would act as a partner in the “back-to-back” lending program.

As soon as the Franchisor receives the first indicator of interest, it has to be ready to undertake the following steps either at the first business meeting or shortly after it.

1) *Business Plan.* A business plan is a cornerstone of all “back-to-back” lending programs and training in banking, sponsored by international financial organizations. The plan should not contain an excessive amount of words. In fact, bankers prefer dealing with short and to the point business plans containing a one page executive summary.

Very often, the Kazak intermediate bank requires that the business plan is written according to the bank’s format. If that is the case, it does not present any difficulties to reformat an existing version of a business plan into the required format using a word processing program.

One of the most important issues is to have Russian translation of a business plan as well as to have at the meeting a representative fluent in Russian and who thoroughly understands of the concept of an enterprise.

This section does not contain a suggested business plan format since the Franchisor is very well acquainted with requirements on how to write a business plan and has done that in the past.

II) *Market Studies.* Market studies are usually presented in a form of appendixes of most business plans. As a rule, conclusions of these research works are included into the table of content and listed in references with the main enterprise’s objectives.

Such market studies are usually of a great interest for the Kazak bankers, and this determines presentation of these studies in a form of a separate document, translated into Russian.

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Availability of market studies summary is often a necessary condition which has to precede any further discussions with the Kazak intermediate bank. However, Kazkommertsbank, for example, does not always insist on market studies since employees of the marketing department of this bank possess information on present market development.

III) *Financial Statement Forecasts.* The Franchisor should have a summary and detailed income and loss statements, as well as cash flows projections for an average enterprise available. All these financial documents have to be similar to those which are available at an actually operating enterprise. Any statements, if they are a result of franchisee unit operations in Kazakhstan or other N.I.States, can give bankers' confidence that the franchisee of average performance is able to service long term loan liabilities. If the Franchisor has not yet established flag businesses in Kazakhstan and other N.I.States, then it makes sense to prepare the mentioned statements using adjusted information based on experience of similar enterprises in other countries. These statements must as closely as possible reflect the results of activities of enterprises, which the Franchisor intends to finance in Kazakhstan or other N.I.States.

IV) *Loan Size (Main and Working Capital).* Bankers want to get themselves acquainted with a detailed structure of investment capital to determine the cost of main assets and to assess a loan amount which could later be used as collateral.

The objective of the Franchisor is to attract as much funds as possible. Otherwise, the franchisee will have to generate equity capital in a bigger amount than he is able to obtain, which can lead to a failure in obtaining a license.

Main assets of the enterprise are usually defined as physical items, such as production facilities (buildings) and equipment that can be sold in the event of the enterprise liquidation and repayment of a default loan.

Working capital includes software, depreciated costs of personnel training, license fee, enterprise modernization expenses, inventory, and start-up losses. This capital can be either of a low or no value in the case of the enterprise liquidation. Beside this, bankers can look at it as at an ineffective use of capital and therefore, as a lost of funds, raised through a loan and private capital to start up the business.

As a rule, all banks offer loans only with collateral equal to the liquidation cost of the enterprise main assets. According to some banks' policy, collateral must be more than the loan by 35-40%. The liquidation cost of some assets can be up to 80% of their purchase price, and sometimes even more, if an enterprise is sold as "being in

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operation". An enterprise, which is managed ineffectively at the moment, and therefore is not able to service its debt, but which nevertheless, produces some cash flow, is considered "to be in operation". In such cases, a new owner of an enterprise with better management skills and knowledge, will be able to make the enterprise operate more profitable, and consequently the value of its main assets appreciates.

If the Franchisor is able to demonstrate: a) that there is a stable market for the enterprise's main assets or b) that one ineffectively managed franchisee can be easily substituted with another one; then the franchise owner is more likely to receive a larger loan and a bigger number of franchisees can be financed on the basis of the ratio between the costs of the loan and the capital, known as "a loan to assets ratio".

V) *Selecting a Franchisee.* Bankers understand that only an effectively managed unit can produce positive cash flows, rather than some disembodied franchise concept. For this reason most of bankers' decisions on financing a certain franchise enterprise are based on the appraisal of the applicant's abilities to organize production.

The Franchisor has to be ready to explain to bankers which selection criteria are used in selecting a qualified candidate. These criteria should include not only the indicator of the shareholders' equity capital, although this indicator is the most important element influencing the banker's final decision.

If the Franchisor can find a candidate with a small unit operating experience, the banker then takes this as a big advantage. On the other hand, the banker tries to reduce the risk of a loss of a part or the whole loan by insuring himself in the fact that both the franchisee's capital and the personal assets of the franchise owner are insured by the collateral, and therefore the franchisee shareholders' equity capital remains an important indicator.

However, if the franchisee fails to pay off the debt, it is always difficult to liquidate the debt and to obtain a collateral against personal guarantees. It is clear that from the bankers' point of view, the preference is given to cases of insignificant number of financial liabilities violations, regardless of the adequacy of collateral and personal pledges from legal franchisees.

VI) *Enterprise Profile.* It is evident that if the Franchisor is able to develop a profile of existing franchisees, which could be used to predict success or failure of potential franchisees, the bankers then would consider it a big advantage.

Franchise Financing in the Republic of Kazakhstan

The use of profile will allow to reduce the price offered for some new franchisees since a number of applicants with sufficient equity capital, can, however, be rejected due inadequate profiles. This can postpone sales of some new franchises and royalties associated with them until a new candidate able to purchase the franchise is found.

However, additional costs of the Franchisor having to provide more field assistance to ineffective franchise enterprises, as well as those caused by the loss of royalty income from an unprofitable enterprise, are usually even more.

Furthermore, if several franchisees fail to pay off their debts at one and the same time due to poor selection, then the banks stop lending to new franchise enterprises of the given specific franchise system. If provision of alternative sources of finance is impossible, the development of this system then can be considerably slowed down in comparison with what it could be if a more thorough development plan was used.

An example of such enterprise profiles can be TIMS Profile issue (Russian translation of it is available). It can be obtained from Thomas International Ltd. Harris House, 17 West Street, Marlow, Bucks SL7 2LS, England (tel.: 01 628 475366). This system is successfully utilized by West by organizations offering their trade marks to other companies on the franchise basis.

VII) The Franchisor Security. Numerous Kazak bankers will try to find out what value is added by the Franchisor to the enterprise cost of production in return for the money it receives from the sale of license and payment of royalties.

a) Professional Training. The Franchisor has to be able to provide bankers with copies of manuals on organization of the enterprise production system in Kazakhstan. In some sense, this can be regarded as tangible presentation of a two to three week professional training, which franchisee would have to attend.

b) Training Program for Franchise Enterprise Employees. The Franchisor can in some cases either invite a banker to attend one of the sessions of a professional training program for franchisees, or to provide him with one or several video tapes with this program, if they are available in Russian.

c) Equipment. The Franchisor must explain its role in selection and delivery of equipment, necessary for production. It also has to be prepared to provide information on the income ration, which it generates from sales of equipment to franchisees.

Franchise Financing in the Republic of Kazakhstan

d) *Selection of Construction Site and Provision of Constructing Services.*

Kazak bankers realize that the location of a franchisee can play a significant role in its successful operation. In this respect, they are trying to find out what criteria should be used to select a location for an enterprise and what is the role that the Franchisor plays in its purchase and sanction. The bank can also condition funding loans on the basis of the potential enterprise location.

e) Premises Leases: Negotiations and Terms of a Contract. Most likely, the banker will want to know leasing terms to determine how stable the location of the enterprise is and economic influence of some of these terms on the cash flow. The banker may as well decide he will need to know the role the Franchisor plays in negotiating over the premises lease terms and in renegotiating these terms.

f) Field Service Support. The Franchisor must explain to the banker a standard method of providing field service support within the first several months of franchisee operation. The Franchisor will also have to provide a schedule for an upcoming period when the franchisee will have already gained some operating experience. Special mention has to be made regarding how the Franchisor detects emerging operation problems and what it does to eliminate them.

g) Promotion. You can expect that the banker will ask for information on how the Franchisor will assist the franchisee in promoting and advertising products (services) to increase the latter's income, as well as for information on the cost of such assistance. A lot of bankers would like to get acquainted with written calculations of revenues for the first two-year period produced on the basis of monthly forecast estimations which contain data on promotional costs, scheduled in order to reach the enterprise revenue growth.

h) Product Supply. The banker, most likely, will try to obtain information on how the franchisee receives products and raw materials, how reliable distribution channels are, how sensible the prices are to the growth of customs duties, and also if the Franchisor delivers products by itself and what its profit is. The banker has to be provided with a certain level of informational comfort by assuring him that the vitally important products will be delivered on time and that prices will not be higher than average which will not allow to expose to risks the viability of the whole business.

i) Failure to Repay Debts. The banker will be interested in obtaining information on actions which the Franchisor will undertake in the case when the franchisee fails to pay off its debt and how effective these actions can be for the bank (or if it is not helpful for the bank at all). Although, these questions will be

Franchise Financing in the Republic of Kazakhstan

discussed in more details further on, it has to be mentioned that the majority of bankers will still try to obtain some form of collateral from the Franchisor for franchisees they finance. Instead of saying “no” and seriously interfere with the implementation of a project, the Franchisor will suggest other variants which are not actual guarantees, but which allow assure the bank in a low level of the risk.

VIII) Operational Safety Issues. A big share of the cash flow of retail and franchise business can be withdrawn by means of extortion coming from organizations known under one name - Mafia. Physical assets of the enterprise can be stolen or damaged as a result of physical pressure imposed by such organizations.

A lot of bankers will also want to obtain from the Franchisor data on whether the franchisee will hire security officers to guard the enterprise assets which are the bank’s loan collateral, as well as to secure cash flows required to service the debt. In a number of cases, the bank can recommend security services which it considers reliable. In some cases, the Franchisor will have to spent its time and effort looking for reliable security services. If no adequate solution of this problem is found, it is necessary to use assistance of an intermediate company.

Franchisor Concessions.

A lot of Kazak bankers (and their western colleagues) see benefits from organization of franchise systems, going mostly in one direction: from the bank to the franchisee. The Franchisor then is considered a main beneficiary (who receives all benefits), and the bank is considered to have a larger share of risks. As a result of such understanding, the majority of financial institutions will want to assign part of the risk to the Franchisor and/or to obtain a portion of benefits received by the Franchisor in order to organize business in a more effective way.

Since in the nearest future Kazakhstan will have just a few sources of franchise financing and there will be many deals from which the banks can choose, then the banks will keep the right of choice. Therefore, the Franchisor will have to deal with the issue of concessions demanded by bankers.

I) Guarantees. The most common benefit for the bank is its demand that the Franchisor to guarantees all its loans which it will make to its franchisees. Most Franchisors can turn down such demand as a matter of principal, stating that if they were to guarantee loans, then too many franchisees will not take responsibilities for

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successful operations, and in the most difficult cases they will be able to get out of the business, put the loan in default and will leave the Franchisor with the debt.

However, if the Franchisor has to compulsorily follow this condition, and there are no other creditors, the Franchisor can significantly reduce an impact of the bank's attack by requesting from the bank the following modifications of the guarantees provided by the Franchisor:

a) *Types of Guarantees.* The Franchisor's guarantees have to be provided in respect to the "deficiency" of the loan, rather than to the whole loan. "Deficiency" is a difference between an unpaid remainder of the debt and the amount of the collateral liquidated.

b) *Liquidation Right.* The Franchisor must have a right to liquidate funds of the franchise unit if necessary. This will allow to obtain a maximum of their cost and to decrease the amount of the deficiency.

c) *The Right to Service the Loan.* The Franchisor should not have a right to make payments within the period of time preceding the demand to pay off the entire amount of the deficiency.

d) *The Right to Operate.* The Franchisor must have a right to assume a loan and to operate the unit until an substitute franchisee is found.

e) *The Right to Transfer.* It is necessary to be able to transfer a loan to a new franchisee and to secure this transference from being unreasonably withheld by the bank.

f) *Reducing the Amount of the Collateral.* The Franchisor can request to reduce the amount of the collateral from 100% of the deficiency in the first year, to 75% in the second year, 50% - in the third one, and 0% - in the forth year as the risk of business failure declines over time.

i) *The Loan Loss Reserve Fund.* The Franchisor can ask the bank to establish a slightly higher interest rate. For every repayment received from the franchisee on time, a small portion of that payment, which is the amount of the slight increase, can be placed to a bank's reserve account. The balance of this account will grow as the bank continues to receive repayments on a timely basis. The account balance can be used to service loans in default or to pay off deficiencies. This fund can be supplemented with commission fees obtained for franchise transfers, as well as with a portion of royalty payments.

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II) **Alternatives to Guarantees.** If we decide to use the method mentioned above, then collateral will not have to mean “the end of the world” for the Franchisor. However, there exist some other means of protection, which the Franchisor can offer as a substitution for collateral and which will probably be accepted by many banks.

a) **The Franchisor’s Promissory Note for Franchisee Fee.** The Franchisor can agree to accept a promissory note from the franchisee for a part or the whole amount of franchise and training fees. This will make a lot of the franchisee funds available to be used to resolve operational problems during a start-up period and to reduce the risk of arrears. Beside this, it will allow to demonstrate to the bank the desire of the Franchisor to share part of the risk with the franchisee.

b) **Bank Debt Priorities.** The Franchisor can agree with the fact that in the event of lack of franchisee’s funds, the loan payments to the bank are made first, and promissory note payments and royalties to the Franchisor are made last. This will allow to persuade the bank in continuity of the repayment process. It also imposes responsibilities on the Franchisor to correct the problem.

c) **Mutual Responsibility for Debt Repayment Failure.** The Franchisor may agree that in the case the franchisee fails to repay the loan, it is also in default with the Franchisor. Using this approach will leave the bank assured that if the franchisee encounters any problems, both parties will work together to resolve those problems.

d) **Best Remarketing Efforts.** The Franchisor can agree to use all its capabilities in remarketing a failed franchise unit in attempt to find a new franchisee who would be able to assume and start repaying a loan in default.

Franchise Financing in the Republic of Kazakhstan

The Variety of Banks

The Franchisor cannot rely only on one financial institution in obtaining a loan for its franchisee. It must constantly attract new sources of finance in order to secure a constant crediting process necessary to finance its system's development. Existing sources may stop making loans to franchisees due to numerous cases of default loans or to a big number of monotonous loans. Beside, the bank's management may just change their policy.

And finally, cooperation with more than one bank facilitates the creation of a competitive environment, which is favorable for both the Franchisor and the franchisee. The Franchisor can be in a position when it will be able to negotiate fewer concessions for itself and lower of interest rates for its franchisees.

Equity Capital Participants

There are some situations in which an enterprise applying to obtain the franchise, can turn out to be operationally adequate, however it will not have sufficient equity capital, which would comply with all financial requirements. In such cases, such western financial institutions as the Central Asian American Enterprise Fund, can express interest in having a share in the enterprise's equity capital.

I) *Conditions.* The conditions of an equity participant (a shareholder) can vary from 25% to 60% of the total amount of the equity depending on the total amount of the capital which can be raised by a potential franchisee through private sources. A shareholder's return on investments is usually determined in a stock purchase agreement, and will usually be obtained through some sort of "put" by the participant at the end of the holding period based upon some multiple of earnings or sales of the franchise unit.

II) *Presentation.* In such cases, the Franchisor may prepare the shareholder in the way it would prepare the bank. However, a potential franchisee, which requires this capital, will be the most important player and eventually will have to make the final presentation himself.

Franchise Financing in the Republic of Kazakhstan

Leasing Companies

The leasing sector in Kazakhstan, which includes long term lease of machinery, equipment, and real estate, is just starting to develop, and providing creation of the legal and normative base takes place and that companies involved in leasing relations receive tax and customs concessions, it can soon become an alternative source of finance which will allow to expand existing operation on the basis of franchise.

Leasing companies (those offering long term lease of machinery, equipment, and real estate) will tend to strictly tie expenses to main assets financed by the business. The cost of lease may exceed the purchase price of assets by 10-15% to accommodate tax, transportation and training costs.

The section on leasing, contained in this document, includes more detailed information on creation of a new source of finance.

Franchise Financing in the Republic of Kazakhstan

Long Term Approaches

It is important that Franchisor understands that due to undeveloped nature of franchise financing program in Kazakhstan, it is important to analyze other, more artistic approaches, in order to facilitate the franchise system development. This can include the Franchisor providing part or the whole amount of debt capital, as well as a part of the company's equity capital required to finance qualified potential franchisees, especially those who have successful experience of company or a franchisee management.

Dependability of Funds On a Franchisor's Type.

One possible approach suggests that the Franchisor obtains debt capital for financing its franchisee. In this case, the Franchisor becomes a lender and in some cases, a co-owner of the equity capital of its franchise companies. In this respect, it is important to thoroughly study the Banking Legislation of Kazakhstan, unless the Franchisor prefers to work through an intermediate bank.

The main concept of this approach is that the Franchisor is obliged to provide debt capital in the amount up to 70% of the total cost of the franchise. The franchisee is to provide remaining 30%. After the franchisee starts performing in accordance with the plan, the Franchisor will sell the promissory note to another lending institution for its nominal price or for at least 2% below the rate it charges the franchisee. The Franchisor might continue to service its promissory note and remit to the new note holder all but its two hundred basis point spread as a fee for its services. The money received for the sale of the note would be used to provide debt financing for another franchise.

Loan loss reserve funds similar to those described in Section 2 could be established to protect the fund from losses through defaults. However, since the Franchisor is a guarantor of the loans it holds, it will have a strong incentive to be very careful in selecting and supporting franchisees it finances. Another strong incentive would be to remarket a franchise that was in default of the loan agreement. These incentives apparently, can result in low loan default and loss rates.

In this way, the modest reserve fund of 40 million could be sufficient to finance \$40 to \$50 million of franchises over time.

Franchise Financing in the Republic of Kazakhstan

Appendixes

Contacts: Names, addresses, phone numbers, and e-mail addresses of the following institutions and organizations are included in the General Contact List, which is incorporated in the appendix for Section 1 of this manual. The contact list includes:

- A. Assisting Organizations**
- B. Kazakstani and International Banks**
- C. International Financial Institutions**
- D. Kazakstani Banks participating with International Financial Institutions**
- E. Kazakstani Leasing Companies**

Contacts in Financial Institutions willing to provide finances to franchisees

KAZKOMMERTSBANK
Credit Department
135 zh, Gagarin Str.
Almaty, Kazakstan, 480060,
Tel.: (3272) 444-662
Fax: (3272) 509-958

Askar Toksanbayev
Central Asian American Enterprise Fund
531, Seifullin Str.,
Almaty, Kazakstan, 480083
Tel.: (3272) 638-815,
Fax: (3272) 694-589

* Please, get in touch with these representatives, they will introduce your organizations to bankers.

More detailed information on contacts and their activities is contained in the General Contact List as an appendix of Section 1 of this manual.



Leasing Issues for Franchises in Kazakhstan

Section 3 of 4 Sections

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Leasing for Franchises in the Republic of Kazakhstan

STATUS OF LEASING FINANCE IN KAZAKSTAN

Definitions and Glossary of Terms

The leasing concept (long term lease of machinery, equipment, and real estate) is not new in Kazak: since July 1, 1964, has contained regulations of the practice of lease financing of capital goods and equipment. These regulations were elaborated upon and modified by the Fundamental Principles of Legislation of the USSR and the Republics on Leasing, dated November 23, 1989, by the Fundamentals of the Civil Code of the USSR and the Republics, dated May 31, 1991. Apart from the Legislation and the Civil Code of the Republics, the lease issues were regulated by a big number of normative acts, such as the Law on Cooperation. However, operational and financial leasing has not yet been widely used in Kazakhstan.

However, the Republic of Kazakhstan strongly encourages leasing development. In order to accelerate introduction of leasing relations, the Leasing Legislation is being developed. In this respect, the State Program for Small Enterprise Support for 1997-2000 provides some actions on formation of the legal base which would comply with the world norms. According to this Program, Kazakhstan is also to sign the World Ottawa Convention on Leasing of 1989. The research officers of Kazakhstan Legislation believe that most of the Soviet Laws regulating leasing, will be changed by applicable or in Part II of the new Civil Code of the Republic Kazakhstan or in the Law on Leasing, adoption of which is due in the nearest future.

Part II of the Civil Code of Kazakhstan and the Law on Leasing which are in development at the moment, are significantly different in dealing with issues of leasing relations in the Republic of Kazakhstan.

1. According to the draft of the Law on Leasing, Lease is understood to be a legal contract containing terms and conditions by which a Lessor acquires capital goods or equipment on behalf of a Lessee/client which either rents it or buys it from the Lessor. All lease agreements between the parties, compose Leasing Contract and are implemented in writing. Parties are understood as entities participating in leasing. Lessor is any "legal entity realizing entrepreneurial activity or a citizen registered as an individual entrepreneur, as a party leasing property for use according to a lease agreement. In respect to the state property, only a special state organ has the right to act as the Lessor." Lessee is commonly understood to be a legal entity or an individual which has temporary possession and use of an asset under the terms of an agreement with a Lessor. Leasing Object is understood as any tangible or intangible property which is subject of depreciation, including

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property rights and share packets. Leasing Company is a commercial organization executing functions of a Lessor according to the charter documents and the license. According to the Legislation of the Republic of Kazakhstan, leasing companies are defined as resident and non-resident depending on the place of their registration.

2. The second draft of the Civil Code of the Republic of Kazakhstan does not contain description of characteristics of types of leasing, the definition of a leasing company, etc. According to the draft of the Civil Code of the Republic of Kazakhstan, leasing object is defined as any non-consumable asset. Securities and natural resources cannot be considered leasing objects. According to the lease agreement, Lessor is obliged to acquire property mentioned by Lessee and provide it to Lessee for a fee.

3. Furthermore, the Law of the Republic of Kazakhstan On Taxed and Other Budget Payment Liabilities, defines Leasing as lease of assets subject to depreciation, if it complies with one of four main conditions stipulated in the Law: 1) the term of lease is longer than the lifetime of the main assets by 80%; 2) lessee has the right to purchase main assets at a fixed price or at a price assessed at the end of the project; 3) the balance value of main assets by the end of the lease period is less than 20% of their value at the beginning of lease; 4) the present payment value for the whole leasing period is more than 90% of the value of leased assets. The conditions stipulated in clause 2 are valid for the period within which the right to prolong lease can be utilized.

Since the new Legislation of Kazakhstan is in the stage of development, Kazak leasing companies temporarily use the Special Part of the Civil Code of the Kazak SSR of July, 1964, and special documents developed for some sectors. The only official document dealing exclusively with leasing issues which is active in the Republic of Kazakhstan, is the temporary Resolution on Leasing in Agricultural Sector, adopted by Resolution #1851 of the Republic of Kazakhstan on December 23, 1995.

The draft of Part II of the Civil Code of the Republic of Kazakhstan and the Law on Leasing (Part 29 "Lease of Property") discuss payment terms for property lease, the main focus is profits generated in the result of leasing activities or purchase of capital goods and/or property..., being the final result of the financial transaction. Since leasing (financial rent) is defined as transference of main assets from one owner to another, leasing companies usually represent buyers and sellers of equipment and are not considered structures providing financial assistance to Lessees.

In the USA, for example, there are two types of leasing deals: (a) **Financial leasing** and (b) **Operational or renting leasing**. According to the Law on Leasing, in Kazakhstan, a leasing operation is the one that satisfies one of the following

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conditions: (1) -the leasing term is 80% more than the Object's lifetime; (2) -the lease contract contains an option of purchase at the end of the leasing period; (3) - the balance value of the Object by the end of the lease contract is less than 20% of its value at the beginning of lease; (4) -the present (discounted) value of leasing payments made for the whole leasing period is more than 90% of the Object's value. The term of the capital leasing contract cannot be less than 80% of the normative term determined by the Legislation of accelerated amortization of the Object. The operational leasing is determined as a type of leasing when the Object is leased by the Lessor repeatedly within the service period, when conditions, provided for capital (financial) leasing are not observed.

Leasing deals concluded between Kazak structures (contract participants are residents), are classified as "internal" lease agreement, while agreements between Kazak and foreign companies (one of the contract participants is not a resident) are considered "international" lease agreements. Internal lease agreements are to be evaluated in Tenge and all payments under such agreements are made in local currency. International lease agreements should be made in hard currency and all leasing fees under such agreements should be done through international transfers.

Organizational Structure of Leasing Industry

As a result of Resolution #117 of the Government of the Republic of Kazakhstan of January 29, 1996, the Leasing Fund was created. The Leasing Fund carries out only internal leasing operations in the Republic of Kazakhstan.

The status of the private sector of Kazak leasing industry (as of October 1996) is determined by its original. Unfortunately, just a few companies in the Republic are actively involved in activities on lease financing. The rest are starting commercial enterprises or leasing companies which just formally strive to establish financial relations and the system of potentials lessees.

Kupava private company has been functioning on the Kazak leasing market since 1993, as well as Asia-Leasing, a well-known leasing company involved in leasing of automobiles, oil processing and production equipment. In November 1995, Agro Leasing joint-stock company was created. One of its main activities is to provide Kazak agricultural product manufacturers with technologies on processing on the leasing basis through the Asian Development Bank Loan Program. The Agro-Leasing leasing company works on uniting companies involved in leasing business into an Association of Kazakhstan leasing companies.

Most of actively operating leasing companies are "hostages" of commercial banks, or are mostly in the property of these banks, which provide debt capital to Lessors.

Leasing for Franchises in the Republic of Kazakhstan

Following is the structure of the leasing industry of Kazakhstan within the whole financial sector of the Kazak economy. Giving a brief description of the present situation, it can be mentioned that among the main participating institutions are the Central Bank of Kazakhstan, which is a chief financial institution in developing the financial and budget policy; commercial banks, and financial lending institutions including leasing companies.

Scheme for Typical Cash Flows

Leasing financing usually, comes from the Lessor who borrows funds at a commercial interest rate (a lot of Lessors are in fully depend on banks or financial institutions' subsidiaries) in order to purchase capital goods or equipment preferably from foreign suppliers. The Lessor finances a leasing contract to service the Lessee/buyer (a lot of whom are solvent bank clients), willing to purchase new equipment. The Lessee, in its turn, pays off the debt to the Lessor according to the conditions provided by the leasing contract. Lessor pays off its debt to a commercial bank using the lease fees received from its Lessee.

In more developed leasing industries operating outside of Kazakhstan, there are three types of leasing companies: (1) willy-nilly lessors (which are part of manufacturing companies or banks); (2) independent lessors; and (3) brokering companies (or companies which act as intermediates between lending institutions and borrowers). At the present stage of the leasing development in Kazakhstan, there is only group of leasing companies existing (group #1) which is determined mainly by the fact that funds for financing equipment purchases can be raised through banks and lending institutions which have close relations with banks. We can expect that group (2) will emerge soon - leasing companies will start emerging with the development of the leasing industry in Kazakhstan.

Lease Documentation

The scope and level of documentation required to consummate a lease agreement in Kazakhstan is not dissimilar to documentation used in US or European markets. Refer to Appendix Section D for a complete listing of a typical lease documentation package. In brief, a complete lease documentation package will include: application form and supporting financial information, lease contract, equipment purchase contract, collateral or guaranty papers and proof of insurance.

However, given a lack of reliance of Kazakhstan today upon contract law and the relatively untested enforcement mechanisms available through the legal system,

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Lessors may take little comfort in properly executed documentation alone. Additional steps are usually taken by Lessors to minimize risks and reduce potential losses from lease defaults. For example, Agro-Leasing Company, Kazkommertsbank, and the Lessee sign an additional three-party agreement which provides guaranty liabilities of all the parties.

Kazak Taxation System as Affects Leasing

A new Tax Legislation has been adopted in the Republic of Kazakhstan, in July 1, 1995. Kazakhstan is one of the first CIS countries that adopted the taxation system, used by a lot of industrial countries. There exist 11 types of taxes at the moment: 5 state and 6 local taxes and duties. At the same time, the Legislation of Kazakhstan does not consider real conditions currently existing in the Kazak economy.

All structures involved in commercial activities, including financial consulting companies, must be registered in their local Tax Inspectorate offices and must present a completed tax declaration annually. A company cannot receive a loan or leasing financing assistance without producing its last annual tax declaration.

For all taxpayers the tax year in Kazakhstan ends December 31 and the total annual income and deductions must be declared by March 31 of the following year. Legal non-resident entities operating in Kazakhstan through an existing institution, are also to provide an audit conclusion verifying the data contained in their income declaration. Such verification should be submitted to the Tax Inspection within a year following the reported year, but no later than 10 days after auditing is completed. An auditor, assisting in filling out the taxpayers tax declaration is to sign this declaration, stamp it, and provide the registration number he has assigned to the taxpayer.

(A) Profits Tax Rate: The profit tax rate for legal entities is 30%. The profit tax rate for registered legal entities operating in a special economic zone, is 20%. Interest rates, charged by resident banks are tax exempt. In addition to the profit tax, the net profit tax is charged from a permanent legal entity's establishment in the rate of 15%. Profit of a nonresident coming from the Kazak source, which is not tied up with a permanent establishment, is taxable in the source of payment, on total profit without deductions. Current payments are to be made within the 20th of each month based on the provided interest rate and financial results for the previous month.

(B) Value Added Tax: 1) *On business activities.* The tax rate is 20% of the taxable turnover. There is a list of reduced tax rates for some business activities. The tax declaration is presented no later than the 15th of the month following the reported

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period: if average monthly payments for a quarter are less than 500 monthly specified rates, the reported period is then a quarter; if average monthly payments for a quarter are over 500 monthly specified rates, the reported period is then a month.

2) *On imported goods.* The rate is 20% of the taxable import size including goods customs value, assessed in accordance with the Customs Legislation of the Republic of Kazakhstan, as well as the sum total of duties and fees due to be paid for products imported to the Republic of Kazakhstan. Some types of imports are tax exempt including "...goods imported at the cost of budget funds..., as well as imported goods purchased through foreign credit lines guaranteed by the State.", and goods "required for exploitation of international transportation of freight, luggage, and passengers." According to some competent sources, other production equipment such as bakeries, may also obtain a right to be VAT exempt.

(C) Property Tax: The tax on production and non-production assets of legal entities and individuals involved in business activities, is paid at a rate of 0,5% of these assets value. If a noncommercial, budget supported organizations or individuals use part of their property in their entrepreneurial activities, the tax rate is 0,5%. Current payments are made by parts on February 20, August 20, and November 20 of the tax year. The Property Tax Declaration is to be presented by March 31 of the year following the reported year and should contain information as of December 31 of the current year.

(D) Depreciation: Depreciation and amortization are calculated according to an established accounting procedure using the method of straight line depreciation. Depreciating payments on main depreciated assets which are used in production are to be deducted in accordance with Paragraph 20 "On Depreciation Payments and Deductions on Main Assets" of the Law "On Taxes and Other Budget Payment Liabilities". The Law provides the maximum amortization level in percentage for various groups of main assets subject to depreciation: automobiles, computers and data processing equipment - 20%; premises and buildings - 7%, etc. Amortization deductions for each group are calculated by applying the amortization norm to the value balance of the group at the end of the tax year. On premises, constructions, and buildings amortization is computed individually for every building. If the value of premises is less than 40 minimal monthly wages as a result of depreciation, then their value is considered as current expenses and is subject to deduction. The value balance of the group at the end of the tax year is understood as the amount which includes reevaluation implemented according to norms established by the Cabinet of Ministry of the Republic of Kazakhstan. If the amount obtained from sale of main assets is more that the value balance of the group at the end of the year, the remainder adjusted to inflation is included into income, hence the value balance equals zero. If the value balance of the group at the end of the tax year is less than

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100 of minimal monthly wages, the size of the value balance of the group is subject to deduction. If all main assets of the group were sold or liquidated, the value balance at the end of the tax year at the end of the tax year is subjected to deduction. The value of purchased technological equipment used in production is less than three years old, is subject to deduction upon taxpayer's discretion at any moment within the amortization period within the amount of remained amortization. The taxpayer has a right to use other norms of amortization upon his discretion, but no higher than the established limit. According to Instruction #37 of July 26, 1995, "On the VAT Assessment and Payment Procedures", the VAT, applied to premises and automobiles, which is not accounted to, is included into the taxpayer's expenses as a part of those through the amortization sum total.

According to the Tax Code, amortization of main assets in terms of taxation should be computed only once a year according to the main assets balance at the end of the year. Enterprises reevaluate its main assets using the State Statistics Committee inflation ratio. immaterial assets such as services or patents, are depreciated for a longer asset exploitation period and the period of company's operation (within 1-5 year).

(E) Tax registration and Fines: The Kazak Tax Legislation provides 1) compulsory taxation system: to provide debt payments, the tax inspectorates have a right to arrest property in the event of lack of funds on the taxpayer's and his creditor's accounts according to procedures established by the Cabinet of Ministers of Kazakhstan; 2) Liabilities of legal entities and individuals: taxes, not paid on time, are exacted to the budget with an add-up of a fine in the amount of 1.5% of a refinancing rate assessed by the National Bank of the Republic of Kazakhstan for every day of a delay (including the day when payment is due). In case of a delayed presentation of the tax declaration a monthly fine is charged at a rate of 5% of the amount due to be paid. In case of income or the amount of monthly current payments is lowered and in case of sales of products (work or services) are not reflected in the statement, the fine is charged at a rate of 100% of the lowered amount by which the taxable amount is lowered.

(F) Customs Duties: Customs duties are applied in relatively large amounts to a wide range of products, such as equipment and production machinery, which are subject to selective tax exemption for raw materials and socially vital products. Products are classified according to a unified normative base, and duties are usually collected according to the declared value of goods. According to Cabinet of Ministers of the RK Resolution #299 of March 12, 1996, "On Amendments to Resolution of the Cabinet of Ministers of the RK #1125 of August 15, 1995", the rates of customs duties were determined for goods imported to and exported from the Republic of Kazakhstan.

Leasing for Franchises in the Republic of Kazakhstan

Accounting Issues

Accounting and reporting for leasing activities should be carried out in accordance with the Law of the Republic of Kazakhstan “On Accounting” adopted in December 1995. Since legislative acts dealing with leasing relations in Kazakhstan are in the stage of development, the National Accounting Commission at the Ministry of Finance of the Republic of Kazakhstan is determining peculiarities of leasing operations in accounting and reporting.

Leasing Economy in Kazakhstan

At this stage, as a result of evolution, which Kazak financial institutions are undergoing at the moment, as well as due to the state of the money and budget and financial policies, decisions on financing purchases of equipment (i.e. leasing Vs purchasing), most likely, are made on the basis of the analysis of large convincing indicators which influence activities of enterprises. They include money availability, use of established business relations with banks, loan terms, easy use, delivery dates. Such pure economic indicators as assets value and possibility of obtaining reduced tax rates, do not usually have any influence on this decision making process. Some Kazak Lessees carry out a standard analysis of lease Vs purchase comparison which in general may resemble factors listed below:

Leasing for Franchises in the Republic of Kazakhstan

Chart 3. Financial Lease vs. Loan Factor Analysis

	<u>Loan</u>	<u>Lease</u>
Factors:		
Interest Rate: Rubles	210%	221-250%
Interest Rate: Hard Currency	12-18% (1 yr.)	15-22% (3 yrs)
VAT on Payments	None	21.5%
Depreciation Deductible	Yes*	Yes*
Source of Existing Finance	Yes	Yes
Use of Asset Prior to Full Payment	No	Yes
Maximum Term / Duration	6-9 mos+	36 mos#
Tax Position	Pay Pre-Tax	Pay After-Tax
Guaranties	Bank Guaranty or equivalent collat.	(I)Bank Guaranty (ii) equiv. collateral (iii) or none.
Existing Bank Client	Yes	N. A.
Equipment / Residual Risk	No	Yes-limited.
Notes:		
* According to statutory depreciation tables.		
+ Roll-over of loan possible for additional period.		
# Some sources may extend credit 60 months.		

Leasing for Franchises in the Republic of Kazakhstan

Sample Comparison of Lease vs. Loan Analysis

Part I. Actual Figures displays a typical set of figures for importation and financing of a \$100,000 item of equipment. For simplicity, all figures are shown in US Dollars. In this example, the borrower/Lessee makes a 15% downpayment and wants financing for the 85% remainder of the equipment cost. The calculated total loan repayments are \$124,624 at the prevailing hard currency interest rate of 18% per year. By comparison, the total lease installments are \$162,376 at the prevailing higher lease rate of 20% per year.

Part II. Typical Normalized Figures For Yr. 1 and Yr. 2 to reflect After-Tax Results shows a comparison between Loan, Financial Lease and Operating Lease payments over a hypothetical two year period. This table clearly demonstrates, due to the additional cost to the Lessor/Lessee of a 21.5% VAT tax on lease income, that the **Loan option** is a less expensive method of financing equipment.

Part III. Normalized Figures for Yr. 1 and Yr. 2 after elimination of Value-Added Tax on Rental Income shows the revised cashflow results when the 21.5% VAT tax on lease/rental income is eliminated. Here the **Leasing option** is equivalent in cost to the Loan option and results in equivalent positive after-tax cashflows (\$531,306 vs. \$537,500) even though the relative cost of funds may be higher (i.e. 20% vs. 18% per year) under the leasing option.

Leasing for Franchises in the Republic of Kazakhstan

Sample Comparison of Lease vs. Loan

Part 1. Actual Figures	Original Cost	\$100,000	
	Customs Duties	10.00%	\$10,000
	VAT on Import	21.50%	\$21,500
	Landed Cost		\$131,500

Loan in USD	Principal Required	Interest Yr. \$ Rate	Term / Month	Payment	Principal	Profit	Note Balance Remain
Downpayment 15%	\$111,775	18.0%	12	\$31,156			
\$19,725							
Payments 1					\$26,126	\$5,030	\$93,468
Quarterly 2					\$27,303	\$3,853	\$62,312
3					\$28,531	\$2,625	\$31,156
4					\$29,814	\$1,342	\$0
				Sub Totals	\$111,774	\$12,850	
				Grand Total			\$124,624

LEASE in USD	Principal Required	Interest Yr. \$ Rate	Term / Month	Payment	Principal	Profit	Note Balance Remain	Increase by VAT
Downpayment 15%	\$111,775	20.0%	24	\$17,293				
\$19,725			(8 qtr.)					
(add 21.5% VAT)								
Payments 1					\$13,972	\$3,321	\$121,051	\$3,004
Quarterly 2					\$13,972	\$3,321	\$103,758	\$3,004
3					\$13,972	\$3,321	\$86,465	\$3,004
4					\$13,972	\$3,321	\$69,172	\$3,004
5					\$13,972	\$3,321	\$51,879	\$3,004
6					\$13,972	\$3,321	\$34,586	\$3,004
7					\$13,972	\$3,321	\$17,293	\$3,004
8					\$13,972	\$3,321	\$0	\$3,004
				Sub Totals	\$111,775	\$26,569		\$24,032
				Grand Total			\$138,344	

Leasing for Franchises in the Republic of Kazakhstan

Typical Normalized Figures For Yr. 1 and Yr. 2 to Reflect After-Tax Results

Loan Analysis			
	Term in Months	Year 1 12	Year 2 12
Original Equipment Cost		\$100,000	
Customs Duties	10%	\$10,000	
VAT on Import	21.50%	\$21,500	
Landed Equipment Cost		\$131,500	
Downpayment	15.00%	\$19,725	
Principal Loan Amount		\$111,775	
Commercial Interest Rate / Year	18.00%		
Total Interest Payments		\$12,850	\$0
Add VAT to Lease income	(21.5%)	\$0	\$0
Moscow Property Tax	2%	\$2,630	\$2,630
Depreciation in Years	8	0.12	0.12
Simplified Cash Flow Analysis:			
Hypothetical Income		\$500,000	\$500,000
Less Depreciation Expense		(\$15,780)	(\$15,780)
Less Loan / Interest Payments		(\$12,850)	\$0
Less Property Tax		(\$2,630)	(\$2,630)
Less VAT on Lease		\$0	\$0
EQUALS Net Profit Before Tax		\$468,740	\$481,590
Profits Tax Calculation	35%	(\$164,059)	(\$168,557)
NET PROFIT AFTER TAX:		\$304,681	\$313,034
Purchase Option to Acquire Equip.		\$0	\$0
NET NET INCOME		\$304,681	\$313,034
Net Income as % of Revenues		60.9%	62.6%
Actual Cash Flow to Business			
(add back depreciation)		\$320,461	\$328,814
# Less Debt / Lease Principal Payment		(\$111,775)	\$0
FREE CASH FLOW TO BUSINESS		\$208,686	\$328,814
		TOTAL	\$537,500

Note (A): Capital equipment allowance permits offset of any profits tax liability for Year 1 of a new operation up to the amount of original equipment costs, i.e. \$100,000.

Leasing for Franchises in the Republic of Kazakhstan

Typical Normalized Figures For Yr. 1 and Yr. 2 to Reflect After-Tax Results

Lease Analysis	Financial Lease		Operating Lease	
	Year 1	Year 2	Year 1	Year 2
Term in Months:	12	12	12	12
Original Equipment Cost				
Customs Duties				
VAT on Import				
Landed Equipment Cost	\$131,500		\$131,500	
Downpayment	\$19,725		\$0	
Principal Loan Amount	\$111,775		\$131,500	
Commercial Interest Rate / Year	20.00%		20.00%	
Total Interest Payments	\$13,285	\$13,285	\$81,188	\$81,188
Add VAT to Lease Income	\$12,016	\$12,016	\$12,016	\$12,016
Moscow Property Tax	\$2,630	\$2,630	\$0	\$0
Depreciation in Years	0.12	0.12	0.12	0.12
Simplified Cash Flow Analysis:				
Hypothetical Income	\$500,000	\$500,000	\$500,000	\$500,000
Less Depreciation Expense	(\$15,780)	(\$15,780)	\$0	\$0
Less Loan / Interest Payments	(\$13,285)	(\$13,285)	(\$81,188)	(\$81,188)
Less Property Tax	(\$2,630)	(\$2,630)	\$0	\$0
Less VAT on Lease	(\$12,016)	(\$12,016)	(\$12,016)	(\$12,016)
EQUALS Net Profit Before Tax	\$456,290	\$456,290	\$406,796	\$406,796
Profits Tax Calculation	(\$159,701)	(\$159,701)	(\$142,379)	(\$142,379)
NET PROFIT AFTER TAX:	\$296,588	\$296,588	\$264,418	\$264,418
Purchase Option / Acquire Equip.	\$0	\$1	\$0	\$13,150
NET NET INCOME	\$296,588	\$296,587	\$264,418	\$251,268
Net Income as % of Revenues	59.3%	59.3%	52.9%	50.3%
Actual Cash Flow to Business				
(add back depreciation)	\$312,368	\$312,367	\$264,418	\$251,268
# Less Debt/Lease Principal Payment	(\$55,888)	(\$55,888)	\$0	\$0
FREE CASH FLOW TO BUSINESS	\$256,481	\$256,480	\$264,418	\$251,268
	TOTAL	\$512,961	TOTAL	\$515,685

Note (b): If a new business is small business (defined as having less than 500 employees) and involved in one of the special categories; i.e. construction, transport, medical, meals, then that business may adapt the following taxation exemptions: Year 1) 100% (effective rate 0%), Year 2) 75% (effective rate 8.75%), Year 3) 50% (effective rate 17.5%), Year 4) 25% (effective rate 26.25%), Year 5) 0% (effective rate 35.00%).

Leasing for Franchises in the Republic of Kazakhstan

Normalized Figures For Yr. 1 And Yr. 2 after Elimination of VAT on Rental Income

Loan Analysis			
	Term in Months	Year 1 12	Year 2 12
Original Equipment Cost		\$100,000	
Customs Duties	10%	\$10,000	
VAT on Import	21.50%	\$21,500	
Landed Equipment Cost		\$131,500	
Downpayment	15.00%	\$19,725	
Principal Loan Amount		\$111,775	
Commercial Interest Rate / Year	18.00%		
Total Interest Payments		\$12,850	\$0
VAT on Lease Income Eliminated	0	\$0	\$0
Moscow Property Tax	2%	\$2,630	\$2,630
Depreciation in Years	8	0.12	0.12
Simplified Cash Flow Analysis:			
Hypothetical Income		\$500,000	\$500,000
Less Depreciation Expense		(\$15,780)	(\$15,780)
Less Loan / Interest Payments		(\$12,850)	\$0
Less Property Tax		(\$2,630)	(\$2,630)
Less VAT on Lease		\$0	\$0
EQUALS Net Profit Before Tax		\$468,740	\$481,590
Profits Tax Calculation	35%	(\$164,059)	(\$168,557)
NET PROFIT AFTER TAX:		\$304,681	\$313,034
Purchase Option to Acquire Equip.		\$0	\$0
NET NET INCOME		\$304,681	\$313,034
Net Income as % of Revenues		60.9%	62.6%
Actual Cash Flow to Business			
(add back depreciation)		\$320,461	\$328,814
# Less Debt / Lease Principal Payment		(\$111,775)	\$0
FREE CASH FLOW TO BUSINESS		\$208,686	\$328,814
		TOTAL	\$537,500

Note (A): Capital equipment allowance permits offset of any profits tax liability for Year 1 of a new operation up to the amount of original equipment costs, i.e. \$100,000.

Leasing for Franchises in the Republic of Kazakhstan

Normalized Figures For Yr. 1 And Yr. 2 after Elimination of VAT on Rental Income

Lease Analysis	Financial Lease		Operating Lease	
	Year 1	Year 2	Year 1	Year 2
Term in Months:	12	12	12	12
Original Equipment Cost				
Customs Duties				
VAT on Import				
Landed Equipment Cost	\$131,500		\$131,500	
Downpayment	\$19,725		\$0	
Principal Loan Amount	\$111,775		\$131,500	
Commercial Interest Rate / Year	20.00%		20.00%	
Total Interest Payments	\$13,285	\$13,285	\$81,188	\$81,188
Add VAT to Lease Income	\$0	\$0	\$0	\$0
Moscow Property Tax	\$2,630	\$2,630	\$0	\$0
Depreciation in Years	0.12	0.12	0.12	0.12
Simplified Cash Flow Analysis:				
Hypothetical Income	\$500,000	\$500,000	\$500,000	\$500,000
Less Depreciation Expense	(\$15,780)	(\$15,780)	\$0	\$0
Less Loan / Interest Payments	(\$13,285)	(\$13,285)	(\$81,188)	(\$81,188)
Less Property Tax	(\$2,630)	(\$2,630)	\$0	\$0
Less VAT on Lease	(\$0)	(\$0)	(\$0)	(\$0)
EQUALS Net Profit Before Tax	\$468,306	\$468,360	\$418,812	\$418,812
Profits Tax Calculation	(\$163,907)	(\$163,907)	(\$146,584)	(\$146,584)
NET PROFIT AFTER TAX:	\$304,399	\$304,399	\$272,228	\$272,228
Purchase Option / Acquire Equip.	\$0	\$1	\$0	\$13,150
NET NET INCOME	\$304,399	\$304,398	\$272,228	\$259,078
Net Income as % of Revenues	60.9%	60.9%	54.4%	51.8%
Actual Cash Flow to Business				
(add back depreciation)	\$320,179	\$320,178	\$272,228	\$259,078
# Less Debt/Lease Principal Payment	(\$55,888)	(\$55,888)	\$0	\$0
FREE CASH FLOW TO BUSINESS	\$264,291	\$264,290	\$272,228	\$259,078
TOTAL		\$528,581	TOTAL	\$531,306

Unfortunately, Kazak lessees did not conduct any similar research work. However, due to the fact that economic situations in Russia and Kazakhstan are similar, this analysis should represent some interest for Kazak lessees.

Leasing for Franchises in the Republic of Kazakhstan

Insurance

Insurance, if leasing deals are based on the Law of the Republic of Kazakhstan “On Insurance”.

In general, leasing companies require property and casualty insurance coverage for the replacement value of the leased asset. This insurance cost is carried by the Lessee and may be added into the lease payments, or paid separately in advance. Typically, insurance policies are held in the name of the Lessee with the Lessor’s named as first loss payee in the event of a claim.

The Draft of Part II of the Civil Code of the Republic of Kazakhstan (Paragraph 29 “Property lease (rent)”) stipulates that the lessee is obliged to insure products according to the established procedures.

Opposite to Russia, there are no insurance companies in Kazakhstan which would issue special form of insurance against risks of commercial default by Lessee. (It is noteworthy that no Western insurance companies would underwrite such coverage for leases or loans in Russia or in the West.)

Leasing for Franchises in the Republic of Kazakhstan

Competitive Advantages and Disadvantages of Leasing in Kazakhstan

The following is the list of benefits and advantages to use of leasing in Kazakhstan.

For Lessee:

External Form of Financing: Like loans, leasing provides capital to business which is external to its own sources. Thus, the business conserves its own capital for operating needs and leverages other funds for applications to increase production or profitability.

Funds Availability: If a small business, the Lessee may not be able to qualify for loans which are typically lent to him directly. With a lease arrangement, Lessor purchases equipment directly from supplier on behalf of Lessee so funds do not pass through Lessee's business.

Leasing Finance Avoids Financial Covenants of Loans: Leasing finance is more flexible and not as restrictive as bank debt which typically requires maintenance of certain financial ratios, or opening of bank account with lending bank or maintenance of countervailing cash deposits with lending bank.

Leasing Finance is Off-Balance Sheet and does not Use up Bank Credit Lines: Where businesses can qualify for bank line of credit, these funds remain in tact for use in the operations of the business. Operating Leases do not show up as a financial liability.

Term: Commercial loans are usually 3-6 months but may stretch to 12 months. Lease term is typically 24 months but can stretch to 36 months.

Use of Assets Prior to Full Payment: Leasing finance allows the Lessee to utilize the asset before making full payment. Use of the asset in the business operations to generate income can facilitate payment by the Lessee for eventual ownership of the asset.

Leasing Finance May Provide Tax Benefits: Under current Kazak tax laws pertaining to rental agreement (i.e. Operating leases) it is possible to deduct lease payments as business expenses before calculating income taxes which can reduce taxes otherwise payable to "oblast" and federal governments. Further, it may be possible to also deduct lease payments made under a financial lease so long as the

Leasing for Franchises in the Republic of Kazakhstan

lease contains a purchase option which can be exercised at the end to the lease term. This finding was the interpretation of one major leasing company in Moscow.

Avoidance of Bank Guaranty: Because the Lessor owns the leased asset, it may be willing to for-go a bank guaranty which is typically required for loans. Depending upon the financial soundness of the Lessee, additional security may be requested like real estate, equipment or cash collateral. Avoidance of a bank guaranty is crucial because it may cost the Lessee between 3-5% per annum of the outstanding obligation.

Leasing of Equipment Avoids Risk of Obsolescence: When the Lessee rents the equipment and has the option to return it at the end of the lease term, they can avoid owning technologically obsolete equipment and is free to rent or purchase new equipment.

Leasing Finance May Include Selective Soft Costs: The monthly lease payment can include additional expense items like repairs, maintenance or insurance which may be financed together by the Lessor. Such payments may also include installation, training and maintenance charges in the lease. This advantage may be especially helpful to Franchisees where “soft costs” like training, installation and signage expenses may be folded into the property and equipment lease and financed over the lease term.

Leasing May Provide Accounting Benefits: In contrast to Loans or Financial leases (i.e. installment sales) an Operating lease permits the business to expense the equipment costs more rapidly (a substantial portion of the asset during lease term of 24 -36 months) and achieve the accounting benefits of accelerated depreciation.

For Lessor:

Lessor is Owner of Leased Asset: In the case of default, the Lessor can repossess the asset and reduce his exposure in the deal. Alternatively, if the Operating lease transaction runs full term the Lessor may receive the equipment back at lease end and sell it to realize an additional profit.

Lessor can Assist Lessee Financially without Giving Money Directly: Lessor has added security over loans by controlling how the funds are used. Typically, Lessor will pay equipment supplier directly.

Lessor can Offer Funds at Longer Term: Leasing finance can match the funding term to the useful life of the asset. Many leases will run beyond the typical maximum term of 6-12 month for loans.

Leasing for Franchises in the Republic of Kazakhstan

The following are the key disadvantages of leasing in Kazakhstan:

1. Lessors possess a small capital or do not have it at all, which determined their need to borrow funds from banks. This, in its turn, lead to increase of funds up to the level of an interest rate applied to commercial loans.
2. From the stand point of long-term expanding of business activities, trustful relations with the Lessor are not so valuable in comparison with the trust of the bank.

As described earlier in Section 1.8, an economic comparison between loans and leases favors loan financing over leasing as of June 1995. If the VAT tax on lease/rental income were to be reduced or eliminated then one would expect leasing finance to become a preferred option for equipment financing in Kazakhstan and a powerful tool to support franchise development.

Leasing for Franchises in the Republic of Kazakhstan

Use of Leasing to Support Franchise Financing

Interviews with several major Western franchisors reveal that their corporate management is not willing to finance leasing of Kazak companies. Lease financing in Kazakhstan is limited and can be applied only to major customers of these organizations (representing American and European companies), which operate in Kazakhstan.

Relatively low cost of foreign hard currency financial sources (according to OPIC, IFC, EBDR), which American franchisors can afford at the moment, will lead to noncompetitive position of Kazak leasing companies on an initial stage of financing of corporate enterprises. However, franchisors express their interest in examining a possibility of use of lease financing to pursue their plans.

US franchisors may find local lease financing an attractive alternative to bank loans for their acquisition of new equipment and for expansion investments beyond their initial few corporate units because:

- Leasing finance will conserve local bank lines of credit
- Leasing finance opens a new source of external financing
- Leasing can be available to franchisees who may not qualify for loans
- Credit terms for leasing finance are longer terms than loans
- Use of Operating leases can result in favorable tax benefits
- Leasing may provide 100% financing
- Greater flexibility in structuring lease payments
- Expert assistance in acquiring foreign equipment and importing
- Lessors may obtain for Lessees possible discount in equipment price

In Kazakhstan, loans are typically available from banks within specific geographical regions and within the industries that are served traditionally by the bank. Financing outside the industry specialization of the bank and/or outside the geographical region is difficult and may only be done by building a relationship with another bank. However, today Kazak leasing companies are not so constrained, although clearly they tend to serve the clients of the parent bank or those clients of the bank that lends the Lessor capital to purchase equipment. Thus, leasing finance can evolve to provide franchisors access to financing cutting across industries and in various geographical locations, which may prove critically important to franchisors as they expand business across Kazakhstan.

Leasing for Franchises in the Republic of Kazakhstan

Summary of Major Obstacles of Growth of Leasing

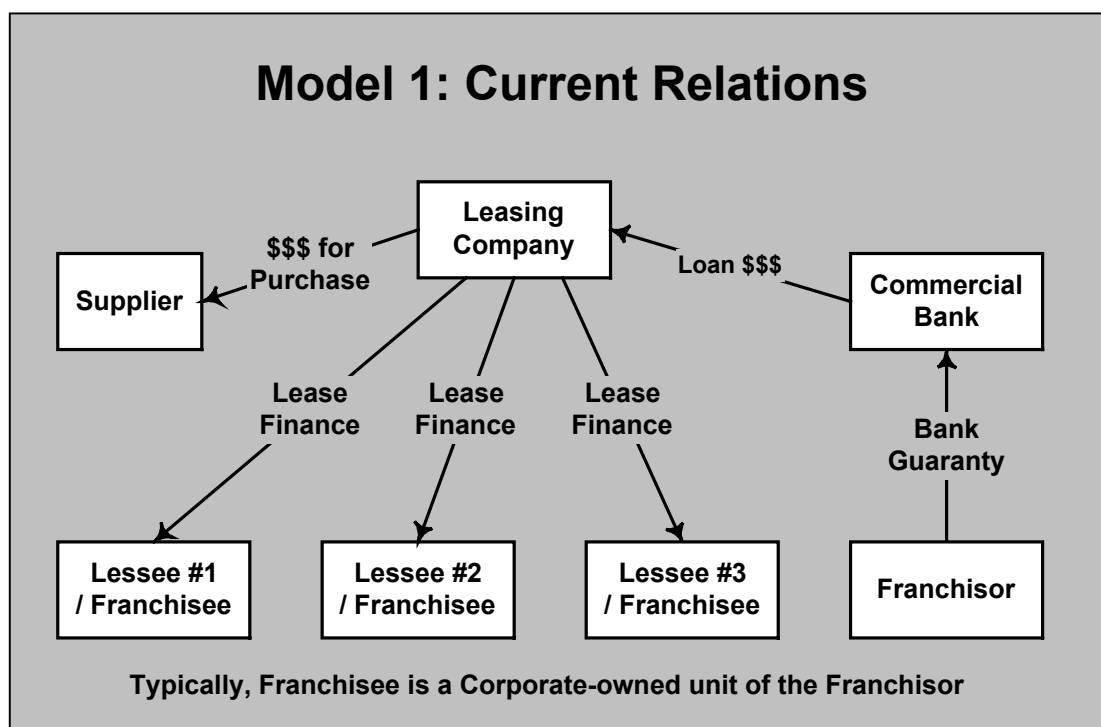
Kazak leasing by private-sector, commercially-run companies is today in an embryonic phase of development. One knowledgeable source in Moscow estimated that the total portfolio of active leases in Kazakhstan, as of June 1995, may be approximately \$16 million Dollars. By contrast, business investment in the US annually financed using leasing exceeds \$45-\$50 billion Dollars. Given the significant capital equipment needs of Kazakhstan companies as well as the future needs of franchisors entering Kazakhstan, the opportunities for leasing seem bright.

Among the primary obstacles, however, which are likely to retard the growth of leasing in Kazakhstan are:

- Lack of legislative base
- Economic disincentives due to VAT tax on lease/rental income to Lessor
- Early phase of public acceptance of contract law and its enforcement
- Limited experience of banks in lending to leasing companies
- Weak and relatively untested legal system concerning right to repossession of assets
- Lack of collateral and credit history of small enterprises.
- Unwillingness by business owners to disclosure financial information.
- Constant change in laws and regulations works against long-term, fixed price leases

Leasing for Franchises in the Republic of Kazakhstan

RECOMMENDATIONS TO ESTABLISH LEASING MECHANISMS FOR FRANCHISORS: MODEL & ANALYSIS

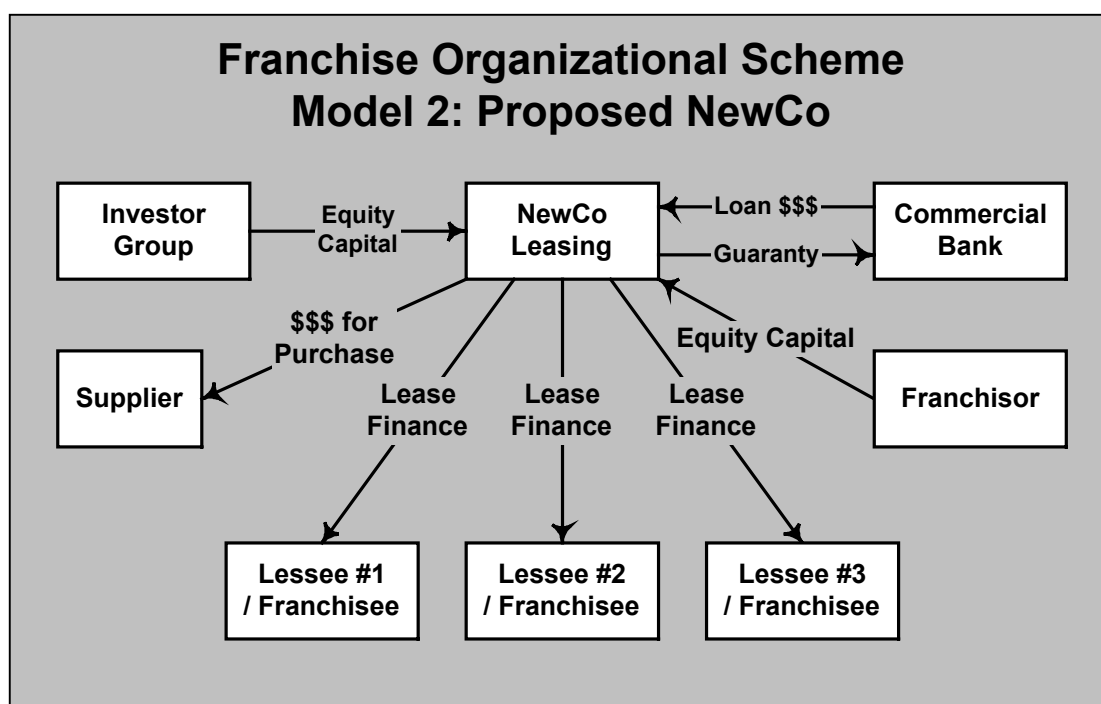


Leasing for Franchises in the Republic of Kazakhstan

Introduction to Franchise Lease Model

Model 1 entitled “Current Relations” describes in a general way the existing relations among the leasing company, commercial bank, foreign supplier, franchisor and Lessee in Kazakhstan. At present, most leases will be backed by a corporate guaranty from the Lessee granted in favor of the Lessor or the bank ultimately funding the transaction.

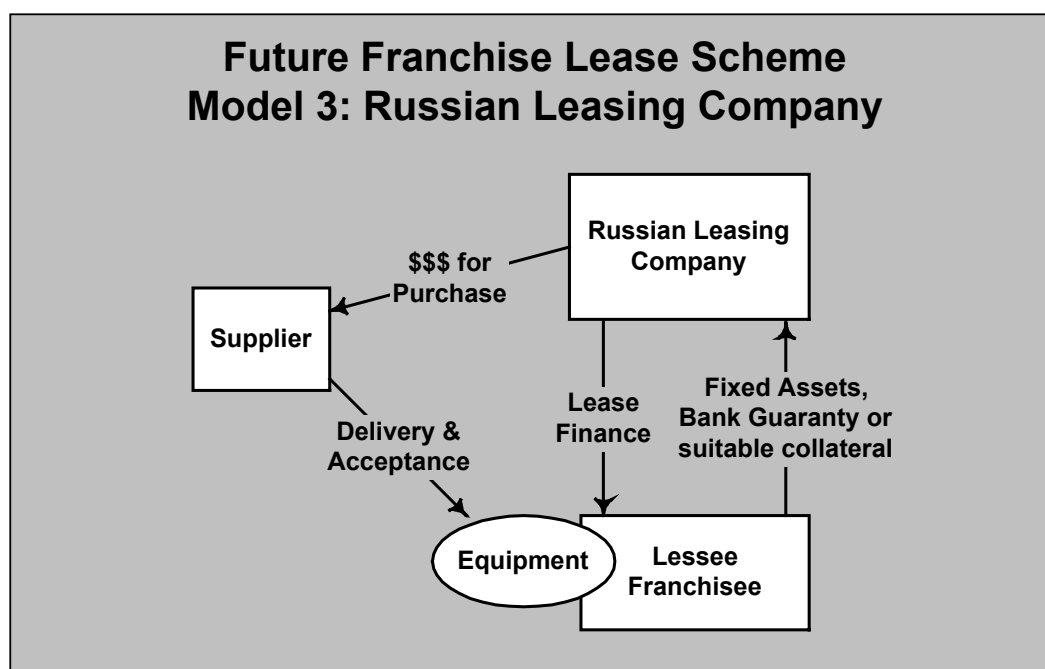
During interviews with two commercial banks in Almaty, they expressed interest in financing leased equipment for a franchisee, but under the condition that the Franchisor provides its guarantee to the bank or under the condition of availability of collateral.



It is unlikely that franchisors will consider lease financing to be a method of expanding their franchise units if the corporation is to provide collateral (or any other guarantee) for that. After the corporation sets up one or two “flag” franchise units, franchisors typically seek to arrange “off-balance sheet” financing for additional units or transfer the risk of equipment financing to the Franchisee. In combination, the banking community’s unfamiliarity with franchise financing and the absence of risk capital for entrepreneurs probably will constitute a major roadblock for expansion of franchising in Kazakhstan unless an innovative funding mechanism can be developed.

Leasing for Franchises in the Republic of Kazakhstan

Proposed Model and Recommendations



The chart entitled “Model 2 : Proposed NewCo” describes an organizational scheme for an entity which could provide lease financing to Franchisees seeking to acquire a franchise business unit. It is proposed that a new company be created with equity capital raised from investors and from one or more Franchisors. As an alternative to an equity infusion, a Franchisor may provide debt capital or subordinated debt. The NewCo Leasing entity would secure a line of credit financing from a commercial bank using the strength of its own balance sheet. The NewCo Leasing would take title to the leased equipment and leverage its own equity by borrowing against the value of the equipment. In this way, the Franchisor realizes “off-balance sheet” financing for the equipment used in its franchise network and gains direct access to funding for its Franchisees which is a multiple of its contributed equity.

This proposed Model could be implemented as a special “Franchise Account” within the operations of an existing Kazak leasing company. To avoid raising fresh equity capital for the Model, a financing program might be devised similar to US Vendor Financing programs whereby the Franchisor(s) would have access to established limits of capital from the Lessor in return for a corporate guaranty, re-marketing agreement and/or right to use the franchise license in an event of default.

Leasing for Franchises in the Republic of Kazakhstan

Potential Sources of Funding to Implement the Proposed Model

Specific discussions were held in October 1996 with some financial institutions concerning the proposed Model for franchise lease financing. Each institution expressed a keen interest in such a Model and a willingness to consider acting as a finding source. Two of these institutions mentioned a readiness to invest equity capital to develop such a funding mechanism if US franchisors became involve which were large multi-national corporations with brand recognition (e.g. McDonalds, Xerox, etc.)

Leasing for Franchises in the Republic of Kazakhstan

OBSTACLES TO BE RESOLVED IN KAZAKSTAN TO PROMOTE FRANCHISE LEASING

Legal Issues:

1. Legality and enforceability of Lease agreement - especially notarization, signatures.
2. Interaction and potential conflicts between three sources of leasing regulations: Law of Pledge, Civil Code Part I & II, and Temporary Regulations on Leasing- which legal sources will rule in which circumstances?
3. Enforcement of ownership rights to equipment, inspections, and re-possession; there is a weak track-record for contract law and for enforcement mechanisms.
4. Legal system has no case precedents rather each case is judged on its merits.
5. Can leasing companies extend credit under Central Banking regulations?
6. In case of bankruptcy by Lessee, the Lessor's claims to recover payments come third after workers' claims for unpaid labor and claims from the State like taxes.
7. In case of default, Lessor is unable to obtain legal injunction to stay actions of Lessee in continuation of use of Lessor's equipment.
8. Flux and rate of change in legal and regulatory environment creates uncertainty not favorable for long term lease contracts.

Key Recommendations:

Clarify the legal status of leasing companies specifically pertaining to extension of credit to private businesses. Resolve ambiguities and conflicts between three principal sources of law and regulation which govern leasing finance arrangements. Pass additional regulations which specifically grant to Lessors (a) the right to enforce its ownership of leased assets by re-possessing equipment under defaulted leases without first resorting to judicial review and (b) the right to legal injunctions to stay actions of Lessee which default but continue to enjoy use of leased assets without payment.

Leasing for Franchises in the Republic of Kazakhstan

Taxation and Accounting Issues:

1. No leasing approvals granted unless Tax Inspectorate certifies tax situation, still this is no real proof of financial condition of Lessee.
2. Periodic re-indexation of valuation of Assets (due to exchange rate variations between Dollar and Tenge) has impact on re-valuation of fixed assets, but leaves untouched value of loans and paid-up capital. Asset variations are captured in an exchange loss/gain account.
3. Depreciation schedules need updating to reflect conventional useful life of fixed assets.
4. Taxation on lease payments is onerous in comparison with other forms of financing because VAT is paid on total lease payments and the Profits Tax already includes a VAT on the purchase/importation of the asset.
5. Leasing companies typically finance assets in multiple locations and often in many geographical areas. Kazak tax laws require maintaining records and paying taxes to the “oblast” or local authority in which the asset is located, which results in a serious administrative burden to Lessors.

Key Recommendations:

Revise depreciation and amortization schedules to reflect conventional term or useful life of equipment and machinery. Eliminate excessive taxation of VAT on lease income to Lessor. Revise and centralize tax filing regulations whereby a Lessor owning equipment in several “oblasts” need not make a separate tax filing with related documentation in every “oblast.”

Leasing for Franchises in the Republic of Kazakhstan

Role of Contract Law and Legal Rights

1. While the Federal Government of Kazakhstan (the “State”) has been involved in leasing finance during the USSR period, privately-owned and commercially run leasing enterprises are newly established (starting in 1991). Moreover, there is no franchising industry yet developed in Kazakhstan. Hence, in the private sector there is no familiarity with use of contract law and dependence upon rule of law and adherence to rights and obligations conferred by contract documents. Recourse to legal remedies to resolve disputes and to enforce contract rights is underdeveloped and relatively untested-- particularly with respect to leasing and franchising. Finally, when one party may successfully assert its contractual right (say to repossess equipment) there is no certainty that the legal system will swiftly enforce a court order or an arbitration award. Physical force either through official police or through private “protection guards” may ultimately be required to assert one’s right to repossess equipment or be repaid upon default.

Key Recommendation:

None.

Leasing for Franchises in the Republic of Kazakhstan

Corruption and Bribes

1. While petty corruption and bribe-taking is omnipresent in most developing countries, the current situation in Kazakhstan seems pervasive and well-established. Privately-owned businesses are subject to intimidation and threats unless they agree to pay for “security” and “local protection.” For the business owner, this amounts to a non-governmental “tax” on his gross profits. Wherever this “corruption tax” is nominal, the actual cost can be passed along to the customer as higher prices for finished goods and services. However, “corruption taxes” and/or extortion for protection may be substantial and may hence adversely impact the viability of the business itself. Moreover, these added costs skew the reliability of financial statements as such payments are not recorded as expenses in the income statement. Finally, specific stories exist in Kazakhstan of entrepreneurs being forced out of their businesses at gun-point due to disputes with their so-called “protection guards.”

Key Recommendations:

It will make sense to create a Kazak Franchise Association with branches in major cities, co-sponsored by a local Chamber of Commerce and the local City Council. By affiliation with the local government, the Kazak Franchise Association may be able to obtain security and some measure of protection against “gangs” and demands for protection “bribes.”

Leasing for Franchises in the Republic of Kazakhstan

Role of Small Business

1. For decades under the socialist command economy, most businesses were created and operated as large enterprises. The State and the Communist Party were clearly the largest employers of workers. The Kazak Government is currently encouraging privatization, formation, and development of small business development. There is the Congress of Entrepreneurs of Kazakhstan operating in the country.

In spite of the importance of small businesses, their official legal status (the taxation system and registration) as well as specific business environment is not yet ready for nurturing small businesses. For the foreseeable future, small business financing, like franchise financing, will likely to be done by quasi-governmental entities which have a twin-goal of for-profit operations matched with social objectives. The existing banking system is very conservative in lending practices and will not likely provide funds to franchisees who have little or no collateral and personal assets but seek to own their own business.

Key Recommendations:

None.

Leasing for Franchises in the Republic of Kazakhstan

Lack of Capital and Collateral Owned by Small Businessmen

1. Most small businessmen do not possess adequate capital to contribute as equity for ownership interest in a small business or franchise in addition to the additional capital or collateral assets which a lending institution will require as a precondition for a loan. The collateral which is generally acceptable to lending institutions (and most leasing companies) are: real estate like residence, apartment or dachas, autos, cash collateral, business equipment. Many first-time businessmen will not likely possess any of these acceptable forms of collateral. Equity risk capital is currently available in Kazakhstan for only foreign entrepreneurs and that mostly from donor agencies or multilateral financing institutions- like OPIC, IFC, EBRD etc. Thus, the combination of needed equity capital and 100% collateral for the loan funds is out of reach for most would-be Kazak small businessmen. Leasing, whereby the acquired equipment is utilized as collateral for the lease finance, can be partly a solution for this dilemma.

Key Recommendation:

Training should be given to leasing company and bank staff who are making credit decisions in order to enhance their understanding of the mechanics of leasing finance. Once legal issues are clarified relating to Lessor's right to re-possess leased assets, then credit analysts can accept higher risks associated with small businesses and entrepreneurs. Further, the suggested Franchise Lease Model (in Section II), if implemented, can help overcome the lack of collateral owned by small businessmen.

Leasing for Franchises in the Republic of Kazakhstan

Need to Disclosure Financial Information

1. Any business or person applying for a loan or a lease in Kazakhstan is requested to submit the following project and financial information:
 - Business Plan With Financial Projections
 - Financial Statements Latest Year End
 - Bank Statements Of Past Two Months
 - Certification By Tax Inspectorate That Relevant Taxes Are Paid
 - Charter Of Incorporation Or Association
 - Founders Agreement
 - Description Of Collateral Assets (And Appraisal If Required)
 - Formal Request For Amount Of Financing
 - References
 - Personal Financial Statement Of Key Principal(S)

Given the standards of secrecy concerning financial matters historically prevalent in Kazakhstan, it will likely take time for businessmen to become comfortable with full disclosure of personal and financial information to financial and credit institutions. Moreover, one never knows for certain whether such sensitive information may be circulated or passed to governmental offices (like tax authorities) or to “protection groups” to be used for future audits or extortion threats. Even legitimate businessmen may be reluctant to “bare all” personal and financial information for fear that someone may misuse this information.

Key Recommendation:

Sensitive personal information and business financial data must be safeguarded by the banks, leasing companies and financial institutions that receive it. The concept of “business confidential” information should evolve in Kazakhstan in order to provide Lessees and other applicants for credit with assurance that such sensitive information will not be circulated outside the credit department nor to any governmental authority.

Leasing for Franchises in the Republic of Kazakhstan

Rate of Change in the Private Sector Business Environment

1. Kazakhstan is a vast, diverse geographical territory consisting of 20 administrative regions (with the population of over 16,5 million people) which is undergoing rapid social, political and economic change. The transformation of the former USSR command economy into a “free-market”, privately-managed economy is an enormous task which has precipitated multiple crisis of political and economic import. It is highly probable that the rate of evolutionary change will continue for 5-10 years whereby stability in business will be impossible and short-term survival of businesses will crowd out any serious medium or long-term planning. Among the factors contributing to the current rapid rate of change:
 - Monthly inflation rate requiring re-indexation of assets and financial transactions.
 - Disclosure of workers and producers due to GDP shrinkage.
 - Constant welter of new laws, regulations and edicts from Government authorities and local municipal governments relating to taxes, wages, environment, trading, etc.
 - Fluctuations on exchange rates between Tenge and hard currencies, such as Dollar.

When the business environment is in such flux and changing constantly on a number of different levels, then it is understandable why commercial banks refuse to lend funds beyond 180 days. Hence, leasing companies generally will not extend their terms beyond 12-24 months (although longer periods up to 36 months are possible) and will continue to insist that leasing margins be adjusted in tandem with any changes in the Central Bank interest rate.

Key Recommendation:

None.

Leasing for Franchises in the Republic of Kazakhstan

APPENDIXES

List of Kazak Leasing Companies as of October 1996

Agro-Leasing	Almaty
Asia-Leasing	Almaty
Kupava Limited Partnership	Almaty
FMS Central Asia Travel	Almaty
Check Point	Almaty
Scott Holland Estates	Almaty

Additional contacts for leasing, lease financing, and financing can be found in the General Contact List provided as an appendix in the first section of this manual.

Leasing for Franchises in the Republic of Kazakhstan

SAMPLE LEASING AGREEMENT 1

Domestic Equipment

Almaty “___” _____ 199__

“_____”, a closed joint-stock company, hereinafter referred to as LESSOR, in the person of its General Director, acting with the authority of the Charter, on the one hand, and _____ hereinafter referred to as LESSEE, in the person of _____ acting with the authority of the Charter, on the other hand, according to LESSEE’s inquiry of “___” _____ 199_ have made the present

Agreement as follows:

1. SUBJECT OF AGREEMENT

1.1. LESSOR acquires from _____ hereinafter referred to as SELLER, _____ (hereinafter referred to as EQUIPMENT) in range, price and quantity as per Purchase-Sale Contract No. ___ of “___” _____ 199_ concluded between LESSOR, SELLER AND LESSEE (hereinafter referred to as CONTRACT).

1.2. LESSOR offers for leasing EQUIPMENT specified by 1.1 of the present Agreement to LESSEE on the conditions specified by the present Agreement.

1.3. The sum of leasing fees as per present Agreement amounts to _____ (_____) Tenge.

2. ACQUISITION, ASSIGNMENT FOR LEASING AND USE OF EQUIPMENT

2.1. LESSOR assigns and LESSEE accepts all the rights and liabilities as per present Agreement, related to acceptance and claims with respect to quality, completing units and guarantee maintenance of EQUIPMENT. LESSEE exempts LESSOR from all the relevant losses and suits.

2.2. Delivery of EQUIPMENT by SELLER and its acceptance by LESSEE shall be effected in conformity with the conditions of clause 3 of CONTRACT.

2.3. LESSOR shall not be held responsible to LESSEE (as the latter has selected EQUIPMENT and SELLER by himself) either for delay in delivery or non-delivery of EQUIPMENT by SELLER, or for defects, particular characteristics or fitness of EQUIPMENT, or the damage resulting from its operation. In case LESSEE suffers damage resulting from the untimely delivery or non-delivery, as well as from the defects, low quality

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or non-completeness of EQUIPMENT, LESSOR assigns to him all the rights relating to compensation for damages by SELLER, while LESSOR does not provide any guarantees with respect to reimbursing the sum of compensation.

2.4. LESSOR shall not be held responsible for the losses, damages or detriments suffered as a result of any defects of EQUIPMENT, both latent or revealed during inspection. Besides, LESSOR shall not be obliged to compensate LESSEE for the expenses relating to claims made to the latter in connection with such defects.

2.5. Payment for EQUIPMENT delivered to LESSEE's address shall be effected by LESSOR as per clause 4 of CONTRACT.

2.6. LESSOR offers EQUIPMENT obtained from SELLER for leasing to LESSEE in the condition specified by the acceptance certificate at the time of acceptance of EQUIPMENT.

LESSEE is entitled to start using EQUIPMENT in accordance with the conditions of the present Agreement from the time of LESSOR'S obtaining the acceptance certificate.

2.7. In case of non-delivery or untimely delivery of EQUIPMENT by SELLER to LESSEE, or in case of non-fulfillment by the latter of his obligations specified in clause 4.5 of CONTRACT, LESSEE is not exempted from his obligations under the present Agreement.

2.8. While the present Agreement is valid, EQUIPMENT is located at the address: Almaty, _____ according to Agreement No. _____ of "____"
_____ 199__ between _____.

3. WARRANTY

3.1. As a security for all the LESSEE'S claims with respect to LESSOR resulting from the present Agreement in case the latter does not properly fulfill his obligations hereunder, LESSOR provides LESSEE with the following warranty whose availability is a legally binding condition of the present Agreement: - Pledge Agreement No. ____ of _____ 199__ valid throughout the term of validity of the present Agreement.

Leasing for Franchises in the Republic of Kazakhstan

4. INSURANCE

4.1 LESSEE undertakes to effect at his own expense insurance of EQUIPMENT acquired by LESSOR in the latter's favor for the term of validity of the present Agreement and submit to LESSOR the insurance policy within 14 days after signing the inspection report relating to EQUIPMENT. Otherwise LESSEE shall pay to LESSOR a penalty at the rate of 5% of the sum specified in clause 1.3 of the present Agreement. LESSEE is not exempted from fulfilling all his obligations hereunder. EQUIPMENT shall be insured for not less than _____. Insurance shall be effected by the company "_____" or by other insurance company agreed earlier. The terms and conditions of insurance are also agreed by the parties in advance.

4.2. Upon occurrence of the insured accident confirmed by the proper documents, and receipt by LESSOR of the insurance indemnity as per insurance contract, deduction from the leasing fees is liable to agreement signing an additional contract by the parties.

5. TERM OF LEASING

5.1. LESSOR provides LESSEE with EQUIPMENT for leasing for the term of ____ (_____) months, calculated from the time of payment for EQUIPMENT according to the conditions of CONTRACT.

6. MAINTENANCE AND USE OF EQUIPMENT

6.1. LESSEE shall operate EQUIPMENT as a conscientious user. He is obliged to obtain and maintain at his own expense all the needed licenses, permissions for use, register them on a regular basis, observe all the manufacturer's rules, recommendations and instructions for operation, servicing and maintenance of EQUIPMENT, operate EQUIPMENT at his expense in conformity with its purpose and see to its technical fitness. He is also obliged to replace all the missing or damaged parts with new ones delivered or recommended by the manufacturer of EQUIPMENT. In case LESSEE does not observe this, he is obliged to pay to LESSOR a penalty at the rate of 10% of the sum specified in 1.3 of the present Agreement, which does not exempt LESSEE from fulfilling his obligations hereunder.

Leasing for Franchises in the Republic of Kazakhstan

7. IMPROVEMENTS AND ALTERATIONS OF EQUIPMENT

7.1. Alterations of EQUIPMENT are allowed only with LESSOR's written consent. If LESSEE makes some additions, improvements or alterations of EQUIPMENT without LESSOR's consent, the latter has the right to demand immediate removal of the above alterations and return of EQUIPMENT into its original condition, which, in its turn, does not exempt LESSEE from the liabilities hereunder. In case EQUIPMENT is altered without LESSEE's written consent, LESSOR shall be held financially responsible and shall pay a penalty at the rate of 5% of the value of the present Agreement, which does not exempt the latter from fulfilling his liabilities hereunder.

7.2. Any alterations, additions and improvements of EQUIPMENT made with LESSOR's consent shall make an integral part of EQUIPMENT.

8. PROPERTY RIGHT

8.1. From the time of payment (fulfillment of clause ___ of CONTRACT) EQUIPMENT is owned by LESSOR.

8.2. LESSEE undertakes not to make any action infringing LESSOR's property right.

8.3. LESSEE undertakes to do all possible to prevent infringement of LESSOR's property right for EQUIPMENT, in particular by third persons. In case LESSOR's property right for EQUIPMENT is doubted, violated or subjected to risk within the term of validity of the present Agreement, LESSEE is obliged to make all the necessary steps to eliminate such doubts, violations and risks.

8.4. Property right for EQUIPMENT returns to LESSEE on expiration of the Agreement or ahead of time.

9. PRE-SCHEDULE REPURCHASE OF EQUIPMENT

9.1. Pre-schedule repurchase of EQUIPMENT by LESSEE is only possible upon fulfillment by him of all his liabilities hereunder and with LESSOR's written consent. Pre-schedule repurchase of EQUIPMENT shall be documented by an additional agreement hereto. In pre-schedule repurchase of EQUIPMENT LESSEE shall have to transfer to LESSOR's account:

- the remaining cost of EQUIPMENT at the time of pre-schedule repurchase;
- the due (regular) leasing fee;

LESSEE is obliged to notify LESSOR in writing 30 days before the actual repurchase of EQUIPMENT.

Leasing for Franchises in the Republic of Kazakhstan

10. ASSIGNMENT OF RIGHTS BY LESSEE, SUB-LEASING

10.1. LESSEE has no right without LESSOR's written consent to sell, assign, offer for sub-leasing, mortgage, use as a security for the debt or in any other way be in command of property right for EQUIPMENT. In case LESSEE does not observe the condition of this clause, he shall be held financially responsible and shall pay a penalty at the rate of 10% of the value of the deal as per 1.3. Neither shall LESSEE be exempted from fulfilling his obligations hereunder.

10.2. LESSEE has no right without LESSOR's written consent to sell, mortgage, offer for leasing, use land or premises where EQUIPMENT is located as a security for the debt, or conclude a contract for one of the above actions without LESSOR's prior consent (at least six weeks before). In any case LESSEE shall guarantee that any of the above actions — sale, mortgaging, use as a security for the debt, offer for leasing, assignment or any other change in the status of the above said land or premises - provide for LESSOR's right to take back EQUIPMENT at any time, irrespective of whether EQUIPMENT or part of it is located on the indicated land or premises. For that purpose LESSOR must have a free access to the land or premises, as well as have the right to separate EQUIPMENT from the said land or premises.

10.3. In case LESSEE does not observe the condition specified by 10.2, he shall be held financially responsible and shall pay a penalty at the rate of 10% of the value of the Agreement as per clause 10.3. Neither is he exempted from fulfillment of his liabilities hereunder.

11. ASSIGNMENT OF RIGHTS BY LESSOR

11.1 LESSOR is entitled to assign or mortgage, fully or partly, his rights and liabilities hereunder without LESSEE's consent.

12. ACCOUNTABILITY

12.1. LESSOR controls LESSEE's proper fulfillment of the assumed liabilities hereunder. The right to control is realized by regular (not less often than once a quarter) checks of the state of EQUIPMENT and conditions of its operation. The checks effected by LESSOR are documented by bilateral reports of inspection of EQUIPMENT. In addition to the said checks of the state and conditions of EQUIPMENT operation, LESSOR has the right to demand at any time detailed information of LESSEE's financial status.

12.2. In case of any change in the legal address, the actual location, payment requisites and organizational format of the LESSEE, as well as change in the EQUIPMENT operation conditions, the latter is obliged within 5 days from the time of the change to inform LESSOR about it. If LESSEE does not observe this condition, he shall be held financially responsible to LESSOR and pay a penalty at the rate of 5% of the Agreement value, as per clause 1.3 (neither is he exempted from fulfilling his obligations hereunder).

Leasing for Franchises in the Republic of Kazakhstan

13. LEASING PAYMENTS AND SETTLEMENT PROCEDURE

13.1. LESSEE remits to LESSOR a leasing payment in the amount specified in clause 1.3 hereof. The procedure and terms of leasing payments are specified in Supplement No.1 hereto making an integral part of it.

13.2. Settlement of leasing of EQUIPMENT is effected by the parties hereto by means of remittance orders. In case of non-observance by LESSEE the dates of settlement hereunder (Supplement 1), LESSOR transfers to LESSEE's clearing account a payment request - an order for non-acceptance withdrawal of the money due to LESSOR. Payment is considered to be made on the day of leasing payment entering in LESSOR's account.

Within 10 days from the date of signing the present Agreement LESSEE shall make the following amendments to the agreement with his bank for settlement-cash service and submits the original amendments to LESSOR.

In case LESSEE does not meet this requirement, he shall be held financially responsible and shall pay a penalty at the rate of 10% of the value of the present Agreement as per clause 1.3. LESSEE shall not be exempted from fulfilling his liabilities hereunder.

13.3. Violation by SELLER of his obligations under CONTRACT after payment by LESSOR of the cost of EQUIPMENT does not exempt LESSEE from making the leasing payment provided for by the present Agreement.

13.4. The above said leasing payments are reviewed when there are changes in:

- the bank rate for credit which is LESSOR's financial source for leasing; the cost of EQUIPMENT with consideration of revaluation made in accordance with Republic of Kazakhstan Government Resolution.
- state charges and duties collected in connection with leasing agreement.

The reviewed leasing payments shall be agreed by LESSOR and LESSEE and documented with an additional agreement hereto. If agreement on the given clause is not achieved, the conditions of clause 14 hereof become operative.

13.5. LESSEE has no right to demand that LESSOR compensate for any losses or reduce leasing payments as a result of an interval in the use and operation of EQUIPMENT for any reason including force-major.

In case of partial or full loss of EQUIPMENT, LESSEE shall notify LESSOR about it. At the same time LESSEE has no right to deviate in his payments from the amount specified by the present Agreement, even if the damage or partial loss are caused by force-major circumstances.

Leasing for Franchises in the Republic of Kazakhstan

13.6. All the expenses, costs, inputs relating to the present Agreement, as well as drawing up all the documentation resulting from or connected with the present Agreement, and registration expenses and taxes collected in connection with Leasing Agreement in LESSEE's country are referred to his account. In any case LESSOR must receive the specified leasing payments in full amount.

14. DELAY IN LEASING PAYMENTS

14.1. LESSEE shall be obliged to pay a fine for a delay in leasing payments, from the date beyond the deadline, for each day of the delay as follows:

- for less than 10 days of delay - at the rate of ___% of the delayed amount;
- for 10-20 days of delay - at the rate of ___% of the delayed amount;
- over 20 days of delay - at the rate of ___% of the delayed amount.

14.2. In case LESSEE delays the current leasing payment for more than 10 days (from the date beyond the deadline for payment), LESSOR has the right to apply the following sanctions at his option:

- demand that the remaining amount under the Agreement due at the date of its termination;
- make use of the guarantees given to LESSOR as per clause 3 hereof;
- withdraw EQUIPMENT being used by LESSEE.

In the latter case LESSOR shall notify LESSEE in writing that EQUIPMENT will be withdrawn. The notification shall indicate the date, time and place of transfer of the EQUIPMENT withdrawn. LESSEE shall put EQUIPMENT in the condition specified by the inspection report (minus normal wear and tear) within 5 days from the time of receiving LESSOR's notification.

In case the condition of EQUIPMENT does not correspond with that indicated in the inspection report, LESSEE shall pay to LESSOR the amount needed to bring EQUIPMENT into the original condition. The document to confirm the withdrawal of EQUIPMENT shall be the inspection report. EQUIPMENT may be returned to LESSEE on the conditions specified herein within 30 days after the withdrawal, if LESSEE will pay the total sum he owes LESSOR (leasing payments plus penal sanctions). Otherwise EQUIPMENT shall be sold to cover LESSEE's debt to LESSOR. If the money obtained as a result of sale of EQUIPMENT is not sufficient, LESSOR has the right to choose some other property possessed by LESSEE to settle the deal.

No matter which sanction is applied, LESSEE shall pay to LESSOR a penalty at the rate of 20% of the remaining cost of EQUIPMENT.

14.3. In case of delayed current leasing payment by LESSEE, LESSOR shall use all the money received from LESSEE later to urgently settle the delayed leasing payment and the fine calculated for each day of the delay.

Leasing for Franchises in the Republic of Kazakhstan

14.4. LESSOR's losses resulting from the pre-schedule cancellation of the Agreement shall be immediately and fully remunerated.

15. DISPUTE RESOLUTION PROCEDURE

15.1. All the disputes between the parties related to the present Agreement shall be resolved in the adopted procedure for handling claims. If agreement cannot be achieved, they shall be referred to Almaty Arbitration for consideration.

16. CONCLUSION AND TERMINATION OF AGREEMENT

16.1. The present Agreement comes into force subject to simultaneous fulfillment of the following conditions:

- it shall be signed by both parties;
- LESSOR shall be granted a credit by "PROMSTROYBANK INC." to pay for EQUIPMENT as per CONTRACT (clause ____);
- LESSEE shall submit warranty as per clause 3 hereof.

16.2. The Agreement shall not be terminated unilaterally before its expiration for any reasons except directly specified herein.

17. OTHER CONDITIONS

17.1. The parties have not concluded any additional oral agreements. Any amendment to the present Agreement shall be made only in written form.

17.2. The Agreement is signed in two copies, one for each party, both copies having the same legal validity.

17.3. In case LESSEE's legal address or payment requisites change, the latter shall notify LESSOR within 5 days from the time of the change. If LESSEE does not fulfill this stipulation, he shall be held financially responsible and shall pay a penalty at the rate of 10% of the value of the Agreement as per clause 1.3 (nor is he exempted from fulfilling his obligations hereunder).

Leasing for Franchises in the Republic of Kazakhstan

18. LEGAL ADDRESSES AND PAYMENT REQUISITES OF THE PARTIES

18.1 LESSEE: _____

Account No. _____ MFO _____ Bank
Correspondent Account _____ MFO _____

18.2. LESSOR:

15, Sq. of the Republic
480013, Almaty
Account No.37400467555 in OPERU-4
MFO

LESSEE
General Director

LESSOR
General Director

(Seal)

(Seal)

“ _____ ” _____ 199 _____

“ _____ ” _____ 199 _____

Leasing for Franchises in the Republic of Kazakhstan

SAMPLE LEASING AGREEMENT 2

Foreign Equipment

Almaty “ ” _____ 199__

“ _____”, a closed joint-stock company, hereinafter referred to as LESSOR in the person of its General Director, acting with the authority of the Charter, on the one hand, and _____ hereinafter referred to as LESSEE, in the person of _____ acting with the authority of the Charter, on the other hand, according to LESSEE's inquiry of “ ” _____ 199__ have made the present

Agreement as follows:

1. SUBJECT OF AGREEMENT

1.1. LESSOR acquires from the company _____ hereinafter referred to as SELLER, _____, in conformity with Contract No. _____ of “ ” _____ 199__ (hereinafter referred to as CONTRACT) _____ as per specification (Supplement 2 hereto), hereinafter referred to as EQUIPMENT.

1.2. LESSOR offers for leasing EQUIPMENT specified by 1.1 of the present Agreement to LESSEE on the conditions specified by the present Agreement.

1.3. The sum of leasing fees as per present Agreement is calculated in Kazak Tenge and amounts to _____ (_____).

2. ACQUISITION, ASSIGNMENT FOR LEASING AND USE OF EQUIPMENT

2.1. LESSEE (as per clause of CONTRACT) shall incur the expenses by paying VAT, special EQUIPMENT TAX, customs duties and tariffs in conformity with the operating laws of the Republic of Kazakhstan.

2.2. At customs house LESSOR may pay the duties and charges in lieu of LESSEE at the latter's official request. The above said expenses incurred by LESSOR shall be reimbursed by LESSEE in the amounts and on the terms specified by a separate agreement.

Leasing for Franchises in the Republic of Kazakhstan

The separate Agreement shall be agreed on and signed by the parties with due consideration of the actually paid sums. It makes an integral part of the present Agreement.

2.3. Within 10 days from the date of delivery of EQUIPMENT as per CONTRACT, LESSEE shall present to LESSOR the original customs declaration for the delivered EQUIPMENT with a note "customs duties and charges paid" and a customs stamp "EXPORT PERMITTED", as well as a consignment note for transfer of EQUIPMENT from LESSOR, addressed to LESSEE.

In case the above mentioned documents are not presented in the time frame indicated above, LESSEE shall pay a penalty for each day of the delay in presenting the documents at the rate of 0.5% of the sum of the Agreement (clause 1.3 of the present Agreement) but not totaling more than 10%, after which the sanctions specified in section 14.2 become operative.

2.4. In case of non-delivery or untimely delivery of EQUIPMENT by SELLER to LESSEE, or in case of the latter's non-fulfillment of his obligations as per clauses (delivery, acceptance) of CONTRACT or clause 2.1 hereof, LESSEE is not exempted from his liabilities.

2.5. LESSOR assigns and LESSEE accepts all the rights and liabilities under the present Agreement relating to inspection, claims with respect to quality, completeness and warranty maintenance of EQUIPMENT. LESSEE shall exempt LESSOR from all the damages and suits connected with it.

2.6. Delivery of EQUIPMENT by SELLER and its acceptance by LESSEE shall be effected in conformity with the terms and conditions of CONTRACT.

2.7. On the strength of the terms and conditions of CONTRACT signed by the representatives of SELLER and LESSEE, LESSOR shall not be held responsible to LESSEE, who himself selected EQUIPMENT and SELLER, either for delay in delivery or non-delivery of EQUIPMENT by SELLER, or for the defects or unfitness of EQUIPMENT, or for the damage resulting from its transportation or operation. In case LESSEE suffers damages as a result of untimely delivery or non-delivery of EQUIPMENT, as well as of the defects, low quality or non-completeness of EQUIPMENT, LESSOR shall assign to him all the rights with respect to compensation for the damages by SELLER.

2.8. Hereby canceled are all other obligations of LESSOR with respect to any conditions and warranties relating to the condition of EQUIPMENT, irrespective of the manner these obligations are expressed: directly or indirectly, or of their origin: whether they arise from the present Agreement or any other previous agreement, written and oral declarations made by any person or on his behalf in the course of negotiations that LESSEE and his representatives participated in before concluding the present Leasing Agreement.

2.9. Payment for EQUIPMENT delivered to LESSEE's address shall be effected by LESSOR in accordance with the terms and conditions of CONTRACT.

Leasing for Franchises in the Republic of Kazakhstan

2.10. LESSOR offers for leasing EQUIPMENT acquired from SELLER to LESSEE in the condition specified by the acceptance certificate at the time of acceptance of EQUIPMENT. LESSEE may use EQUIPMENT in accordance with the conditions of the present Agreement from the time of obtaining the acceptance certificate.

2.11. In all cases LESSEE shall assume property risk and risk of accidental loss, disappearance, partial or full (resulting from damage) loss or the resultant unfitness of EQUIPMENT for operation from the date of issue of the acceptance certificate.

2.12. While the present Agreement is valid, EQUIPMENT is located at the address: Almaty, _____ according to Agreement No. _____ of "_____" _____ 199____ between _____.

3. WARRANTY

3.1. As a security for all the LESSOR'S claims with respect to LESSEE in case the latter does not properly fulfill his obligations hereunder, LESSEE provides LESSOR with the following warranty whose availability is a legally binding condition of the present Agreement:
- Pledge Agreement No. ____ of _____ 1994 valid throughout the term of validity of the present Agreement.

4. INSURANCE

4.1 LESSEE undertakes to effect at his own expense insurance of EQUIPMENT acquired by LESSOR in the latter's favor for the term of validity of the present Agreement and submit to LESSOR the insurance policy within 14 days after signing the inspection report relating to EQUIPMENT. Otherwise LESSEE shall pay to LESSOR a penalty at the rate of 5% of the sum specified in clause 1.3 of the present Agreement. Besides, LESSEE is not exempted from fulfilling all his obligations hereunder. EQUIPMENT shall be insured for a sum equivalent to not less than (_____). Insurance shall be effected by the "_____" company or another insurance company agreed on earlier. The terms and conditions of insurance shall also be agreed by the parties additionally.

4.2. Upon occurrence of the insured accident confirmed by the proper documents, and receipt by LESSOR of the insurance indemnity as per insurance contract, LESSOR is entitled to reducing the mandatory leasing fees by the amount of the insurance indemnity received. Reduction of the leasing payments in this case is liable to agreement and signing an additional contract by the parties.

5. TERM OF LEASING

5.1. LESSOR provides LESSEE with EQUIPMENT for leasing for the term of ____ (_____) months, calculated from the time of payment for EQUIPMENT according to the terms of CONTRACT.

Leasing for Franchises in the Republic of Kazakhstan

6. MAINTENANCE AND USE OF EQUIPMENT

6.1. LESSEE shall operate EQUIPMENT as a conscientious user. He is obliged to obtain and maintain at his own expense all the needed licenses, permissions for use, duly register them, observe all the manufacturer's rules, recommendations and instructions for operation, servicing and maintenance of EQUIPMENT, operate EQUIPMENT at his expense in conformity with its purpose and see to its technical fitness. In case LESSEE does not observe this, he is obliged to pay to LESSOR a penalty at the rate of 10% of the sum specified in 1.3 of the present Agreement, which does not exempt LESSEE from fulfilling his obligations hereunder.

7. IMPROVEMENTS AND ALTERATIONS OF EQUIPMENT

7.1. Alterations of EQUIPMENT are allowed only with LESSOR's written consent. If LESSEE makes some additions, improvements or alterations of EQUIPMENT without LESSOR's consent, the latter has the right to demand immediate elimination of the above alterations and return of EQUIPMENT into its original condition, which, in its turn, does not exempt LESSEE from the liabilities hereunder. In case EQUIPMENT is altered without LESSOR's written consent, LESSEE shall be held financially responsible and shall pay a penalty at the rate of 5% of the sum of the present Agreement, which does not exempt the latter from fulfilling his liabilities hereunder.

7.2. Any alterations, additions and improvements of EQUIPMENT made with LESSOR's consent shall make an integral part of EQUIPMENT.

8. PROPERTY RIGHT

8.1. From the time of payment for EQUIPMENT (fulfillment of clause 5.2 of CONTRACT), it is owned by LESSOR.

8.2. LESSEE undertakes not to make any actions infringing LESSOR's property right for EQUIPMENT.

8.3. LESSEE undertakes to do his best to prevent infringement of LESSOR's property right for EQUIPMENT, in particular, by third persons. In case LESSOR's property right for EQUIPMENT is doubted, violated or subjected to risk within the term of validity of the present Agreement, LESSEE is obliged to make all the necessary steps to eliminate such doubts, violations and risks.

8.4. Property right for EQUIPMENT passes to LESSEE on expiration of the term of the Agreement or ahead of time subject to LESSEE's full repurchase of EQUIPMENT.

Leasing for Franchises in the Republic of Kazakhstan

9. PRE-SCHEDULE REPURCHASE OF EQUIPMENT

9.1. Pre-schedule repurchase of EQUIPMENT by LESSEE is only possible upon fulfillment by him of all his liabilities hereunder and with LESSOR's written consent.

LESSEE is obliged to notify LESSOR in writing 30 days before the actual repurchase of EQUIPMENT. Pre-schedule repurchase of EQUIPMENT shall be documented by an additional agreement hereto. In pre-schedule repurchase of EQUIPMENT LESSEE shall have to transfer to LESSOR's account: - the remaining cost of EQUIPMENT at the time of pre-schedule repurchase;

In case of LESSEE's violating this clause, the latter shall be held financially responsible and pay a penalty at the rate of 15% of the sum of the present Agreement (1.3).

10. ASSIGNMENT OF RIGHTS BY LESSOR, SUB-LEASING

10.1. LESSEE has no right without LESSOR's written consent to sell, assign, offer for sub-leasing, mortgage, use as a security for the debt or in any other way be in command of property right for EQUIPMENT.

10.2. LESSEE has no right without LESSOR's written consent to sell, mortgage, offer for leasing, use as a security for debt for the land or premises where EQUIPMENT is located, or conclude a contract to effect one of the above actions, without LESSOR's prior consent (at least six weeks before). In any case LESSEE shall guarantee that any of the above actions — sale, mortgaging, use as a security for debt, offer for leasing, assignment or any other change in the status of the above said land or premises - provides for LESSOR's right to take back EQUIPMENT at any time, irrespective of whether EQUIPMENT or part of it is located on the indicated land or premises. For that purpose LESSOR must have a free access to the land or premises, as well as have the right to separate EQUIPMENT from the said land or premises.

10.3. In case LESSEE does not observe the conditions specified by 10.1,10.2, he shall be held financially responsible and shall pay a penalty at the rate of 10% of the sum of the present Agreement as per clause 10.3. He is not exempted from fulfillment of his liabilities hereunder.

11. ASSIGNMENT OF RIGHTS BY LESSOR

11.1 LESSOR is entitled to assign or mortgage, fully or partly, his rights and liabilities hereunder without LESSEE's consent.

Leasing for Franchises in the Republic of Kazakhstan

12. ACCOUNTABILITY

12.1. LESSOR controls LESSEE's proper fulfillment of the assumed liabilities hereunder. The right to control is realized by means of regular (not less often than once a quarter) checks of the state of EQUIPMENT and conditions of its operation. The checks effected by LESSOR are documented by bilateral reports of inspection of EQUIPMENT. At the request of LESSOR, LESSEE shall immediately present to the latter information about his financial status, as well as ensure LESSOR's free access at any reasonable time to the premises or territory where EQUIPMENT is located, kept or operated.

13. LEASING PAYMENTS AND SETTLEMENT PROCEDURE

13.1. All the payments hereunder shall be effected by the parties in Kazak Tenge.

13.2. LESSEE shall remit to LESSOR a leasing payment in the amount specified by clause 1.3 hereof. The amounts and terms of making leasing payments are specified in Supplement No.1 hereto, which is an integral part of the present Agreement. The amounts of leasing payments shall be calculated in Tenge at the rate used in the sale of non-cash currency by the servicing bank on the date of conversion.

LESSOR shall convert the received Tenge into _____ within 2 bank operation days (from the moment this money is placed on his account) to repay the currency credit to the servicing bank in Almaty. The losses incurred by the parties due to the exchange rate difference, shall be compensated for by the parties within 5 bank operation days from the date of conversion.

13.3. Settlement of leasing of EQUIPMENT shall be effected by the parties hereto by means of bank transfer orders. In case of non-observance by LESSEE the dates of settlement hereunder (Supplement 1, other additional agreements hereto), LESSOR transfers to LESSEE's clearing account a payment request - an order for non-acceptance withdrawal of the money due to LESSOR. Payment is considered to be made on the day of the leasing payment entering LESSOR's account (including the penalty and penal sanctions specified by the present Agreement).

Within 10 days from the date of signing the present Agreement, LESSEE shall make the following amendments to the agreement with his bank for settlement-cash service entitling LESSOR to non-acceptance withdrawal of the money from LESSEE's account and submit the original amendments to LESSOR.

In case LESSEE does not meet this requirement, he shall be held financially responsible and shall pay a penalty at the rate of 10% of the sum of the present Agreement as per clause 1.3. He shall not be exempted from fulfilling his liabilities hereunder. This requirement shall be operative for no more than 20 days, after which LESSOR has the right to effect the sanctions as per clause 14.2. hereof.

Leasing for Franchises in the Republic of Kazakhstan

13.4. Violation by SELLER of his obligations under CONTRACT after payment by LESSOR of the cost of EQUIPMENT does not exempt LESSEE from making the leasing payment provided for by the present Agreement.

13.5. The above said leasing payments are reviewed as there comes a change in:

- the bank rate for credit which is LESSEE's financial source for leasing; the cost of EQUIPMENT with consideration of revaluation made in accordance with the Republic of Kazakhstan Government Resolution;
- state charges and duties collected in connection with leasing agreement, or after introduction of new ones;

The reviewed leasing payments shall be agreed on by LESSOR and LESSEE and documented by an additional agreement hereto. If agreement on the given clause is not achieved, the conditions of clause 14 become operative.

13.6. LESSEE has no right to demand that LESSOR compensate for any losses or reduce leasing payments as a result of an interval in the use and operation of EQUIPMENT for any reason.

In case of partial or full loss of EQUIPMENT, LESSEE shall notify LESSOR about it. Notwithstanding this, LESSEE has no right to deviate in his payments from the amount specified by the present Agreement.

13.7. All the expenses, costs, inputs relating to the present Agreement, as well as drawing up of all documentation resulting from or connected to the present Agreement, plus registration expenses and taxes collected in connection with Leasing Agreement in LESSEE's country are referred to his account. In any case LESSOR shall receive the specified leasing payments in full amount.

14. DELAY IN LEASING PAYMENTS

14.1. LESSEE shall be obliged to pay a fine for a delay in leasing payments, from the date of occurrence of delay, for each day of the delay as follows:

- for less than 10 days - at the rate of 0.5% of the delayed amount;
- for 10-20 days - at the rate of 0.75 % of the delayed amount;
- over 20 days - at the rate of 1.2 % of the delayed amount.

Leasing for Franchises in the Republic of Kazakhstan

14.2. In case LESSEE delays the current leasing payment for more than 10 days (from the date of occurrence of delay), LESSOR has the right to apply the following sanctions at his option:

- demand that the remaining amount under the Agreement due at the date of its termination should be paid immediately;
- make use of the warranties given to LESSOR as per clause 3 hereof;
- withdraw EQUIPMENT being used by LESSEE.

In the latter case LESSOR shall notify LESSEE in writing that EQUIPMENT will be withdrawn. The notification shall indicate the date, time and place of transfer of the EQUIPMENT withdrawn. LESSEE shall put EQUIPMENT in the condition specified by the inspection report (minus normal wear and tear) within 5 days from the time of receiving LESSOR's notification.

In case the condition of EQUIPMENT does not correspond with that indicated in the inspection report, LESSEE shall pay to LESSOR the amount needed to bring EQUIPMENT into the original condition.

The document to confirm the withdrawal of EQUIPMENT shall be the inspection report. EQUIPMENT may be returned to LESSEE on the conditions specified herein. Otherwise EQUIPMENT shall be sold to cover LESSEE's debt to LESSOR. If the money obtained as a result of sale of EQUIPMENT is not sufficient, LESSOR has the right to choose some other property possessed by LESSEE to settle the deal.

No matter which sanction is applied, LESSEE shall pay to LESSOR a penalty at the rate of 20% of the remaining cost of EQUIPMENT.

14.3. In case of LESSEE's delay of current leasing payment, LESSOR shall use all the money to be received from LESSEE later to urgently settle the delayed leasing payment and the fine calculated for each day of the delay.

14.4. LESSOR's losses resulting from the pre-schedule termination of the Agreement shall be immediately and fully remunerated.

15. DISPUTE RESOLUTION PROCEDURE

15.1. All the disputes between the parties related to the present Agreement shall be resolved in the adopted procedure for handling claims. If agreement cannot be achieved, they shall be referred to Almaty Arbitration for consideration.

Leasing for Franchises in the Republic of Kazakhstan

16. CONCLUSION AND TERMINATION OF AGREEMENT

16.1. The present Agreement comes into force subject to simultaneous fulfillment of the following conditions:

- it shall be signed by both parties;
- LESSOR shall be granted a credit by "PROMSTROYBANK INC." to pay for EQUIPMENT as per CONTRACT (clause 5.1);
- LESSEE shall submit warranty as per clause 3 hereof.

16.2. The Agreement shall not be terminated unilaterally before its expiration for any reasons except directly specified herein.

17. OTHER CONDITIONS

17.1. The parties have not concluded any additional oral agreements. Any amendment to the present Agreement shall be made only in written form.

17.2. The Agreement is signed in two copies, one for each party, both copies having the same legal validity.

17.3. In case of change of LESSEE's legal address, the actual location, payment requisites or change in LESSEE organizational and legal format, as well as any change in the conditions of operation or location of EQUIPMENT, the latter shall notify LESSOR within 5 days from the time of the change. If LESSEE does not meet this stipulation, he shall be held financially responsible and shall pay a penalty at the rate of 10% of the value of the Agreement as per clause 1.3 (he is exempted from fulfilling his obligations hereunder either).

Leasing for Franchises in the Republic of Kazakhstan

18. LEGAL ADDRESSES AND PAYMENT REQUISITES OF THE PARTIES

18.1. LESSEE: _____ Almaty Account No. _____
MFO _____ Bank
Correspondent Account _____ MFO _____

18.2. LESSOR: Closed Joint-stock Company "Agro Leasing"
15 Sq. of the Republic,
Almaty, 480013
Account No.37400467555 in OPERU-4
"PROMSTROYBANK INC." in Almaty
MFO 161046

LESSOR
General Director

LESSEE
General Director

(Seal)

(Seal)

“ _____ ” _____ 199 _____

“ _____ ” _____ 199 _____

Leasing for Franchises in the Republic of Kazakhstan

Sample Terms Of Leasing Offered By Leasing Company

Leasing is a mechanism alternative to loan of acquiring equipment (industrial, office, vehicles etc.) or any other property (furniture, premises etc.). In leasing operations the company Leasing Business acquires necessary equipment (property) from the customer defined seller (supplier) on the customer order and then grants it to customer according to the leasing agreement. Client as a lessee uses the property and pays on a regular basis (once a month or a quarter).

Here are some attractive features of leasing:

- external financing - possibility to purchase property with credit payment;
 - possibility to use payment out of profit from exploitation of the property for leasing;
 - possibility to surcharge expenses related to purchase of the equipment, (this important feature should be used with consideration of normative documents requirements);
 - profit and profit tax savings;
 - accelerated depreciation of property (leasing fees are not included in the standards of depreciation);
 - possibility of adaptation of charges schedule to a planned cash-flow of the lessee;
 - possibility of preserving of personal funds as turn-over capital, which in certain areas is more profitable and the income is higher than loan expenses;
 - different leasing schemes, which include “Leasing Business” taking the risk of the remnant of the payment, and realization of the equipment after the end of rent;
- possibility of making “complex” agreement, that include insuring the equipment, service, substitute before the end of the contract.

Leasing for Franchises in the Republic of Kazakhstan

General conditions of leasing (exception - automobiles)

Term of Leasing	2 Years	3 - 4 Years	5 Years
Annual rent percentage (interest) %	21.2 %	***	14.81 %
Overall sum of leasing fees, percentage from purchase cost of equipment %	142.4 %	conditions of 3-4 yr. leasing are provided upon request	174.05 %
Structure of rent payments	24 equal monthly payments each 5,93 % of the total cost of equipment	***	8 equal quarterly payments, each 15.43 % (off total cost) + 12 equal quarterly payments, each 4.21 %
	client pays in advance (20-30% of the total cost of equipment)		

The conditions mentioned above can be corrected if frequency of payments changed (monthly / quarterly) and/ or conditions of charges (equal or non-equal).

Tax advantages of using 2yr leasing mechanism in comparison with other ways of obtaining property.

	Purchase	Rent
Cost of property	100 000. 00	
Depreciation of property	18 460. 00	
Overall sum of rent payments	-	142, 290. 00
VAT	-	25, 180. 00
Rent (no VAT)	-	117, 110, 00
Decrease of base of profit tax which is a subject to taxation		98, 650. 00
Savings made on profit tax, paid with 35% of interest		34, 527. 00
Overall sum of rent payments including savings made on profit tax		107, 762. 50
Percentage of equivalent credit		10. 33 % per annum

Leasing for Franchises in the Republic of Kazakhstan

The order of making a lease agreement / contract:

Step 1 A client makes inquiry about the possibility of making a contract for leasing; by that point he should know the following:

- specific kind of equipment he wants
- the supplier
- the cost of equipment

Step 2 Based on the information received from the client the company provides the client with the INFO on conditions of leasing.

Step 3 Should the client know the conditions and agree with them, he is to submit an official application for leasing, which consists of:

- application (sample included)
- notarized copies of founders documents of the client (chart, founders agreement, registration certificate)
- copies of accountability check of the client from the last date of checking of the last year (for projects less \$ 100,000 US) and for two last years (for projects over \$ 100,000 US) with addendum (forms No.2 and 5), the documents have to have a stamp of the client's organization / firm and a note from GNI;
- information of possible ways to guarantee the deal (bank guarantee letter, description of the downpayment etc.);
- credibility guarantee of the client (business plan of store development with TAO project).

Step 4 Company reviews received application and according to the review results:

- a) confirms the possibility of making the contract on requested conditions, or
- b) refuses the client, or
- c) proposes different conditions of the contract (such as change of the contract terms, change of advance payment etc.).

Review of application is 10 days.

Step 5 Authorized representatives of the company and of the client sign leasing agreement.

Leasing for Franchises in the Republic of Kazakhstan

D. List of Typical Lease Documentation

- Lease Application / Request
- Lease Agreement
- Equipment Description & Purchase Agreement
- Guaranty
- Delivery & Acceptance
- Business Plan / Financing Projections
- Bank Account Statements
- Appraisal of Fixed Assets and Collateral
- Personal / Company Financial Statements
- Tax Certificate
- Corporate Charter and Shareholders Agreement

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Legal Issues for Franchises in the Republic of Kazakhstan

Issues related to Intellectual Property for Franchises

Lawyers, specialized in trademark and intellectual property, and experts, taking part in developing appropriate legislative acts, express an opinion that the current Trademark Law in the Republic of Kazakhstan is not stringent enough, especially if compared to the trademark laws in other countries, where breach of trademark law and service marks law are subject to harsh sanctions, even up to criminal liability. Kazakh State Patent Office informs that currently an issue of possible introduction of alterations and amendments to the appropriate standard acts, namely criminal liability for unfair use of trademarks and service marks is under consideration, since for our low-abiding citizens administrative responsibility, not supported with more considerable sanctions, is not very tough punishment. Partly, that was the reflection of the recent law suits, arising from unlawful use of trademarks, and, as a rule, foreign businesses acted as claimants.

In Kazakhstan administrative responsibility for infringement of the intellectual property right and unauthorized use of the trademark was adopted in 1991 by the Law on Competition Development and Restriction of Monopolistic Activities of the Republic of Kazakhstan. However this Law did not apply to the rights, arising from legislative acts on author's inventions, production samples, trademarks, service marks and copyright, except for the cases when appropriate rights are deliberately exercised by their owners to cut down competition. Should it be a case of such unfair use arbitration courts, adhering to this Law, may impose penalties.

Law on Private Enterprise Protection and Support was adopted in 1992, Article 29 of which provides for responsibility for infringement of the industrial property right, according to which penalty is still collected in Soviet Rubles. At the present moment all penalty amounts for infringement of the anti-monopoly law and other laws are re-computed in accordance with the Law of the Republic of Kazakhstan on Introduction of Amendments and Alterations into the Administrative Infringements and Penalty Recomputation Order Code, Stipulated by the Administrative Infringements Code of the Republic of Kazakhstan.

General Provisions of the Civil Code, Article 125, put into force on March 1, 1995, recognize an exclusive right of a legal entity to have its own tradename, trademark, service marks, etc. These means of individualization may be used by third persons only upon prior consent of an owner of the right. Two basic documents, governing legal relations with respect to trademark and other means of industrial property

Legal Issues for Franchises in the Republic of Kazakhstan

within the territory of the Republic of Kazakhstan are the “Patent Act of the Republic of Kazakhstan” and Law on Trademark, Service Marks and Places of Origin of the Intellectual Property”, adopted in 199 and 1993, respectively.

Trademark Law of the Republic of Kazakhstan (“Trademark Law”) came into force in January, 1993. This law protects trademarks, registered in the Republic of Kazakhstan, governs registration procedures in Kazakhstan and furnishes trademark owners with means of struggle against unfair use of trademarks. Trademark Law meets the minimal requirements of protection, stated with the current international agreements (described further below) thus helping Kazakhstan to draw up an up-to-date trademark legislation. However, problems still exist though they refer more to application of this Law.

Trademark Law

Trademark Law was prepared by the Kazakh State Patent Office under the Cabinet of Ministers of the Republic of Kazakhstan - KAZPATENT. Trademark Law acknowledges both trademark and service marks. Recognition of service marks is important since some franchises do not produce goods.

Trademark holders must register trademarks in KAZPATENT in order to establish the right of possession within the territory of the Republic of Kazakhstan. Any verbal, graphical, volumetric or another sign, helping to distinguish one product/service from a similar product/service may be registered as a trademark. Trademark may be registered in KAZPATENT by both natural persons and legal entities. Foreign legal entities or natural persons, natural persons, residing beyond the territory of the Republic of Kazakhstan, or their patent counsels conduct business, connected with the registration of trademarks, through patent counsels, registered in Patent Office.

Kazakhstan method of registering of trademark is based on priority, meaning that the first person or entity, which registered a trademark in the republic, becomes a trademark holder within the territory of the Republic of Kazakhstan. Priority is determined by an application date in the Patent Office. Since Kazakhstan confirmed its adherence to the Madrid and Paris conventions when in February, 1993 President Nazarbayev signed Declaration on Extension in Validity of International Agreements, priority of a trademark may be also determined by an application date in a state - Paris Convention member, if an application was filed within 6 months from the appointed date. Priority of a trademark may be also determined by a date of an open demonstration at an officially recognized trade show, conducted in the state - member of International agreements on industrial property protection (conventional priority) should an application be filed at the Patent Office within 6 months from the appointed date.

Legal Issues for Franchises in the Republic of Kazakhstan

Kazakhstan law does not stipulate that registration of a trademark is conducted only upon presenting evidence of its use by its holder in Russia or anywhere else. It to a considerable extent registration procedure for trademark holders. On the other hand, it makes life easier for the piracy, i.e. unlawful registration of another's trademark in another country with the intention to sell the registered trademark to its true holder, when the latter tries to register this trademark beyond his own state. Such infringement of rights of a true trademark holder, still not reflected in the current legislation, is not a crucial problem for Kazakhstan; however, as franchise business will expand it is most likely that risk of piratical use of others' trademarks will increase.

Registration of a Trademark in the Republic of Kazakhstan

In accordance with the Patent Act of the Republic of Kazakhstan and Law on Trademarks, Service Marks and Places of Origin of Goods, as well as on the basis of the Regulations on the State Patent Office under the Cabinet of Ministers of the Republic of Kazakhstan, approved by Decree # 877 of the Cabinet of Ministers as of October 16, 1992 and Order # 16-14/1690 of the Cabinet of Ministers as of February 17, 1993 patent agreements and Industrial Property Certificates (inclusive of trademarks and service marks), as well as license agreements on the right to use objects of industrial property and know-how, are subject to registration in KAZPATENT*.

License agreements are registered in two steps: preliminary examination, which lasts one month and within this period contents of an application form and compliance of accompanying documents are checked, and final examination - full examination of attested symbol in accordance with provisions of the Trademark Law. In general KAZPATENT is obligated to consider an application within 1 month from an application date. When these two examinations are completed KAZPATENT either registers a trademark or rejects its registration. In case of rejection an applicant has three months to appeal against a decision in the Appeal Board of the patent Office and six months to consider the case in the court if the Appeal Court rejects.

* Sample Application Form on Registration of a Trademark or a Place of Origin in KAZPATENT is attached in Appendices to this Section.

Legal Issues for Franchises in the Republic of Kazakhstan

KAZPATENT may reject registration of a trademark by virtue of the following reasons:

- if a trademark solely consists of symbols, i.e. depicts a State arms, flag or emblem, official names of states, etc.;
- possesses no of distinguishing power;
- used generally as a symbol of a definite product;
- a trademark is a generally accepted symbol or term;
- a trademark designates type, quality, quantity, properties and value of a product, and place and time of its production or sale;
- a trademark is false or may delude a customer with respect to a product or product manufacturer;
- a trademark violates or contradicts public interest, principles of humanism and ethics.

In addition to the foregoing “absolute grounds” rejection may be based on the earlier obtained rights. A trademark cannot be registered in Kazakhstan if its designation is identical or similar to the extent of confusion with an earlier registered trademark or if it has been registered or applied for registration before by another person with respect to the similar product/service. Since in Kazakhstan the priority rule is based on the principle of who effects an application first a trademark that wins - i.e. a trademark will be registered for the first applicant.

Section 4 of the Trademark Law contains a detailed description of the documents, protecting rights to the trademark and designation of a place of product origin. Order of filing an application for protection of a place of product origin is the same as for a trademark.

A historical name of a geographical location can be recognized a place of product origin. Verbal names of geographical locations or their combinations with the specific or conventional product names can be used as names of places of product origin. Designations, though representing or containing geographical names but generally used as a popular product name, not connected with the place of its production, can not be used as names of places of origin.

A name of a place of product origin is not a subject of an exclusive right of one or a group of businesses - is belongs to a state. Registration of a name of a place of product origin by one or a group of business by no means impede possible filing of an application for registration of a specific designation by other businesses, manufacturing products, possessing unique properties, exclusively or mainly connected with the place of production and located in the same geographical area,

Legal Issues for Franchises in the Republic of Kazakhstan

i.e. protection of a name of a place of product origin is not an exclusive right and can be transferred to other natural persons or legal entities.

An application for registration of a name of a place of product origin is submitted to the Patent Office as well. It contains:

- an application for registration and right to use the name of a place of product origin or the right to use earlier registered name of a place of product origin, indicating applicant's or applicants' name(s) and his(their) location(s) or place(s) of residence;
- declared designation;
- type of product, requiring registration, indicating place of production (borders of a geographical area);
- description of specific properties of this product.

Attached to an application are:

- evidence of the local authorities that an applicant is located in the specified geographical area and manufactures a product, specific properties of which are determined with the natural conditions and/or human factors, typical for this geographical area;
- a document, confirming the right of a foreign applicant for a declared designation of a place of product origin in the state of product origin;
- a document, verifying powers of a patent counsel (if an application is filed by him).

Certificate of the right to use a designation of a place of product origin is valid for 10 years. To prolong a term of validity of the certificate its holder has 6 months after an expire date of the certificate if an extension fee was paid. Trademark Law binds the Patent Office to publish information on registration of new designations and trademarks within 6 months from the date of registration in the Register. Article 7 of the Trademark Law contains provisions, allowing the Patent Office to withdraw a certificate for protection of the right of designation of a place of product origin in those cases, when, for instance, a product loses its properties, vesting it with this right.

Registration can be terminated during 5 years if someone proves that a trademark or a designation of a place of product origin were out of use for 5 years from the date of registration without reasonable grounds. Among other grounds for termination are:

Legal Issues for Franchises in the Republic of Kazakhstan

- closing down of a legal entity, which registered a trademark or a designation of a place of product origin;
- unlawful issue of a certificate for possession of a trademark/designation of a place of product origin.

Initially a trademark is registered for 10 years. This period can be extended if an appropriate application, containing:

- an original copy of a trademark certificate;
- a receipt, confirming that an extension fee was paid in the specified amount;
- a document, confirming powers of a patent counsel if an application for extension is filed by him will be filed.

An expired trademark can not be re-registered during 3 years from the expire date of registration by another person. Fair holders of a trademark or a designation of a place of product origin or other designations, identical or similar with the registered designation of a place of product origin not less than during 6 months prior to its registration retain the right to the further use of such designations within the period of time, determined by the Patent Office case by case.

Use of a Trademark by Unauthorized Persons

Trademark right must be registered in KAZPATENT not only by their holders (Licensors) but also by lawful users (for instance, franchises or, using legal terms, Licensees). If a franchise does not register a trademark KAZPATENT will not confirm that it uses this trademark on lawful grounds. At the present moment there is still no law, stating whether it is mandatory for franchises to register an entire franchise agreement in order to establish this right. It is mostly likely that for the purpose of registration they will have to submit an extract from the agreement, indicating only those articles, referring to trademarks. It is very important to note that Trademark Law requires that a license agreement contains a condition that quality of a Licensee's product/service, sold under a licensed trademark, must correspond to a Licensor's product/service and the latter is entitled to supervise product/service quality.

Legal Issues for Franchises in the Republic of Kazakhstan

Application of the Law

If any organization uses a registered trademark with an infringement of this law involved, a trademark holder may prohibit to use it and put a claim for full compensation for incurred losses or pay total profit, obtained in the result of unlawful use of a trademark. This Trademark Law stipulates only for the administrative responsibility for an infringer.

It is still considered that Kazakhstan courts pass prohibitive judgments with respect to law infringers from Russia and in the majority of cases they are justified. However this opinion can not be referred to the foreign trademark holders. A good example of it is a legal proceeding in connection with the use by Kazakhstan companies of well known to a local consumer trademark of Bulgarian cigarettes - "Tu-134", "Stewardess", etc. But since Kazakhstan companies managed to register these trademarks on their own behalf the court pronounced judgment in favor of the Kazakh companies.

Means of fight against unlawful use of a trademark, registered in accordance with the Trademark Law and protected by the Paris Convention, which trademark holders have at their disposal, are listed in Clauses 30 and 31 of the Trademark Law. Trademark holder may sue anyone who infringes its rights. The following sanction may be employed by the court:

- prohibition to use a trademark;
- a claim for losses incurred by a trademark holder;
- a claim to remove an unlawfully used trademark or a similar symbol.

In general compared to its Russian analogue the Kazakhstan Trademark law contains less clauses, which is particularly obvious in the sections dealing with the liabilities for infringement of Trademark Law. Perhaps, partly it is due to general legal illiteracy among the major part of Kazakhstan businessmen, who do no care about registration of their trademarks. And so at every turn one can meet companies under tiresome names "Dana", "Sana", etc. Local businesses, with the rare exception, has not yet achieved that level where exclusivity and prestige of a trademark is of crucial importance for the company's overall sales and profit amount. This is an explanation of quite rare legal proceedings in connection with the trademark litigations and the fact that mostly foreign companies act as a claimant, for some strange reason doing their best to protect the right of possession of a trademark in our society, which is still far from understanding of this issue.

Legal Issues for Franchises in the Republic of Kazakhstan

Anti-Monopoly Law

A trademark holder may initiate a hearing in the Anti-Monopoly Committee on the unlawful use of its trademark. Competition Development and Restriction of Monopoly Law (Anti-Monopoly) of the Republic of Kazakhstan is aimed at prevention and restriction of the monopoly and unfair competition (Article 9) in the market, which is defined as:

- “unauthorized use of another’s trademark, service mark, brand name or marking of goods, as well as copying of forms, packaging, exterior design of a product, manufactured by another business;
- obtaining, use or disclosure of the confidential scientific, technical, production or commercial information, including trade secrets, without the consent of its owner.”

Anti-Monopoly Law entitles the Anti-Monopoly Committee to consider within its competence law suits, connected with infringements of the Anti-Monopoly Law and pass decisions, imposing penalties for violations, or initiate proceedings on imposition of such penalties in the cases, established by this law. Anti-Monopoly Committee is also entitled to initiate in the court or arbitration proceedings connected with the violation of the anti-monopoly law (Article 12, Anti-Monopoly Law). In accordance with Article 19, Section 4, of the Anti-Monopoly Law Anti-Monopoly Committee has the right: to enforce payment of a threefold penalty on the groundless profit, obtained in the result of unfair competition (penalties in this case are imposed on legal entities by the arbitration court). According to decision of the arbitration court profit, obtained in the result of unfair competition, is subject to seizure and transfer to the Republican Budget.

Currently the Anti-Monopoly Law makes provision for such sanctions for unlawful use of a trademark only in theory since cases of practical application are very rare.

Legal Issues for Franchises in the Republic of Kazakhstan

International Trademark Conventions

As mentioned above Kazakhstan confirmed its adherence to the international conventions, protecting industrial property, by signing Declaration in February 1993. At the present time Kazakhstan is a member of a number of international organizations: World Intellectual Property Organization - WIPO), Paris Convention, Patent Cooperation Treaty and Madrid Convention on International Trademark Registration. Paris Convention is the international agreement of the first importance, protecting trademarks. This agreement represents two very important rights: right of foreign citizens to equal rights with the local residents and right of priority during registration. Equal rights with local citizens means that countries-members of the Convention will treat foreign citizens the same way as local residents and were subject to the same laws. The rights of priority gives a trademark holder 6 months so that the latter can file an application in another country-member of the Paris Convention reserving the right of priority in comparison with other applicants for registration of this trademark. Paris Convention automatically protects well-known trademarks and in all probability does not demand that this trademark to be registered in other countries-convention members. If the registration were obligatory that would be an additional protection from the piracy.

Madrid Convention allows that a trademark, registered in the member country, can be registered (in French) in the World Intellectual Property Organization in Switzerland, which secures trademark protection in all countries-members of the Madrid Convention. In other words, one application to the WIPO substitutes a quantity of other applications in other countries-members of Madrid Convention upon the condition that the trademark was registered in the country of origin. Each member country has twelve months in its disposal, during which its application may be rejected, while, if registration had place, it is valid during twenty years and may be extended every twenty years.

Legal Issues for Franchises in the Republic of Kazakhstan

APPENDIX 1

Form L-1 **State Patent Office under Cabinet of Ministers of the
Republic of Kazakhstan**
Licenses and Foreign Relations Department
92 Maulenov St., Almaty, 480091, Kazakhstan
From: _____ (full name)
Address: _____

APPLICATION

Hereby I ask to register _____ (type and
designation of a license agreement) for an object of industrial property

_____ between _____
(applicant's full name, address, phone #), hereinafter referred to as _____,
and _____
(applicant's full name, address, phone #), hereinafter referred to as _____,
who is entitled to the right to _____
(contents of transferred rights).

Appendices:

- Original copies of license agreements to be registered in ____ pages with attachments # _____ in _____ pages in _____ copies;
- A patent, a preliminary patent or certificate (decisions on certificate issue^{*}** for an object of industrial property;
- A copy of a receipt of the state registration fee.

Applicant's name, post and signature:

Date: _____

^{*} Original copies of a patent, preliminary patent or certificate must be submitted to the License Department for the further information on registration.

^{**} Check required.

Legal Issues for Franchises in the Republic of Kazakhstan

APPENDIX 2

Form L-2 **State Patent Office under Cabinet of Ministers of the
Republic of Kazakhstan**
Licenses and Foreign Relations Department
92 Maulenov St., Almaty, 480091, Kazakhstan
From: _____ (full name)
Address: _____

APPLICATION

Hereby I ask to register _____ (type and
designation of a license agreement) for an object of industrial property

_____ between _____
(applicant's full name, address, phone #), hereinafter referred to as _____,
and _____
(applicant's full name, address, phone #), hereinafter referred to as _____,
who is entitled to the right to _____
(contents of transferred rights).

Appendices:

- Permit of the Ministry of Foreign Trade Relations of the Republic of Kazakhstan for export and/or import of objects of industrial property;
- Original copies of license agreements to be registered in ____ pages with attachments # _____ in _____ pages in _____ copies;
- A patent, a preliminary patent or certificate (decisions on certificate issue^{*}** for an object of industrial property;
- A copy of a receipt of the state registration fee.

Applicant's name, post and signature:

Date: _____

^{*} Original copies of a patent, preliminary patent or certificate must be submitted to the License Department for the further information on registration.

^{**} Check required.

Legal Issues for Franchises in the Republic of Kazakhstan

Sample Franchise Agreement

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Note Concerning the Use of this Agreement.

This franchise agreement is intended to be a sample outline of terms often included in franchise agreements used in the United States. Neither Brownstein Zeidman and Lore, Sibley International, nor the United States Agency for International Development recommends the use of this document for commercial purposes in Kazakhstan without consultation of a local lawyer. In addition, consideration should be given to consultation with a local accountant. Franchise businesses vary widely, and franchise agreements must be tailored specifically to each individual business. In addition, in light of the evolving nature of the Kazakhstan law, neither Brownstein Zeidman and Lore, Sibley International, nor the United States Agency for International Development can assure that all of the terms and format of this sample document will remain the same.

Legal Issues for Franchises in the Republic of Kazakhstan

Franchise Agreement

This franchise agreement (the "Agreement") is hereby executed in _____ to be effective as of _____ 1996 between : _____, a limited liability society that is registered in Almaty, Republic of Kazakhstan ("Franchisor"), in the person _____, the _____ of Franchisor who acts on the basis of the [organizing documents], and _____, a limited liability company/joint stock company that is registered in _____, Republic of Kazakhstan ("Franchisee"), in the person of _____, (title), who acts on the basis of the (organizing documents), including its legal successors and agents.

This introduction contemplates that the franchisee will be a corporate entity. It is considered preferable for franchisors to contract with corporate entities over individuals, not only because the corporate form may protect the franchisee from liability exposure to third parties (as in the U.S.), but also because termination of contracts can be effected more readily under Kazakhstan Civil Code when the parties are corporations. When both parties are corporations they are also entitled to use the Kazakhstan arbitration courts instead of the civil courts (see Section 26, below). It should be noted, however, that corporate franchisees are also insulated from liability to franchisors; therefore, franchisors often require that the owners of a corporate franchisee personally guarantee the obligations of the corporate franchisee. The same is true of covenants against competition and confidentiality covenants, discussed further below.

FRANCHISOR AND FRANCHISEE AGREE AS FOLLOWS:

1. THE SYSTEM

Franchisor has expended time, skill, effort, and money in developing a system for the establishment and operation of _____ businesses under the service mark "_____" (the "System") in Kazakhstan. The distinguishing characteristics of the System include: standards and assistance in locating a site appropriate for a franchised business outlet (a "Franchised Business"); assistance and expertise in remodeling sites to function as Franchised Businesses; [assistance in obtaining high quality equipment for use in the Franchised Business;]; use of the registered service mark [or trademark] "_____" and other distinguishing marks Franchisor may create for use with the System (the "Proprietary Marks") in interior design, exterior signs, and advertising; standards for high quality supplies; detailed manuals (the "Manuals") describing and providing instruction in the operations of every aspect of operating the Franchised Business; training and assistance in the management, accounting, and bookkeeping functions of the

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Franchised Business; training in customer relations; advertising and promotional programs; and all improvements to the System that Franchisor may make from time to time.

This paragraph describes the components of the System, i.e., what the franchisee can expect, in general terms, from the franchisor. Not all elements contained in this example will apply to all Systems. Therefore a franchisor must carefully consider what his System includes prior to using this agreement.

2. GRANT AND FEES

2.1 Grant: Franchisor grants to Franchisee the right, and Franchisee accepts the obligation, to establish and operate one Franchised Business in ____, according to the terms of this Agreement.

2.2 Trademark License Agreement: Upon execution of this Agreement, the parties shall execute the trademark license agreement ("Trademark License Agreement"), which shall grant Franchisee the right to use the Proprietary Marks in connection with the Franchised Business in Kazakhstan. Franchisor shall immediately submit for registration the Trademark License Agreement at KAZPATENT or any other appropriate trademark office(s) in Kazakhstan. Franchisee acknowledges that such registration of the Trademark License Agreement does not confer to Franchisee any rights in the Proprietary Marks not expressly granted in this Agreement or the Trademark License Agreement.

2.3 Exclusivity: The rights granted under this Agreement shall be exclusive to Franchisee within the area described as: _____.
Franchisor shall not establish, or license others to establish, a Franchised Business within such area during the term of this Agreement, including renewals thereof. However, Franchisor may establish, or license others to establish, Franchised Businesses outside of the area described herein, as well as other business using other proprietary marks, within or outside the area described herein.

We have drafted the Agreement to grant the franchisee the right to operate one franchised business. It is, of course, possible to draft an agreement that allows a franchisee to operate more than one franchised business (a "Development Agreement").

2.4 Initial Franchise Fee: Franchisee has paid to Franchisor an initial franchise fee of the equivalent in Kazakhstan Tenge of _____ U.S. Dollars (U.S. \$ _____). Franchisee acknowledges that the initial franchise fee is paid in consideration of the grant described in Section 2.1, the administrative expenses incurred by Franchisor in entering this Agreement, and the costs of assisting franchisee in site selection and remodeling of the Franchised Business premises, training of Franchisee in all aspects

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of the Franchised Business' operation, and other on-site pre-opening and opening assistance.

This section addresses the initial franchise fee paid by the franchisee to the franchisor. It states that the franchisee acknowledges that the initial fee is paid as consideration for the franchisee's rights under the contract.

The purpose of this language is to reflect the quid pro quo of the transaction. It memorializes that for which the parties bargained, which establishes that a contract exists. The Kazakhstan Civil Code (the "Civil Code") appears to allow the parties to negotiate such consideration freely (Article 148), unless otherwise restricted by additional laws or regulations.

Currently it appears that no regulations exist that could be construed to limit initial franchise fees. The franchisor's contribution to the bargain is spelled out here in order to demonstrate to the franchisee (and, if necessary, a judge) the franchisor's consideration.

2.5 Monthly Franchise Fee: Franchisee shall pay to Franchisor a monthly franchise fee equal to the greater of _____ percent (___%) of the gross sales ("Gross Sales") of the Franchised Business or the equivalent in Kazakhstan Tenge of _____ U.S. Dollars (U.S. \$ _____). Gross Sales shall mean all income received by Franchisee related to the Franchised Business, including _____ or any other incidental items sold to customers on the Franchised Business premises; and any other income related to the Franchised Business. Gross Sales shall not include any sales or service taxes (including value added taxes) collected from customers by Franchisee for payment to State or municipal tax authorities. Franchisee acknowledges that the monthly franchise fee is paid in consideration of Franchisor's on-going assistance and support and the on-going right to use the Proprietary Mark "_____".

This paragraph describes the obligation of the franchisee to pay to the franchisor a monthly franchise fee. More often than not in franchise agreements, the periodic fee is equal to a percentage of gross sales. There was some concern, however, that the franchisor's income could be jeopardized if tied to gross sales, due to the possibility of a franchisee's understating gross sales records in an effort to avoid tax payments. In such a case, a flat amount would be appropriate. On the other hand, the franchisor would like to receive whatever revenue exceeds this flat amount in the event a named percentage of gross sales would exceed such flat amount. The present formula requires the franchisee to pay the greater of a named percentage of gross sales or the flat dollar amount, which ensures a minimum payment to the franchisor each month.

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All fees in this agreement are stated in Kazakhstan Tenge. The Civil Code enacts that Tenge is a legal means of payment, accepted at nominal value within the territory of the Republic of Kazakhstan (Article 127). In accordance with Article 282 all pecuniary obligation within the territory of the Republic of Kazakhstan are performed in Tenge, and under this liability payment is done in Tenge in the amount equivalent of a certain amount in the foreign currency. In this case amount to be paid is determined by the exchange rate of the Kazakhstan Interbank Exchange, fixed for the corresponding foreign currency at date of payment, or in the closest location, if another exchange rate or fixing date are not stipulated by law or agreement of the parties. The Civil Code requires that payments in Russian contracts be stated in Rubles (Article 140 and 317). However, we have tied the amount of Tenge to the U.S. Dollar in light of the current inflation rate and monetary devaluation in Kazakhstan. We have included the conversion rate in Section 2.7. If no conversion rate is stipulated in a Kazakhstan contract, earlier mentioned Article 282 of the Civil Code requires use of the official exchange rate on the date of payment.

2.6 Advertising Fee: Franchisee shall also pay to Franchisor a monthly advertising fee equal to the equivalent in Kazakhstan Tenge of _____ U.S. Dollars (U.S. \$ _____), if Franchisor establishes an advertising fund as described in Section 10.3 below. Such payments shall not include any value added tax imposed by any tax authority, which shall be the responsibility of Franchisee.

This section requires the franchisee to pay to the franchisor a flat fee for any collective advertising that it will do on behalf of all franchisees in the System. This has the advantage to the franchisees of giving them advertising exposure that they might not otherwise be able to afford on their own.

2.7 Due Dates: Franchisee shall make all monthly payments due under Sections 2.4, 2.5 and 2.6 by the _____ (___) day of each month, based on Gross Sales of the preceding calendar month. Franchisee shall make such payments to Franchisor's designated bank account, and shall pay any deposit or other transaction costs related to each payment. The conversion rate to be used when converting dollars to Tenge in Sections 2.4, 2.5 and 2.6 shall be _____. Here we have required the franchisee to pay the deposit fee charged by banks for deposits made into the franchisor's account, which fee is currently 5% of the amount of the deposit. The parties, or the franchisor, should designate the exchange rate.

2.8 Late Payments: Any payment not made to Franchisor or deposited into Franchisor's bank account by the _____ (_____) day of any month is overdue. Franchisee shall pay upon demand by Franchisor any overdue amounts and interest on the overdue amount from the date it was due until the date it is paid, at the rate of _____ percent (___%) per day, in addition to any other remedies Franchisor may have.

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3. TERM AND RENEWAL

3.1 Term: The term of this Agreement shall be _____ (___) years from the date of this Agreement. This term shall be considered a trial period only, and any renewal rights of Franchisee shall be subject to Franchisee's fulfilling the conditions of Section 3.3 hereof.

The length of the term will depend on a number of factors: the nature of the business, the amount of the investment, the length of trial period franchisor want to offer, etc. Long initial terms may be attractive to franchisees, as they may represent a longer period over which to recoup the initial investment, and represent a longer term commitment on the part of the franchisor.

Shorter initial terms may also be attractive to franchisees, who would prefer not to commit to long term obligations in a rapidly changing commercial environment. For the franchisor, short initial terms tend to be preferable, as they give the franchisor a chance to end the franchise relationship in the event of a dispute (through non-renewal), as opposed to terminating the franchisee, which could prove to be more difficult.

3.2 Suspension of Term: If Franchisee loses the right to occupy the premises of the Franchised Business during the term of this Agreement, for reasons beyond Franchisee's control, the term of this Agreement shall be suspended as of the last day the Franchised Business was open for business at the original site. Franchisee shall have _____ (___) months to open the Franchised Business at another site (in accordance with Sections 5 and 7 hereof). The term of this Agreement shall continue upon the opening of the Franchised Business at the relocation site.

This section allows the term of the Agreement to be suspended until the franchisee can relocate the franchised business if the franchisee loses control of the property. This provision may help the survival of a franchise system in Kazakhstan, where rights to real property remain extremely fragile and unpredictable.

3.3 Conditions for Renewal: Franchisee may renew this Agreement for _____ (___) additional consecutive terms of _____ (___) years each. Franchisor may require that any or all of the following conditions be met prior to any such renewal:

Section 3.3 contains renewal terms common to franchise agreements, which describe the behavior required by the franchisee to earn the right to renew the agreement at the end of the initial term. These also provide guidance for the franchisee in following the terms of the franchise agreement during the term.

3.3.1 Franchisee shall give Franchisor written notice of Franchisee's decision to renew between three (3) and six (6) months before the end of the then-current term;

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3.3.2 Franchisee shall renovate the Franchised Business premises in a manner satisfactory to Franchisor, including the installation of new equipment, furnishings, fixtures, and decor to reflect the then-current standards of the System;

3.3.3 Franchisee shall not be in default of any provision of this Agreement, the Trademark License Agreement, any other agreement with Franchisor, [or any equipment [lease/purchase] agreement,] and Franchisee shall have substantially complied with all the terms and conditions of such agreements during the terms thereof;

3.3.4 Franchisee shall have satisfied all monetary obligations owed by Franchisee to Franchisor, and shall have timely met those obligations throughout the term of this Agreement, [and Franchisee shall have achieved an average of the equivalent in Kazakhstan Tenge of _____ U.S. Dollars (\$U.S. _____) in Gross Sales during the previous term of this agreement;

3.3.5 Franchisee shall present evidence satisfactory to Franchisor that Franchisee has the right to remain in possession of the Franchised Business premises for the duration of the renewal term, or shall obtain Franchisor's approval of a new location for the Franchised Business for the duration of the renewal term, according to Section 5.2;

3.3.6 Franchisee shall execute Franchisor's then-current form of franchise agreement, the terms of which may differ from the terms of this Agreement;

3.3.7 Franchisee shall execute a general release, in a form prescribed by Franchisor, of any and all claims against Franchisor;

3.3.8 Franchisee shall comply with Franchisor's then-current qualification and training requirements; and

3.3.9 Franchisee shall pay Franchisor a renewal fee equal to _____ percent (____%) of Franchisor's then-current initial franchise fee.

4. DUTIES AND ASSISTANCE PROVIDED TO FRANCHISEE

Franchisor shall provide the following to Franchisee at no charge to Franchisee:

- 4.1 Site selection guidelines as described in Section 5, if necessary;
- 4.2 Standard plans for construction or renovating a commercial site for the Franchised Business, including electricity, gas, and water requirements, and interior layout plans; [These will vary, depending on the nature of the business.]

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- 4.3 Assistance in procuring parts or other equipment necessary for such renovation;
- 4.4 Supervisory assistance in such renovation, as Franchisor deems necessary;
- 4.5 Specifications for interior design, fixtures, and furnishings;
- 4.6 Assistance in procuring equipment and supplies necessary for meeting design, fixture, and furnishing specifications;
- 4.7 Training, as described in Section 8;
- 4.8 Advice and assistance in advertising programs, as described in Section 10;
- 4.9 Assistance with the opening of the Franchised Business as Franchisor deems necessary;
- 4.10 A copy of the operational manuals (the "Manuals"), on loan, as described in Section 9; and
- 4.11 On-going consultation regarding the operation of the Franchised Business.

We have listed as simply and clearly and possible all of the duties of the franchisor, including a focus on the assistance which will be provided by the franchisor to the franchisee. Detailing this assistance demonstrates to the franchisee what is being gained through paying the initial franchise fee and ongoing franchise fees. But the franchisor must not list here any assistance it is unwilling or unable to provide.

Sections 4.1 through 4.4 describe the assistance provided by the franchisor while the premises are being renovated. It is difficult to overestimate the value of this type of assistance in Almaty currently. This assistance could be a valuable selling point for prospective franchisees.

5. SITE SELECTION AND RENOVATION

5.1 Franchisee shall operate the Franchised Business only at _____
_____.

5.2 If, at the time of execution of this Agreement, Franchisee has not obtained a site for the Franchised Business, Franchisee shall have obtained a site and shall have opened the unit within _____ months of executing this Agreement, according to this Section 5.2. In no event, however, shall Franchisee open the unit, or otherwise use the Proprietary Marks, prior to the registration of the trademark license agreement ("Trademark License Agreement"), attached to this agreement.

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5.2.1 Franchisor may recommend pre-approved sites to Franchisee, if any such sites have been identified by Franchisor.

5.2.2 If Franchisee does not obtain a site described in Section 5.2.1, Franchisor shall loan to Franchisee guidelines for identifying a suitable site for the Franchised Business, which Franchisee may not copy or disclose.

5.2.3 Franchisor shall consult with and advise Franchisee in obtaining a site for the Franchised Business. Franchisor shall evaluate any site in proposed by Franchisee that Franchisor deems a possible site.

5.2.4 Franchisor shall review any proposed lease or sale documents prior to approving any site. Franchisor's approval of any lease may be conditioned upon the inclusion of the following:

Section 5.2.4 includes the right of the franchisor to review any lease arrangement proposed by franchisee prior to the franchisee signing that lease. It contains a list of conditions that Franchisor may require to be in the lease. It is understood that the franchisor may not have the luxury of actually demanding any of these provisions; however, we included them in order to allow the franchisor to demand them if obtaining them appears possible. Of course, all of this should be qualified by the expectation that enforcing any of these provisions could be extremely difficult depending on the nature of the lessor and the court before which the disputants come.

5.2.4.1 that the lessor agrees to the use of the Franchisor sign on the exterior of the premises;

5.2.4.2 that the use of the premises be restricted to the operation of the Franchised Business;

5.2.4.3 that Franchisee be prohibited from subleasing any part of the premises;

5.2.4.4 that the lessor provide notice of Franchisee's default on the lease to Franchisor;

5.2.4.5 that Franchisor have the option to assume all of Franchisee's rights under the lease upon default, termination, or expiration of the lease.

5.2.5 Franchisee shall furnish Franchisor with a copy of any executed lease within _____ (_____) days of execution thereof.

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5.2.6 Upon Franchisor's approving a site, such site shall be entered in Section 5.1 above. Franchisor's approval of any site indicates its meeting Franchisor's site selection guidelines. It does not constitute any guarantee or representation as to the success of the Franchised Business.

Section 5.2.6 contains an important caveat with regard to the franchisor's approval of the site. It states that the franchisor does not guarantee the success of any particular site for the franchised business. This is an effort to avoid the creation of any expectations of guaranteed success in the franchisee.

5.2.7 Franchisee shall renovate, or construct, and equip the Franchised Business, at Franchisee's expense. Before commencing any renovation or construction of the Franchised Business premises, Franchisor shall approve Franchisee's adaptation of Franchisor's standard plans.

5.2.8 Franchisee shall be responsible, at Franchisee's expense, for obtaining all zoning classifications, permits, and licenses that are required by State, municipal, or other authorities, laws, and regulations.

6. EXTERIOR SIGNS

Franchisor shall lease to Franchisee the exterior "Franchisor" sign to be used in the operation of the Franchised Business. In consideration for such use, Franchisee shall pay to Franchisor a rental fee of the Kazakhstan Tenge equivalent of _____ U.S. Dollars (U.S. \$ _____) each month. Such payment shall be made simultaneously with payments made under Section 2. Ownership of such sign(s) shall remain with Franchisor. Such lease shall run concurrently with the term of this Agreement and shall terminate upon the termination of this Agreement. Franchisee shall not use any other sign inside or outside the Franchised Business.

In an effort to fully protect its trademark, the franchisor could lease to the franchisee the sign to be used outside of the Franchised Business. This is in order to facilitate the return of the sign to the franchisor upon termination or expiration of the agreement.

It was feared that if the franchisee has purchased the sign, and was subsequently denied the right to use it, a court might find this inequitable. In addition, in the event of termination or expiration, it was deemed easier to regain possession of a sign to which the franchisor has title, than a sign to which the franchisee has title.

7. OPENING OF THE UNIT

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Franchisee shall obtain Franchisor's written approval prior to opening the Franchised Business, and shall open the Franchised Business within twelve (12) months after the date of this Agreement if Franchisee has obtained a site as of the date of this Agreement, or within twelve (12) months after Franchisee has obtained a site pursuant to Section 5.2.6

8. PERSONNEL TRAINING

8.1 Upon completion of the construction or renovation of the Franchised Business within _____ (_____) weeks before the opening of the Franchised Business], Franchisee [and/or] Franchisee's manager shall attend and complete to Franchisor's satisfaction the initial training program provided by Franchisor. At Franchisor's option, any persons subsequently employed by Franchisee in the position of manager shall attend and complete to Franchisor's satisfaction Franchisor's training program for managers. Franchisee and Franchisee's manager [and other employees] shall also attend additional courses as Franchisor may require.

8.2 Franchisor shall designate the time and place in Russia of all training programs. Franchisee or its employees shall be responsible for any expenses incurred by them in connection with any such courses, including the costs of transportation, lodging, meals, wages, and benefits.

8.3 Franchisor's initial and on-going training shall include the subjects listed in the Manuals.

9. THE OPERATING MANUALS AND CONFIDENTIALITY

9.1 Upon Franchisee's (or Franchisee's manager's, as Franchisor may specify) successful completion of the initial training program, Franchisor shall lend to Franchisee one copy of the Manuals. Ownership of the Manuals shall remain with Franchisor, and Franchisee shall keep the Manual in a secure place on the Franchised Business premises at all times. Only Franchisee and/or Franchisee's manager shall have access to the Manuals.

9.2 Franchisee shall operate the Franchised Business in accordance with the standards and procedures specified in the Manual.

9.3 Franchisor may revise the Manuals, and Franchisee agrees to keep the Manuals current at all times and to comply with each revision thereof. Franchisee may suggest revisions to the Manual or the System to Franchisor, which Franchisor may, in its discretion, incorporate into the Manuals or the System. Any incorporated changes shall become the property of Franchisor without any compensation to Franchisee.

9.4 Franchisee shall treat the Manuals as confidential. Franchisee shall use all reasonable efforts to maintain such information as secret and confidential. Franchisee shall

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not copy, record, or otherwise reproduce the foregoing materials, in whole or in part, or otherwise make the same available to any unauthorized person.

- 9.5 Information, know-how, and trade secrets concerning the operation of the Franchised Business gained from any training, the Manuals, or practical experience shall be considered confidential. Franchisee acknowledges that maintaining the confidentiality of such information, know how, and trade secrets is necessary for maintaining the value of the System. Franchisee shall not communicate or use for the benefit of any other person, business, or association any information, know-how, trade secrets concerning the operation of the Franchised Business, including the Manuals. Franchisee shall divulge such confidential information only to its employees who must have access to it in order to operate the Franchised Business. Any and all information, knowledge, know-how, trade secrets, techniques, and other data that Franchisor designates as confidential shall be deemed confidential for purposes of this Agreement.
- 9.6 At Franchisor's request, Franchisee shall require its manager and any personnel having access to any confidential information of Franchisor to execute covenants satisfactory to Franchisor that they will maintain the confidentiality of information they receive in connection with their employment at the Franchised Business. Such covenants shall identify Franchisor as a third party beneficiary with the independent right to enforce them.
- 9.7 In the event Franchisee breaches this Section 9, Franchisee shall pay to Franchisor the equivalent in Kazakhstan Tenge of _____ U.S. Dollars (U.S. \$_____) in recognition of the damage of the System and Franchisor caused by such breach, and Franchisor may, in its discretion, terminate this Agreement.

Protecting the contents of the operating manuals is usually a very high priority for the franchisor. Franchisors are concerned that, if the contents of the manuals are divulged to a non-franchisee, the franchisor will lose its competitive edge in delivering the products or services that it promises to its customers.

This section contains a number of devices designed to protect the confidentiality of the manuals and other information. For example, the franchisor will loan, not give, the manuals to the franchisee, thereby retaining title and essential proprietary rights to the manuals and the information contained therein. We have also required the franchisee to acknowledge the value of confidentiality to the System (Section 9.5), and to pay a penalty for any breach of confidentiality (Section 9.6).

That does not mean that the purpose of this section is to restrain Franchisee from breaches by compelling performance out of fear of the penalty. Rather, the law should redress breaches by compensating the non-breaching party with its losses. Because Kazakhstan laws (Article 9 of the Anti-Monopoly Law - "obtaining, use and

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disclosure of the confidential scientific and technical, production or commercial information, including trade secrets, without the consent of an owner of the information"; this is also the subject of Article 126 of the General provisions of the Civil Code) allow for penalties for unfair competition, expressed in actions, foreseen by Article 9 of the foregoing Anti-Monopoly Law, in the following amounts:

- from legal entities - from 10,000 (ten thousand) Rubles to 1,000,000 (one million) Rubles;
- from natural persons - from 200 (two hundred) to 1,000 (one thousand) Rubles.

Amounts of penalties have been corrected by the Law on Amendments and Alterations into Administrative Infringements and Recomputation of Penalty Amounts Code of the Republic of Kazakhstan, adopted in October 1993. Henceforward, until adoption of the new wording of the Administrative Infringements Code of the Republic of Kazakhstan, the following procedure of re-computation of penalties, expressed in firm sums (Article 24), will govern:

- 200 Rubles - 5 minimal wages, and amount of a penalty imposed can not be less one minimal wage;
- 300 Rubles - 6 minimal wages/ not less two minimal wages;
- 500 Rubles - 8 minimal wages/ not less three minimal wages;
- 1,000 Rubles - 10 minimal wages/ not less four minimal wages;
- 10,000 Rubles - 15 minimal wages/ not less nine minimal wages¹.

The maximum penalty, determined by this Law, does not exceed 30,000 (thirty thousand) Rubles, and penalty amount equals 20 minimal wages/not less than 15 minimal wages. We have included them in an effort to further compel franchisees to adhere to their confidentiality obligations.

The franchisor is granted rights to enforce those covenants as a "third party beneficiary," meaning it can enforce the agreement even though not a signatory to it.

10. ADVERTISING AND PROMOTION

10.1 Franchisee shall spend the Kazakhstan Tenge equivalent of _____ U.S. Dollars (U.S. \$ _____) on advertising in _____ during each calendar quarter. This expenditure may be reduced by contributions to the Fund described in Section 10.3.

10.2 All advertising by Franchisee shall comply with Russian advertising regulations and shall be approved by Franchisor according to procedures to be prescribed by Franchisor, shall use the Proprietary Mark " _____ " and shall conform to standards as Franchisor may specify. Franchisor shall make available to Franchisee

¹. Shown penalty amounts are fixed by the Administrative Infringements Code of the Republic of Kazakhstan, adopted in June 1991

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from time to time advertising materials, which may include newspaper ads, coupons, direct mail materials, and similar advertising concepts.

- 10.3 Franchisor shall have the right, but not the obligation, to establish an advertising fund (the "Fund"). If Franchisor establishes a Fund, Franchisee shall contribute the Kazakhstan Tenge equivalent of _____ U.S. Dollars (U.S. \$____) to the Fund with each payment required under Section 2. Franchisee acknowledges that the Fund is intended to maximize public recognition and use of the System.
- 10.4 The Fund shall be expended on the cost of conducting advertising campaigns; direct mail advertising; marketing surveys; advertising agencies; promotional items; and other marketing services to all Franchised Businesses operating under the System.
- 10.5 Franchisor, upon request, shall provide Franchisee with an annual accounting of receipts and disbursements of the Fund prior to opening the Franchised Business.
- 10.6 Franchisee shall submit to the _____ public telephone book and the English-language telephone book the name, address, and telephone number of the Franchised Business as soon as practicable prior to opening the Franchised Business.

11. OTHER DUTIES OF FRANCHISEE

In addition to the duties that are found throughout this agreement, Section 11 lists the duties of the franchisee. These duties are very important to the franchisor, as it is these that will ensure the uniformity of the System and the maintenance of standards set by the franchisor. In general, these duties are similar to what would be found in typical franchise agreements; however, it should be noted that they are likely to be much more important in the Kazakhstan context. For example, to the extent to which it is not understood that uniformity has value and should be followed, franchisees may be tempted to depart from the system if, for example, they can buy lower quality supplies at lower price. Therefore, we have drafted the provision so that the franchisee is required to purchase equipment and supplies that meet the franchisor's specifications. The franchisor may encourage franchisees to purchase products from them by offering bulk discounts, steady supply, and possible financing. However, requiring the franchisee to purchase such items from the franchisor may conflict with Kazakhstan anti-competition law. Thus, while the contract itself will not specifically restrict franchisees to the purchase of certain products, the financial reality of the market in Almaty may make it much more attractive for a franchisee to purchase equipment that is readily available from the franchisor at a favorable price, or at least upon favorable terms of financing. To the extent that any interior decor package uses the proprietary marks, the franchisor may require the franchisee to purchase that from them. Local counsel should advise on this point, however.

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- 11.1 Franchisee shall use the Franchised Business premises solely for the operation of the Franchised Business.
- 11.2 Franchisee acknowledges that uniformity is necessary to maintain the value of the System and the Proprietary Marks, and agrees to maintain the standards set out in the Manuals. Specifically, Franchisee shall:
- 11.2.1 maintain in sufficient supply (as Franchisor may prescribe), and to use at all times, only such furnishings, equipment, materials and supplies, as conform with Franchisor's standards and specifications. Franchisee must receive Franchisor's written consent prior to deviating from such standards.
- 11.2.2 purchase and install, at Franchisee's expense, only those fixtures, furnishings, equipment, decor, supplies, and interior signs as Franchisor may reasonably direct from time to time in the Manuals or otherwise in writing.
- 11.2.3 purchase all products to be used in the Franchised Business solely from suppliers who have been approved by Franchisor. Franchisee may request that Franchisor approve certain suppliers. Franchisee shall purchase the following supplies and equipment according to specifications provided by Franchisor: **[These items will depend upon the nature of the franchised business.]**
- 11.3 Franchisee shall stock the initial inventory of equipment and supplies as prescribed by Franchisor in quantities sufficient to meet anticipated customer demand.

This section allows the franchisor to inspect the franchised business at any time. This provision is extremely important in order for the franchisor to supervise the daily operation of the franchised business and to determine whether the franchisee is maintaining the franchisor's standards.

- 11.4 Franchisee shall permit Franchisor to conduct inspections of the Franchised Business at any time during normal business hours. Upon notice from Franchisor, and without limiting Franchisor's other rights under this Agreement, Franchisee shall take necessary steps to correct immediately any deficiencies revealed during any inspection. Should Franchisee, for any reason, fail to correct such deficiencies within the time determined by Franchisor, Franchisor shall have the right, but not the obligation, to correct any deficiencies and to charge Franchisee a reasonable fee for Franchisor's expenses. The foregoing shall be in addition to such other remedies Franchisor may have.
- 11.5 Franchisee shall maintain the Franchised Business in a clean condition and excellent repair, and, in connection therewith, Franchisee shall, at its expense, make such repairs and replacements as may be required for that purpose, including, without limitation, such periodic repainting or replacement of obsolete furnishings, equipment, and decor as Franchisor may reasonably direct.

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- 11.6 The Franchised Business shall at all times be under the direct supervision of a manager who has satisfactorily completed Franchisor's training program. Franchisee shall maintain a competent trained staff, including a fully-trained manager (who may be Franchisee). Franchisee shall take such steps as are necessary to ensure that its employees preserve good customer relations; render competent, prompt, courteous, and knowledgeable service; and meet such minimum standards as Franchisor may establish from time to time in the Manuals. Franchisee and its employees shall handle all customer complaints in a manner that will not detract from the name and goodwill of Franchisor. Franchisee shall be solely responsible for all employment decisions and functions of the Franchised Business, including, without limitation, those related to hiring, firing, training, wage and hour requirements, record-keeping, supervision, and discipline of employees.
- 11.7 Franchisee shall not implement any change, amendment, or improvement to the System without the prior written consent of Franchisor.
- 11.8 Franchisee shall comply with all terms of its lease or sublease, and all other agreements affecting the operation of the Franchised Business.

12. ACCOUNTING, RECORDS, AND REPORTS

This section is also very important to the franchisor because it allows the franchisor to monitor sales by the franchisee. This allows the franchisor to monitor the usage of the Franchised Business, as well as the gross sales of the franchisee, and, consequently, the monthly royalty payments to the franchisor.

- 12.1 Franchisee shall maintain accurate records of all Gross Sales, sales tax, and other charges collected on behalf of customers in accordance with the procedures prescribed in the Manuals.
- 12.2 Franchisee shall, at Franchisee's expense, submit to Franchisor in the form prescribed by Franchisor, the following reports:
- 12.2.1 No later than the _____ (__) day of each month, a report accurately reflecting all Gross Sales during the preceding calendar month;
- 12.2.2 Within _____ (__) days after each calendar quarter a copy of the quarterly tax reports submitted to the Kazakhstan tax authorities [municipal and State].

This section requires the franchisee to submit to the franchisor copies of the quarterly tax report. As part of its ongoing assistance, the franchisor might assist the franchisee in filling out these tax reports, which apparently are extremely complicated. Of course this means that the franchisor will have close contact with

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the financial records of the franchisee, which might be met with resistance from the franchisee in an effort to keep their financial business secret. Similarly, the right of the franchisor in Section 13.3 to examine the books and records and accounts of franchisee might also be met with resistance from franchisees. In the event the franchisor audits the books and records, and discovers an underpayment, we have included a penalty equal to 5% interest per day similarly to the overdue payment fee in the monthly payment section discussed previously.

12.2.3 Within ninety (90) days after the end of each fiscal year of Franchisee, audited financial statements prepared by an independent certified public accountant approved by Franchisor, showing the results of operations of the Franchised Business during such fiscal year; and

12.2.4 Such other reports, records, and information Franchisor may request.

12.3 Franchisor shall have the right at all reasonable times to examine and copy, at Franchisor's expense, the books, records, accounts, and tax returns of Franchisee. Franchisor shall also have the right to have an independent audit made of the books of Franchisee. If an inspection should reveal that any payments have been understated in any report to Franchisor, then Franchisee shall immediately pay to Franchisor the amount understated upon demand, in addition to interest from the date such amount was due until paid, at the rate of five percent (5%) per day, or the maximum rate permitted by law, whichever is higher.

If an inspection discloses an understatement in any report of ____ percent (____%) or more, Franchisee shall, in addition to repayment of moneys owed with interest, reimburse Franchisor for any and all expenses connected with the inspection (including, without limitation, travel, lodging, wages, and reasonable accounting and legal costs). The foregoing remedies shall be in addition to any other remedies Franchisor may have.

13. INSURANCE

13.1 Prior to opening the Franchised Business, Franchisee shall procure maintain in full force and effect at all times during the term of this Agreement, at Franchisee's expense, an insurance policy or policies protecting Franchisee and Franchisor, against any demand or claim with respect to personal injury, death, or property damage, or any loss, liability, or expense whatsoever arising or occurring upon or in connection with the Franchised Business. Such policy or policies shall be written by a responsible carrier or carriers acceptable to Franchisor, shall name Franchisor as an additional insured as specified by Franchisor, and shall provide at least the types and minimum amounts of coverage specified in the Manuals.

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13.2 Prior to the commencement of any operations under this Agreement, and thereafter at least thirty (30) days prior to the expiration of any policy, Franchisee shall deliver to Franchisor certificates of insurance evidencing the required types and minimum amounts of coverage. All certificates shall expressly provide that no less than thirty (30) days' prior written notice shall be given Franchisor in the event of material alteration to or cancellation of the coverages evidenced by such Certificates.

The insurance requirements are self-explanatory. The extent to which such insurance is available in Kazakhstan, however, must be determined by the franchisor.

14. TRANSFER OF INTEREST

In Kazakhstan the franchisor/franchisee relationship is likely to be much closer than it is in the U.S. Because the business climate is so difficult, franchisor and franchisees are struggling to make their systems work, which requires close cooperation. It follows that the franchisor will not want franchisees to sell their franchised businesses to unknown parties, without the permission of the franchisor. This section describes the terms on which the franchisor will approve a transferee of the franchise. It might be more complex than Kazakhstan entrepreneurs are used to at this time; however, we feel that the provisions are essentially clear and justified, particularly because the franchisor wants to ensure that its franchisees are reputable businessmen.

14.1 Franchisor shall have the right to transfer or assign this Agreement and any or all of its rights and/or obligations herein to any person or legal entity.

14.2 Franchisee shall not sell, assign, transfer, convey, pledge, encumber, merge, or give (collectively, "transfer") away any direct or indirect interest in this Agreement, the Trademark License Agreement, in Franchisee, or in all or substantially all of the assets of the Franchised Business, without the prior written consent of Franchisor. Any purported assignment or transfer not having the written consent of Franchisor required by this Section 14 shall be null and void and shall constitute a material breach of this Agreement, for which Franchisor may immediately terminate this Agreement without opportunity to cure.

14.3 Franchisee shall notify Franchisor in writing of any proposed transfer of any interest in this Agreement, the Trademark License Agreement, in Franchisee, or in all or substantially all of the assets of the Franchised Business (including the premises) at least thirty (30) days before agreeing to the transfer. Franchisor shall not unreasonably withhold its consent to any transfer; provided, however, that Franchisor may, in its sole discretion, require any or all of the following as conditions of its approval:

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14.3.1 that all of Franchisee's accrued monetary obligations and all other outstanding obligations to Franchisor have been satisfied;

14.3.2 that Franchisee is not in default of any provision of this Agreement, the Trademark License Agreement, or any other agreement between Franchisee and Franchisor or any affiliate of Franchisor;

14.3.3 that Franchisor and the Franchisee execute a mutual general release, satisfactory to Franchisor;

14.3.4 that the transferee enter into a written assignment satisfactory to Franchisor, assuming and agreeing to discharge all of Franchisee's obligations under this Agreement; and, if the obligations of Franchisee were guaranteed by the transferor, that the transferee guarantee the performance of all such obligations in writing in a form satisfactory to Franchisor;

14.3.5 that the transferee demonstrate to Franchisor's satisfaction that it meets Franchisor's educational, managerial, and business standards; possesses a good moral character, business reputation, and credit rating; has the aptitude and ability to operate the Franchised Business (as may be evidenced by prior related business experience or otherwise), and has adequate financial resources and capital to operate the Franchised Business;

14.3.6 that the transferee execute, for a term ending on the expiration date of this Agreement, the then-current form of franchise agreement, which agreement shall supersede this Agreement in all respects;

14.3.7 that the transferee, at its expense, refurbish the Franchised Business premises to conform to Franchisor's then-current standards and specifications, and complete the refurbishing and other requirements within the time specified by Franchisor;

14.3.8 that Franchisee remain liable for all of the obligations to Franchisor in connection with the Franchised Business which arose prior to the effective date of the transfer and execute any and all instruments reasonably requested by Franchisor to evidence such liability;

14.3.9 that the transferee, and the transferee's manager, at the transferee's expense, complete any training programs then in effect for franchisees and managers upon such terms and conditions as Franchisor may reasonably require;

14.3.10 that Franchisee pay a transfer fee of the Kazakhstan Tenge equivalent of _____ U.S. Dollars (U.S. \$ _____). However, in the case of a transfer to a corporation formed by Franchisee for the convenience of ownership, no such transfer fee shall be required.

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- 14.4 If any party holding any interest in this Agreement, in Franchisee, or in all or substantially all of the assets of the Franchised Business desires to accept any bona fide offer from a third party to purchase such interest, Franchisee shall notify Franchisor, and shall provide such information and documentation relating to the offer as Franchisor may require. Franchisor shall have the right and option, valid within thirty (30) days after receipt of such written notification, to send written notice to the seller that Franchisor intends to purchase the seller's interest on the same terms and conditions offered by the third party. In the event Franchisor fails to exercise this right within such thirty (30) day period or according to the terms of such offer, Franchisee may sell to such third party, but only on the terms specified in the seller's original offer.
- 14.5 Upon the death or mental incapacity of any person with an interest in this Agreement, in Franchisee, or in all or substantially all of the assets of the Franchised Business, the executor, administrator, or personal representative of such person shall transfer such interest to a third party approved by Franchisor within six (6) months after such death or mental incapacity. Such transfers, including, without limitation, transfers by devise or inheritance, shall be subject to the same conditions as any inter vivos transfer. In the case of transfer by devise or inheritance, if the heirs or beneficiaries of any such person are unable to meet the conditions in this Section 14, the executor, administrator, or personal representative of the decedent shall transfer the decedent's interest to another party approved by Franchisor within a reasonable time, which disposition shall be subject to all the terms and conditions for transfers contained in this Agreement. If the interest is not disposed of within a reasonable time, Franchisor may terminate this Agreement, pursuant to Section 15.1.8 hereof.
- 14.6 Franchisor's consent to transfer any interest in this Agreement, in Franchisee, or in all or substantially all of the assets of the Franchised Business shall not constitute a waiver of any claims it may have against the Franchisee, nor shall it be deemed a waiver of Franchisor's right to demand exact compliance with any of the terms of this Agreement by the Franchisee or transferee.

15. DEFAULT AND TERMINATION

This paragraph is important in that it sets out what is a default by franchisee. Again, these provisions are commonly found in U.S. franchise agreements. In Kazakhstan legal relations between the two parties of a bargain are determined with the General Provisions of the Civil Code. However it does not describe any precedent of recognizing a deal invalid due to default of any of the two parties so it is unclear how they would be interpreted by a Kazakhstan court. In other respects liabilities are determined in Articles 271-274 and 277 of the Civil Code. The franchisor's counsel should advise on these provisions.

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15.1 The following are events of default, upon which Franchisor may, at its option, terminate this Agreement without affording Franchisee any opportunity to cure the default:

15.1.1 If Franchisee fails to locate an approved site or to construct and open the Franchised Business within the time limits provided in Section 7;

15.1.2 If Franchisee or Franchisee's manager fails to complete the initial training program described in Section 8 to Franchisor's satisfaction;

15.1.3 If franchisee discloses any confidential information, know how, or trade secrets in violation of Section 9 hereof;

15.1.4 If Franchisee at any time ceases to operate or otherwise abandons the Franchised Business, or otherwise forfeits the right to do or transact business in _____, or otherwise fails to obtain and maintain all permits and authorizations or fails to satisfy and other similar requirements for operating the Franchised Business.

15.1.5 If Franchisee, through its own fault, loses its right to remain at the Franchised Business premises.

15.1.6 If Franchisee is convicted of a crime resulting in punishment of two (2) or more years in jail, or any other crime or offense that Franchisor believes is likely to have an adverse effect on the System, the Proprietary Marks, the goodwill associated therewith, or Franchisor;

15.1.7 If any purported assignment or transfer of any interest in this Agreement, the Trademark License Agreement, in Franchisee, or in all or substantially all of the assets of the Franchised Business is made to any third party without Franchisor's prior written consent;

15.1.8 If an approved transfer is not effected within the time provided following death or mental incapacity, as required by Section 15.4 hereof;

15.1.9 If Franchisee fails to comply with the covenants herein or fails to obtain execution of the covenants required herein;

15.1.10 If, contrary to the terms of Section 9 hereof, Franchisee discloses or divulges the contents of the Manuals or other confidential information;

15.1.11 If Franchisee knowingly maintains false books or records, or submits any false reports to Franchisor; or

15.1.12 If Franchisee misuses or makes any unauthorized use of the Proprietary Marks or any other identifying characteristics of the System, or otherwise materially impairs the goodwill associated therewith or Franchisor's rights therein.

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15.1.13 If the Trademark License Agreement is terminated.

15.2 Upon any other default by Franchisee, Franchisee may avoid termination by immediately initiating a remedy to cure such default, to Franchisor's satisfaction, and by promptly providing proof thereof to Franchisor within thirty (30) days. If any such default is not cured within the specified time or if Franchisee, after curing a default, commits the same default again, whether or not cured after notice, this Agreement may be terminated without further notice to Franchisee.

16. OBLIGATIONS UPON TERMINATION OR EXPIRATION

This is also very important because it describes what happens when the agreement is terminated or expires. Review by local Kazakhstan counsel of all of the provisions herein is crucial to the franchisor's rights. It is important to the franchisor that the franchisee immediately stop using the system and return to the franchisor the manuals. The franchisor would then take possession of the sign and anything else using the trademarks.

Upon termination or expiration of this Agreement, all rights granted hereunder to Franchisee shall terminate, and:

16.1 Franchisee shall immediately cease to operate the Franchised Business;

16.2 Franchisee shall immediately return the Manuals to Franchisor, cease to use the confidential information associated with the System, the Proprietary Mark " " and all other symbols associated with the System, specifically any articles which display the Proprietary Mark;

16.3 Franchisee shall, at Franchisor's option, assign to Franchisor any interest which Franchisee has in any lease or sublease for the premises of the Franchised Business. In the event Franchisor does not elect to exercise its option to acquire the lease or sublease for the premises of the Franchised Business, Franchisee shall modify the Franchised Business premises to distinguish it from a Franchised Business, and shall make such specific additional changes thereto as Franchisor may reasonably request for that purpose. In the event Franchisee fails or refuses to comply with these requirements, Franchisor shall have the right to enter upon the Franchised Business premises, without being guilty of trespass or any other tort, for the purpose of making or causing to be made such changes as may be required, at the expense of Franchisee, which expense Franchisee agrees to pay upon demand.

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- 16.4 Franchisee agrees, in the event it operates any other business, not to use any reproduction or colorable imitation of the Proprietary Marks, which, in Franchisor's sole discretion, is likely to cause confusion or dilute Franchisor's rights in and to the Proprietary Marks.
- 16.5 Franchisee shall promptly pay all sums owing to Franchisor. In the event of termination for any default of Franchisee, such sums shall include all damages, costs, and expenses, including reasonable attorneys' fees, incurred by Franchisor as a result of the default, which obligation shall give rise to and remain, until paid-in-full, a lien in favor of Franchisor against any and all of the equipment, or furniture, owned by Franchisee and on the premises operated hereunder at the time of default.
- 16.6 Franchisee shall immediately deliver to Franchisor the Manuals and all other records, correspondence, forms, and instructions containing confidential information relating to the operation of the Franchised Business (and any copies thereof, even if such copies were made in violation of this Agreement).
- 16.7 Franchisor shall have the option, to be exercised within thirty (30) days after termination, to purchase from Franchisee any or all of the furnishings, equipment, and fixtures related to Franchised Business at fair market value (on an on-going concern basis), and to purchase any or all supplies and inventory of the Franchised Business at Franchisee's cost. If the parties cannot agree on the price of any such items within a reasonable time, an independent appraisal shall be conducted at Franchisor's expense, and the appraisers shall set the price. If Franchisor elects to exercise any such option to purchase, it shall have the right to set off all amounts due from Franchisee, if any, against any payment therefore.

This section is also important for the Russian language context. It states that, upon termination of the agreement, the franchisor shall have the option to purchase from the franchisee any of the furnishings and equipment. The franchisor would like to take possession of the equipment, however it is unclear whether or not by law they can require that franchisee sell the equipment to the franchisor if the franchisee has already purchased the equipment. This provision is also directly related to the non-competition covenant found in Section 17.1, which prohibits the franchisee from operating a business for two years after the termination or expiration of the agreement. While it appears that such a covenant during the term of the agreement might be acceptable, it is not clear whether the two-year limitation after the end of the agreement would be enforceable. The franchisor's counsel should advise.

16.8 Franchisee shall comply with the covenants contained herein.

16.9 The Trademark License Agreement shall immediately terminate.

17. COVENANTS

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Franchisee covenants that, during the term of this Agreement, except as otherwise approved in writing by Franchisor, Franchisee or Franchisee's fully-trained manager shall devote full time and best efforts to the management and operation of the Franchised Business.

17.1 Franchisee shall not, during the term of this Agreement or for a continuous uninterrupted period of two (2) years commencing upon the transfer, expiration, or termination of this Agreement, own, operate, or have any interest in any business that offers services that are similar to the services offered by the Franchised Business.

As mentioned above, it is not clear whether a court would enforce the prohibition against a franchisee's remaining in the same business after the termination of the franchise agreement. The Civil Code appears to be silent on this issue. Therefore, local counsel should advise.

17.2 Franchisee expressly agrees that the existence of any claims it may have against Franchisor, whether or not arising from this Agreement, shall not constitute a defense to the enforcement by Franchisor of the covenants in this Section 17. Franchisee agrees to pay all costs and expenses (including reasonable attorneys' fees) incurred by Franchisor in connection with the enforcement of this Section 17.

17.3 At Franchisor's request, Franchisee shall obtain and furnish to Franchisor executed covenants similar in substance to those set forth in this Section 17 (including covenants applicable upon the termination of a person's relationship with Franchisee and the provisions of Section 14 of this Agreement as modified to apply to an individual) from all managers of Franchisee. Every covenant required by this Section 17 shall be in a form approved by Franchisor, including, without limitation, specific identification of Franchisor as a third party beneficiary of such covenants with the independent right to enforce them.

17.4 In the event Franchisee breaches this Section 17, and in the absence of any specific performance, Franchisee shall pay to Franchisor the equivalent in Kazakhstan Tenge of _____ U.S. Dollars (U.S. \$ __) in recognition of the damage of the System and Franchisor caused by such breach.

18. TAXES, PERMITS, AND INDEBTEDNESS

18.1 Franchisee shall promptly pay when due all taxes and other indebtedness incurred by Franchisee in the operation of the Franchised Business, including any taxes or indebtedness related to this Agreement or the Trademark License Agreement.

18.2 Franchisee shall comply with all State, municipal, and other laws and regulations, and shall timely obtain any and all permits, certificates, or licenses necessary for the operation of the Franchised Business.

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18.3 Franchisee shall immediately notify Franchisor in writing of the commencement of any action or proceeding, and of the issuance of any order or decree of any court or other governmental instrumentality, which may adversely affect the operation or financial condition of the Franchised Business.

19. INDEPENDENT CONTRACTOR AND INDEMNIFICATION

19.1 Franchisee acknowledges that, under this Agreement, both parties are independent, and that this Agreement is not intended to and shall not create a fiduciary relationship between Franchisee and Franchisor, and that nothing in this Agreement is intended to constitute either party an agent, legal representative, subsidiary, joint venture, partner, employee, or servant of the other for any purpose whatsoever.

This is potentially an extremely sensitive point for franchisors. The purpose of this section is distinguish the individual identities of franchisee and franchisor, particularly with regard to any liability incurred by franchisees. The acknowledgment that the relationship is solely contractual protects the franchisor from assuming any liabilities of the franchisee. However, it is not clear whether this acknowledgment will be enforced in Kazakhstan. The franchisor's counsel should advise.

19.2 Nothing in this Agreement authorizes Franchisee to make any contract, agreement, or representation on Franchisor's behalf, or to incur any debt or other obligation in Franchisor's name; and Franchisor shall in no event assume liability for, or be deemed liable hereunder as a result of, any such action; nor shall Franchisor be liable by reason of any act or omission of Franchisee in its operation of the Franchised Business or for any claim or judgment arising therefrom against Franchisee or Franchisor.

Franchisee shall indemnify and hold Franchisor, and Franchisor's officers, directors, employees, and affiliates harmless against any and all claims, losses, costs, expenses, liabilities, and damages arising directly or indirectly from, as a result of, or in connection with Franchisee's operation of the Franchised Business, as well as the costs, including attorneys' fees, of the indemnified party in defending against them.

20. APPROVALS AND WAIVERS

This section allows the franchisor to choose not to enforce certain provisions of the franchise agreement. This allows the franchisor to excuse minor transgressions of the agreement, while still preserving its right to maintain control of more significant aspects. In Kazakhstan such a clause is useful, in that franchisors will have to adapt to

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the complexity and unpredictable nature of the Kazakhstan business climate. Of course, as in the U.S., continuous waiver of the right to enforce any particular contract provision may establish a course of dealing between the parties which would override the franchisor's right to enforce such provision.

20.1 Whenever this Agreement requires the prior approval or consent of Franchisor, Franchisee shall make a timely written request to Franchisor therefore, and such approval or consent must be obtained in writing.

20.2 No failure of Franchisor to insist upon strict compliance by Franchisee with any obligation or condition hereunder shall constitute a waiver of Franchisor's right to demand exact compliance with any of the terms hereof. Waiver by Franchisor of any particular default of Franchisee shall not affect or impair Franchisor's rights with respect to any subsequent default of the same nature; nor shall any delay or omission of Franchisor to exercise any right arising out of any breach by Franchisee of any of the terms or covenants hereof, affect or impair Franchisor's right to exercise the same. Subsequent acceptance by Franchisor of any payments due to it hereunder shall not be deemed to be a waiver by Franchisor of any preceding breach by Franchisee of any terms or conditions of this Agreement.

21. GRANT OF SECURITY INTEREST

As security for the payment of all amounts owed by Franchisee to Franchisor under this Agreement and all other agreements between the parties, Franchisee hereby grants to Franchisor a security interest in all of the assets of Franchisee, including, without limitation, all equipment, furniture, fixtures, and buildings, as well as all proceeds of the foregoing (the "Collateral"). Franchisee and Franchisor shall enter into a separate security agreement adequate to memorialize such security interest. Franchisee warrants and represents that the security interest granted hereby is prior to all other security interests in the Collateral. Franchisee agrees not to remove the Collateral, or any portion thereof, from the Franchised Business without the prior written consent of Franchisor. Upon the occurrence of any event entitling Franchisor to terminate this Agreement or any other agreement between the parties, Franchisor shall have all the rights and remedies of a secured party under the Civil Code of Kazakhstan (Article 3, "Collateral", the Kazakhstan Law of Pledge dated December 23, 1991, the Kazakhstan Law of Mortgage and any other laws concerning security interests, including, without limitation, the right to take possession of the Collateral. According to Article 8 of the Pledge Law foreign legal entities exercise the same rights and bear the same covenants that Kazakhstan legal entities and natural persons. Franchisee agrees to execute and deliver to Franchisor financing statements or such other documents as Franchisor reasonably deems necessary to perfect Franchisor's interest in the Collateral within ten (10) days of receipt by Franchisee of such documents from Franchisor. Any notices delivered or mailed in accordance with Section 22 hereof at least five (5) days prior to disposition of the Collateral, or any portion thereof, and, in reference to a private sale, need state only that Franchisee intends to negotiate such a sale.

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This section allows the franchisor to take a security interest in the franchisee's property, so that in the event the franchisee fails to pay, the franchisor can take possession of the property.

22. NOTICES

All notices required under this Agreement and the Trademark License Agreement shall be in writing and shall be personally delivered or sent to the respective parties at the following addresses, unless and until a different address has been designated by written notice to the other party:

Notices to Franchisor:

Notices to Franchisee:

23. ENTIRE AGREEMENT

This Agreement, any attachments hereto, and the documents referred to herein, constitute the entire Agreement between Franchisor and Franchisee concerning the Franchised Business, and supersede any prior agreements. Except for those permitted to be made unilaterally by Franchisor hereunder, no amendment or change from this Agreement shall be binding on either party unless mutually agreed to by the parties and executed by their authorized officers or agents in writing.

24. SEVERABILITY AND CONSTRUCTION

24.1 Any provision in this Agreement which imposes obligations beyond the expiration, termination or assignment of this Agreement shall survive the expiration, termination, or assignment of this Agreement.

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- 24.2 If, for any reason, any provision of this Agreement or the Trademark License Agreement is determined to be invalid or contrary to any existing or future law or regulation, the other provisions of such Agreement shall remain valid and shall continue to bind the parties hereto. Such invalid provisions shall be reduced to the maximum validity under the law, or be deemed not to be a part of such Agreement. If any such invalid provision is considered by Franchisor to be material to such Agreement, Franchisor and Franchisee shall re-negotiate such provision in good faith. If the parties cannot agree on an alternative to such provision, the parties may agree that this Agreement and the Trademark License Agreement shall terminate without penalty to either party.
- 24.3 If, at any time during the term of this Agreement, any government or agency thereof should require, directly or indirectly, alteration or modification of any term or condition of this Agreement or the Trademark License Agreement, or of the performance of the parties hereunder, Franchisor and Franchisee agree to use their best efforts to comply with such request. If any such invalid provision is considered by Franchisor to be material to this Agreement or the Trademark License Agreement, Franchisor and Franchisee shall re-negotiate such provision in good faith. If the parties cannot agree on an alternative to such provision, the parties may agree that this Agreement and the Trademark License Agreement shall terminate without penalty to either party.

Sections 23 and 24 limit the contents of the arrangement between franchisee and franchisor to the franchise agreement, excluding any prior discussions or promises. Section 25 is of particular importance to the Kazakhstan market. It states that if one provision is found to be invalid then the rest of the agreement will remain valid. Its converse is also included: that if any government agency requires any modification of the agreement, then the parties will attempt to re-negotiate or terminate the Agreement.

25. APPLICABLE LAW

- 25.1 This Agreement shall be interpreted and construed exclusively under the laws of the Republic of Kazakhstan. In the event of a discrepancy between the English and Russian versions of this Agreement, the Russian version shall control. The language of this Agreement shall be Russian.
- 25.2 Any action (whether or not arising out of this Agreement) brought by either party shall be brought in the Kazakhstan arbitration/civil court in _____, except to extent other courts have sole jurisdiction of other courts.

Because this agreement is intended to be between a Kazakhstan franchisor and a Kazakhstan franchisee, the laws of the Republic of Kazakhstan will govern. It is not

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clear whether the Kazakhstan arbitration court or the civil court would be the best forum for disputes under this agreement. Local counsel should advise on this choice of court.

25.3 No right or remedy conferred to Franchisor or Franchisee by this Agreement is intended to be, nor shall be deemed, exclusive of any other right or remedy herein or by law provided or permitted, but each shall be cumulative of every other right or remedy.

25.4 Nothing herein contained shall bar Franchisor's right to obtain injunctive relief against threatened conduct that will cause it loss or damage.

25.5 Franchisee shall pay to Franchisor all damages, costs, and expenses, including all court costs, and reasonable attorney's fees, incurred by Franchisor in successfully enforcing any provision of this Agreement, including, but not limited to the obtaining of injunctive relief.

26. GOVERNMENT APPROVALS

26.1 Franchisor shall obtain all approvals, consents, permits and licenses necessary for to enter into, make enforceable the terms of, or to perform under, this Agreement from all governmental, fiscal, and/or other proper authorities which are required by the applicable laws and regulations of Kazakhstan. In obtaining any such approval, consent, permit or license, Franchisee shall assist Franchisor, as requested in responding to any inquiry in writing to any governmental or other proper authority. In the event such approvals are not obtained within _____ (____) days after the date of this Agreement, Franchisor may terminate this Agreement without penalty, and may return _____ percent (____%) of the initial franchise fee that was paid pursuant to Section 2.3 hereof.

IN WITNESS WHEREOF, the parties hereto have duly executed this Agreement in duplicate on the date first above written.

FRANCHISEE

FRANCHISOR

By: _____

By: _____

Name: _____

Name: _____

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Title: _____

Title: _____

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Sample Trade Mark License Agreement

In accordance with the Patent Law of the Republic of Kazakhstan (Cl. 4 of Article 9 and Cl. 2 of Article 14) and the Law on Trademarks, Service Marks and Designation Of A Place Of Product Origin (Cl. S, Article 26, and on the grounds of the Regulation on the National Patent Office under the Cabinet of Ministers of the Republic of Kazakhstan dated October 16, 1992 # 877 (Cl. 4, paragraph 7), agreements on transfer of rights for a preliminary patent, a patent or a certificate for an object of industrial property (inventions, useful models, etc.), license agreements on the right to use objects of industrial property and know-how, to provide engineering services and option agreements (hereinafter referred to as "Agreements" are subject to registration in KAZPATENT.

An agreement on transfer of rights for a preliminary patent, a patent or a certificate for an object of industrial property is executed after the issuance of these documents by KAZPATENT prior to expire date of a preliminary patent or certificate. An agreement comes into force from the moment of its registration. Registration of an agreement can be rejected in case any discrepancies of an agreement to the current law and international agreements are revealed. Registration fee is paid in the amount of one minimal wage. Foreign natural persons and legal entities - non-residents of the Republic of Kazakhstan - pay a fee in hard currency making a transfer to a currency account, specified by KAZPATENT.

The following documents are attached to an application on registration of an agreement:

1. An agreement with Appendix # 1 "List of patents and other authorizing documents" (if available), submitted by an applicant(s) in Kazakh or Russian in 3 copies; each page of an agreement must be signed by both parties;
2. Permit from the Ministry of Foreign Trade Relations of the Republic of Kazakhstan for export-import activities of objects of industrial property;
3. Original copies of preliminary patents, patents or certificates for objects of industrial property.
4. A receipt of a state registration fee paid.

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Listed documents are delivered to the Licensing Department, KAZPATENT, 92 Maulenov St., 480091, Almaty, Kazakhstan.

Clerical work, connected with the registration, is carried out with an applicant, located in the territory of the Republic of Kazakhstan.

A foreign applicant can appoint a representative, located in the territory of Kazakhstan. In this case an application is followed with a Power of Attorney for accomplishing registration procedure.

In the following 15 days after submitting an application for registration the Department conducts a formal examination in order to check availability of all required documents and their compliance with the requirements of an application.

If any violation of requirements to an applicant's documents is revealed an inquiry, offering to submit the missing or corrected documents within 2 months from the moment of receipt, is made.

If an applicant does not introduce necessary amendments in due date KAZPATENT passes a decision to reject to take up an application for consideration.

In accordance with an application, accepted or consideration, KAZPATENT during a one month period will:

- carry out an examination of the subject matter of an agreement, during which KAZPATENT is entitled to inquire for advisory actions on specific issues from other competent state bodies. Examination term in this case is extended but no more than for 2 months. If any conditions, impeding registration of an agreement, are found out, an applicant must submit corrections within to months from the notice date;
- keep track of the registered agreements so that in case of necessity any person can obtain an extract from an agreement upon the written permit of both parties;
- forwards a decision on registration and two copies of an agreement to an applicant's address. The third copy, kept in KAZPATENT, is a checking copy. Any unregistered amendments in the text of an agreement are considered invalid.

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The Licensing Department of KAZPATENT is obligated to keep all data and terms of agreement under registration confidential. General information, meant for open publication, is an exclusion.

This trademark license agreement is intended to be a sample standard legal agreements, containing conditions and terms, accepted in the Republic of Kazakhstan.

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Sale/Purchase of an Exclusive Trade Mark License Agreement

(Full name, address and phone # of an applicant - a natural person or legal entity),

in the person of _____
(full name and position of an authorized agent),
who acts on the basis of the _____ [organizing documents],
hereinafter referred to as "Licensor", on the one hand,
and

(Full name, address and phone # of an applicant - a natural person or legal entity),

in the person of _____
(full name and position of an authorized agent),
who acts on the basis of the _____ [organizing documents],
hereinafter referred to as "Licensee", on the other hand, taking into account that:

1. Licensor has the exclusive trademark right (Certificate of the Republic of Kazakhstan # _____ by application # _____ dated _____ for _____
(list of products and services, for which the specified trademark is registered);
2. Licensor intends to purchase an foregoing trademark license under the terms of n agreement;
3. Licensor declares that the issuance of this license will not mean violation of the third parties' rights.

agree as follows:

1. SUBJECT OF AN AGREEMENT

1.1 Licensor licenses Licensee on an exclusive basis for the term of validity of an agreement and for a remuneration, paid by Licensee, to use a trademark, developed in accordance with the foregoing certificate of the Republic of Kazakhstan for the purpose of designating produced and/or distributed products (include the exact list of products or refer to a product list in the Certificate) or services _____ (list of services).

1.2 Licensee has the right to designate manufactured and/or distributed products or services in accordance with the Product/Service List (refer to Cl. 1.1.) with the foregoing trademark, stating it is a "licensed trademark".

* Should Licensor or Licensee be a legal entity

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- 1.3 Licensee has the right to use the foregoing trademark equally with its own trademark.
- 1.4 Licensee has the right to use the foregoing trademark both on product and its packaging and in accompanying documents and advertising.
- 1.5 Licensee commits itself to use a trademark in the same style it was registered with the foregoing trademark certificate. Licensee can not alter a trademark.
- 1.6 Licensee has the right to use the foregoing trademark and sub-license it upon the condition that quality of products(services), designated with this trademark, produced (provided) by Licensee or Sub-Licensee, will be no worse than quality of products(services), produced (provided) by Licensor under the same trademark. Technical and quality indexes are listed in Appendix 3.

2. PROTECTION OF TRANSFERRED RIGHTS

- 2.1. During the term of validity of this agreement Licensor acknowledges and will acknowledge validity of rights, arising from the foregoing trademark certificate, with respect to all products and/or services specified.
- 2.2. Should Licensor take a decision not to extend term of validity of the foregoing trademark certificate, it will well in advance give Licensee an appropriate notice and then the parties will settle their relations, arising from this Agreement, in the following manner:
_____.
- 2.3. Should Licensee will become aware of the unlawful use of the foregoing trademark by the third party he is obligated to notify Licensor immediately.
- 2.4. Should the third party violate the rights, granted to Licensee by this agreement, Licensor and Licensee will take common measures in order to discontinue such infringements. Expenses and/or earnings, incurred or obtained in the result of a decision of the court or arbitration award, will be split between Licensor and Licensee as agreed.
- 2.5. Should Licensee be charged with a claim or suit due to the violation of the third party's right to use a trademark license the basis of this Agreement, Licensee will notify Licensor about it.

In this case Licensee is obligated to settle such claims or take other measures, eliminating possible expenses or losses for Licensee.

3. QUALITY INSPECTION

- 3.1 Licensor has the right _____ times a year to check quality of products, manufactured by Licensee, for conformity of technical and quality indexes (refer to Appendix 3 of this Agreement).
- 3.2 Quality inspection may be conducted at Licensee's franchise units with the consent of the latter or in the order, established by a separate protocol to this agreement.

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4. LIABILITIES OF THE PARTIES

- 4.1 Should Licensee designate products with the trademark and quality of these products does not conform to the requirements of this agreement, he will take all possible measures to revive required quality. Licensor will give Licensee possible assistance.
- 4.2 Licensee is granted a term of _____ to revive product quality.
- 4.3 Should quality of a product, manufactured by Licensee, not be revived within the specified term (refer to Cl. 4.2. of this agreement), Licensor has the right to cancel this agreement and claim compensation for losses.
- 4.4. Upon expire of the term of validity of this agreement or in case of its cancellation in accordance with Cl. 4.2. Licensee forfeits the right to use the foregoing trademark in any form.

5. SETTLEMENT PROCEDURE

- 5.1 Licensee is obligated to pay Licensor a royalty fee for the rights, granted by this agreement, in the form of regular payment in accordance with the calculation, attached to this agreement.
- 5.2 Licensee commits itself to do these payments during complete term of validity of this agreement by money transfers to Licensor's banking account.

6. SETTLEMENT OF DISPUTES

- 6.1 Should any disputes or disagreements arise between Licensor and Licensee with respect to the issues, connected with the execution of this agreement, both parties will do their best to settle them in a peaceful way.

If the parties can not come to an agreement disputes will be settled in the following manner:

_____.

7. TERM OF VALIDITY

- 7.1 This agreement is valid during _____ years and comes into force from the date of registration at the National Patent Office of the Republic of Kazakhstan.
- 7.2 This agreement may be extended by the mutual consent of both parties. In case term of validity of this agreement and the foregoing trademark certificate is the same parties will take a decision to extend a term of validity of this agreement by

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submitting in the established order of an extension application of the foregoing trademark certificate. Expenses, connected with the extension procedure, are distributed between both parties.

- 7.3. Parties will determine conditions for extension of this agreement 6 months prior to its expire date.
- 7.4 This agreement may be changed or canceled by mutual consent of the parties.

8. MISCELLANEOUS

- 8.1 This agreement is valid within the territory of the foregoing trademark certificate.
- 8.2 All amendments and alterations to this agreement must be in writing, signed by authorized agents and registered in the National Patent Office of the Republic of Kazakhstan.
- 8.3 Any conditions beyond the frames of this agreement are subject to the rules of the civil and formal laws.
- 8.4 All foregoing appendixes to this agreement, made in _____ pages, are its integral part.
- 8.5 This agreement was executed in _____ (name of the city).

LEGAL ADDRESSES OF THE PARTIES

Licensor

By: _____

Name: _____

Title: _____

Licensee

By: _____

Name: _____

Title: _____

Agreement on purchase/sale of the exclusive trademark license differs from the foregoing agreement, described in Article 1.6., which states that "Licensor reserves a right to use the foregoing trademark and sell non-exclusive licenses to the third parties". In addition to the right to use a trademark Cl. 1.7. of this agreement grants Licensee with the right to sub-license a trademark.

In those cases when for certain reasons it appears necessary to assign an existing franchise unit to the legal successors a franchise owner and its legal successor will execute the special trademark certificate assignment agreement. Address to KAZPATENT Law Service in order to obtain a form of this agreement, as well as consultations on relevant issues.

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Legal Issues related to Leasing for Franchises

Since leasing in Kazakhstan, including legal and financial issues, were in all details covered in Section 3 “Leasing in Kazakhstan”, in this section we bring to attention Russian experience in this area. Similarity of the legislative basis, level of economic development and difficulties of the transition period allow to compare the Russian experience of solving certain problems and introduce some aspects, successfully settled by the Russian legislative system to its Kazakhstan analogue. Every time, when your business may have legal problems of any nature, referring to this manual, address a local consultant or attorney offices.

Russian legal and judicial systems are evolving rapidly and often present the business person with a confusing array of State, regional and municipal laws, regulations, temporary regulations and edicts. Currently, equipment leasing transactions are governed by the Law of Pledge (1992), The Russian Civil Code Part I (10/1994) and recently promulgated Temporary Regulations on Leasing (7/1995). In addition, legislation has been introduced into the State Duma for The Russian Civil Code Part II in which Chapter 34 concerns leasing agreements. The Civil Code (Parts I and II) will govern the actual contracts entered into between a Lessee and a Lessor. In other words, the Civil Code will regulate *specific terms of lease agreements*, defining the parameters of the content of a contract. The Temporary Regulations on Leasing, which were promulgated into law in July, 1995, will regulate *leasing companies*, defining the types of activities they may conduct and how they will be treated by other institutional regulations (e.g. tax authorities). The Law of Pledge, which essentially governs the securing of financial loans with collateral, was often used by analogy for leasing arrangements prior to the advent of even draft leasing laws. As specific leasing laws are enacted, the Law of Pledge will be used to supplement the lease laws and further reduce the risk that Lessors face with regard to losing possession and/or ownership rights in leased property. How these three sets of laws are intended to, or will, interact is still evolving. The key issues of legal import between a Lessor and a Lessee are discussed in the following pages.

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Issue 1: Protection of Ownership Rights

(A) Bill of Sale The nature of the leasing relationship is that the Lessor retains ownership of the property, while the Lessee enjoys use of the property. Because the Lessor has invested the money to purchase the property being leased, and because the property will be out of the physical possession of the Lessor while it is being used by the Lessee, it is very important that the Lessor is, and remains, the owner of record for the leased property.

In Russia, Lessors prove their ownership of leased property by retaining the documents evidencing their purchase of the property. These may include the purchase agreement with the vendor or supplier, receipts and related shipping documents, or customs documents if the equipment is imported. Possession of these original documents grants to the Lessor the ownership rights in the property, which serves to protect the Lessor from the Lessee selling the leased property. In other words, without being able to produce the original ownership documents related to the leased property, a Lessee is likely to have a difficult time selling the equipment.

(B) Registration of Ownership Registration is essentially the recording in a public register of ownership rights to specific property. With regard to leased equipment, registration can facilitate proof of ownership of property through:

Demonstration of Lessor's Ownership Rights: Registration of a lease agreement provides additional protection of the Lessor's ownership rights in the leased property by putting the public on notice of the differing rights in the property. Article 4 of Chapter 34 of draft Civil Code Part II requires that leases for immovable property be registered in a central governmental registry. By registering the lease, the Lessor declares to the public the rights of each party with regard to the leased property (i.e., ownership vs. use). This provision is currently limited to immovable property (e.g., land and buildings), however, which means that leases for moveable property (such as equipment and vehicles) are not required yet to be registered.

Verification of Lease Agreements: Registration of signed leases also provides a verification mechanism in the event a dispute arises as to the content and/or validity of the lease agreement. By registering the actual signed lease, the parties agree that the registered lease is the actual document that will govern their leasing arrangement. Consequently, disputes over the authenticity of the signatories, dates, or terms can be decided by referring to the registered lease agreement. Article 4 of Chapter 34 of draft Civil Code Part II is not clear on exactly what has to be registered with regard to immovable property, i.e., the actual signed contract or the fact that a lease agreement was signed on a given date by two named parties.

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The benefits of registering the signed original contract include avoidance of fraud discussed above. The disadvantages, however, include the lack of confidentiality regarding the terms of the lease signed.

Use of Pledges: A pledge is the process by which a company (or individual) borrows money and uses certain property as collateral for the loan, meaning that the lender will obtain ownership of the property if the borrower does not fully repay the amount owed or does so in an untimely manner. The pledge can either be *possessory* (where the lender takes possession of the pledged property) or *non-possessory* (where the lender does not take possession of the pledged property). Pledges can be used, and sometimes are, to secure payment of lease payments under a lease contract and, indirectly, to protect against the Lessee's misappropriation or sale of the leased property.

The system of pledges is a bit more developed than leasing practices are in Russia, as they have been governed by the law of Pledge since 1992. There are three elements to the creation of both possessory and non-possessory pledges: a) a contract, b) notarization, and c) registration, if necessary. The contract must state the type of pledge, value of the pledged property, terms concerning the nature, value, form of payment, and time for performance of the obligation.

A pledge contract must be notarized in cases involving: land or buildings, mortgage of an enterprise, aircraft, railroad rolling stock, marine vessels, or if the pledge secures a contract, which itself must be notarized. The cost of notarization is typically 3% of the value of the contract.

Registration is necessary if the underlying property is subject to registration, such as an enterprise, land, buildings, and shares of stock. Failure to register a pledge agreement when required invalidates the pledge agreement. Currently, movable property, accounts receivable, inventory and equipment, such as tractors or office equipment, are *not* subject to the mandatory registration.

Collateral which is *not* subject to state-mandated registration must be recorded in a Pledge Notice Book, which the law requires each pledgor to maintain. The book must contain a list of the type and subject matter of all pledges in order to provide all interested parties with notice. The law does not specify who is considered an "interested party." Also, this system of notice raises the problem of not having a neutral party in possession of the pledge book, thereby increasing the risk of fraud and deception. In addition, without a central governmental registry, third parties are unable to determine the existence of any liens on the property.

The 1992 Law on Pledge inhibited secured lending by requiring that the lender go to court prior to retaking ownership of the pledged property. This process was time consuming and often to the detriment of the lender. The Russian Civil Code (Part I), which came into force on January 1, 1995, greatly liberated lenders from this constraint by allowing the pledge

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agreement to state that the pledgeholder (the lender) may assume ownership of the pledged property without having to obtain a court order first (Article 348).

The growth of leasing in Russia would be greatly assisted by a similar right for Lessors when they attempt to take back leased property, which is in the possession of a defaulted Lessees.

(C) Repossession of Leased Assets Obtaining leased property at the end of a lease (either due to expiration or termination) is critically important to Lessors. In the event a Lessee refuses to return the leased property, under current Russian law, the Lessor must first obtain a court order against the Lessee, as well as permission to go and retrieve the property with or without assistance from court marshals or local police. In general, there is little experience with this practice thus far, not only because there has been little experience with commercial leasing, but also because, at least up to now, few Lessees have resisted requests from Lessors that leased property be returned promptly.

When a Lessor cannot receive leased property back immediately upon expiration or termination of the lease, the next best course of action is to secure an injunction against the Lessee in order to prohibit the Lessee from using the property (e.g., equipment) until the court has enforced the return of the property to the Lessor. This is possible under U.S. law, but not apparently possible under the evolving Russian legal regime.

This power of injunction is important for Lessors, as it helps preserve the value of the property in question during the period that the Lessor is unable to realize revenue from it (i.e., while the lessee is not making lease payments). For leasing to become a viable financing option for Lessors, the law must include a right of the Lessor to seek an injunction against a Lessee in the event the outcome of a dispute is still pending, or in the event the Lessee has defaulted on its lease payments to a Lessor. As discussed above, the best solution for Lessors entitled to the return of leased property would be a "self-help" mechanism enabling the Lessor to repossess, in a peaceful and efficient way, leased property upon default or expiration of a lease.

(D) Protection Against Excessive Wear and Tear The Lessor can require under standard Russian lease contracts that the Lessee periodically upgrade and maintain the leased property. In addition, Article 11 of Chapter 34 (Civil Code Part II) states that, unless otherwise stipulated by the contract, the Lessor shall be obligated to make an overhaul repair of the leased property, unless provided otherwise by law, other legal acts or the contract. The overhaul repair must be performed in the period established by the lease contract, and, if not established by the contract, within a reasonable period.

The violation by the Lessor of its obligation to perform the overhaul repair entitles the Lessee either to perform the overhaul repair provided for by the contract (or caused by some urgent event) and to charge the Lessor for the cost of the repair, or consider it as a lease payment, or to demand the appropriate reduction of the lease payment, or the

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cancellation of the contract, and to charge the losses caused by its non-performance against lease installments due.

Article 11 of Chapter 34 also requires the Lessee to maintain the property in working conditions, perform routine repair at his expense, and pay charges for the maintenance of the property, unless provided otherwise by law or the contract.

(E) Improvements and Upgrades to Leased Assets Article 18 of Chapter 34 states that divisible improvements made by the Lessee with respect to the leased property shall belong to the Lessee, unless provided otherwise by the contract.

In the event the Lessee improved the leased property at its own expense, and with consent of the Lessor, and these improvements are not divisible without harming the property, and the Lessee shall have the right, after the termination of the contract, to be compensated for the cost of these improvements, insofar as not provided otherwise by the contract.

This allows the Lessor and the Lessee to negotiate how both divisible and indivisible improvements will be financed. This is an important right for the Lessor because determining the value of certain improvements, particularly indivisible ones, may be a difficult evaluation. Although not expressly stated in Chapter 34, it is possible that the Lessor may state in the lease contract that no improvements may be made to the property without the Lessor's permission. This would allow the Lessor to participate in the process of determining what improvements should be made, and at what reasonable cost. By maintaining such control over improvements to the property, the Lessor can avoid the risk that the cost of improvements made without its permission could offset any lease payments still remaining in the event of an early termination.

Legal Issues for Franchises in the Republic of Kazakhstan

Issue 2: Provisions Prohibited in Lease Contracts

Certain rights and responsibilities of Lessors are incorporated in the draft Civil Code Part II, Chapter 34, which will govern relations between a Lessor and a Lessee irrespective of terms and conditions of their lease contract. While Civil Code Part II has not yet become law in Russia, most observers expect that it will be enacted during 1995.

(A) Provision of property The Lessor is obligated to provide the Lessee with leased property either for interim possession and use, or use for the lease term against periodic lease payments. All revenues received by the Lessee as a result of use of the leased property shall belong to the Lessee (Article 1). If enacted, this provision could restrict a Lessor's right to claim earnings from or the products of the leased assets as potential additional security for extending credit to a Lessee.

(B) Obligation regarding condition The Lessor is obligated to provide the Lessee with the leased property in the condition corresponding to the terms of the contract and consistent with the specifications for such property (Article 6). While this provision is meant to offer protection to Lessees, it may encumber Lessors in cases where the Lessee makes frequent or substantial changes to the specifications of the leased property prior to its delivery.

(C) Defects / first issue The Lessor is liable for defects in the leased property that impede its proper use, even if the Lessor does not know about the defects when concluding the purchase contract. Upon discovering such defects, the Lessee has the right to demand from the Lessor that: 1) the defects be eliminated without compensation, 2) lease payments be proportionately reduced, 3) expenses caused by the elimination of the property defects be compensated, or 4) the contract be canceled early (Article 7).

(D) Defects / Second issue The Lessor is not liable for defects of the leased property that are stipulated when concluding the contract, or that were previously known by the Lessee, or should have been identified by the Lessee during inspection of the property or verification of its good order when concluding the contract or when transferring property into lease (Article 7). This provision seems somewhat ambiguous as to what and when the Lessee knows about the conditions of the leased assets. Hence, a dispute might arise easily between the Lessor and Lessee concerning whether defects in the equipment should be resolved using section (C) above (i.e. Lessor's responsibility) or this section (D) (i.e. Lessee's responsibility).

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Issue 3: Provisions in Lease Contracts Which Are to be Negotiated Case by Case

(A) The term or length of the lease agreement If the specific term of the lease has not been stipulated in the contract, it shall be deemed to have been concluded for an *indefinite* period (i.e. pure rental agreement). Each of the parties shall have the right to withdraw from the lease contract at any time by notification to the other party within one month for movable property and within three months for leasing immovable property. The law or the contract itself may stipulate another period for notification warning that the contract originally concluded for an indefinite period is to be terminated (Article 5).

(B) The nature and terms of payment by the Lessee Civil Code Part II, Chapter 34 gives great leeway in arranging for forms of payments, which can be beneficial to both parties in the currently fluctuating Russian context. Examples stated in the law of the kind of payments that can be contracted for are: 1) fixed amounts to be paid regularly or a lump sum; 2) an established share in the production or incomes received from the use of the leased property; 3) services rendered by the Lessee; 4) charging the Lessee for the expenses incurred in improving the leased property, as stipulated in the contract (Article 9).

(C) Acceleration of payments In the event of a substantial violation by the Lessee including late payment of lease installments, the Lessor can negotiate the right to demand that lease payments be made before the date and time specified in the lease. The Lessor may request in the lease agreement the right to demand accelerated payments but is limited under the law for no more than 2 subsequent periods (Article 9).