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## The legal nature of the franchise agreement (comparative-legal analysis)

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***Abstract:** The article analyses the scientific approaches to understanding the legal nature of the franchise agreement, focuses on clarifying its subject, form and content with reference to the experience of legal regulation of franchising relations in Ukraine and abroad (using individual countries of common and civil law as an example). Comparative analysis of the franchise agreement with related agreements are carried out, namely such as: a concession agreement, a license agreement, a joint activity agreement, an agency and investment agreement, and the characteristic features of the agreement are identified.*

***Keywords:** Franchising, Franchise agreement, Franchiser, Franchisee, Franchising relations.*

### INTRODUCTION

**A**s of today in the world there is a trend of cooperation between legal entities and individuals of different countries, the result of which often becomes the conclusion of various civil and economic agreements, such as purchase and sale, supply, concession, joint activities, agency services, investment, license agreements and the like. Such interest in cooperation is primarily associated with the internationalization of inter-economic relations, the active development of business partnerships, the existing migration processes, and the opening of one's own business. However, such cooperation may also entail risks of problems for participants in these relations, which primarily concern the following issues: a) the emergence of the need for continuous monitoring of the current state of the market for supply and demand; b) the search for effective ways to carry out activities in an aggressive competitive environment; c) the establishment of a production system, supply, separation of itself from competitors by creating its own "brand". Such circumstances significantly affect the results of conduct business and in many cases force owners to terminate or even liquidate. A practical solution to this problem can serve as a franchise agreement, which virtually eliminates all of the above obstacles to the implementation of effective business activities.

The study of the legal nature of the franchise agreement was devoted to works as foreign: Zh. Deltei, F. Kotler, Zh. Lamben, M. Mandelson, Morné Cronje, V. Rudashevskiy, and national scholars: A. Tsytrat., E. Krivonos, O. Bezukha, A. Deringera, I. Koval, O. Kondratieva, L. Kondratenko, S. Stefanovskiy, M. Gudyma, Y. Sydorov and others. Despite a sufficiently large number of scientific works, in today's legal science (both in Ukraine and abroad) there is no single consistent approach to understanding the legal nature of the franchise agreement, and there are no progressive unifications (both at the international and national levels) regarding the legal regulation of the investigated contractual structure, which ultimately negatively affect on arise, change and termination of legal relations in this field.

The purpose of the article is to analyse existing doctrinal and legislative approaches to understanding the legal nature of the franchise agreement; researching the subject and form of the specified agreement by analysing of foreign and domestic experience and criteria for distinguishing the franchise agreement from related agreements.

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## STATEMENT OF THE BASIC MATERIAL

Modern legal science has a large number of definitions of franchising. Thus, I.A. Blank defines franchising as the sale of a license for a technology or trademark of a company that has a high image in the market, provided that the buyer (the franchisor) complies with the quality standards of the products and services specified by the seller (the franchisee) in the process of its implementation.<sup>1</sup> A.S. Tsesliv, Stephen Spinella under franchising understand the form of organization and conduct of business, according to which one of the entrepreneurs (the franchisor) develops a business process model and sells the rights to conduct business in accordance with this model to another entrepreneur (franchisee).<sup>2</sup> I. Kylymyk, in turn, understands franchising as a long-term cooperation of two or more partners, which are combined with the purpose of sharing the trademark, the technology, know-how and other objects of intellectual property rights.<sup>3</sup> B. Putinskyi understands franchising as a system of contractual relations of large manufacturers with small organizations in which the responsibilities for the sale of goods are carried out on the basis of a license of the company's name or trademark of the parent company, as well as compliance with production technology and strategies of commodity marketing.<sup>4,5</sup>

Analysing these definitions, it can be argued that in general they are focused on the activities of the franchisee in the implementation of certain goods or services, or on the franchisor's control over the franchisee's compliance with all the schemes of activity given to it, depends on the kind of franchising that is the basis of the definition, namely: trade or business format franchising. This approach, namely: the preference for consumers' expectations and interests in the context of the relationship between the franchisor and the franchisee is characteristic of the doctrines of European states, in contrast to the scientific doctrine of researchers of the United States of America (hereinafter referred to as the USA), where attention is focused on controlling one side over another.<sup>6</sup>

In the context of the proposed scientific discussion, it is interesting precisely the approach proposed in scientific works by researchers from the USA, which distinguish three approaches to establishing the essence of franchising relationships that not always mediated by concluding a franchise agreement. The first approach is contractual, according to which the franchise agreement is considered as a logical element of understanding franchisor-franchise relations, and it is noted that such an approach reflects the content, clarity and fairness of these relations; however other researchers argue that such an approach does not justify itself with practical point of view, since contractual norms are inherent in any contractual relationship, and therefore do not reflect the specifics of such relations. Moreover, these relations cannot be fully regulated by the agreement; therefore, their further regulation is carried out thanks to such sources as legal custom, legal doctrine, judicial practice and the like.<sup>7</sup> In our opinion, the reasoning of the latter group of scientists is more justified, since such an approach is only a formal one, leaving an essential characterization of these relations without attention.

The second approach is called behavioral or processual. According to its content, relations between the parties arise on the main adjustment of the three processes: initiative – find counterparty;

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<sup>1</sup> I.A. Blank Glossary-reference book of financial manager // I. A. Blank. – K. : "Nika-Center", 1998.- p. 480.

<sup>2</sup> A. S. Tsesliv Commercial concession and related agreements: a comparative aspect / A. S. Tsesliv // *Business Inform.* – 2013. – No. 6. – p. 351-355.

<sup>3</sup> V. Evdokymova Franchising and commercial concession agreement // *Patents and licenses*, 1998.- № 1. – p. 23

<sup>4</sup> A. A. Eremin. Monograph: Franchising and commercial concession agreement: theory and practice of application.

<sup>5</sup> Dobrin, S., & Chochia, A. (2016). The concepts of trademark exhaustion and parallel imports: a comparative analysis between the EU and the USA. *Baltic Journal of European Studies*, 6(2), 28-57.

<sup>6</sup> An international model for vicarious liability in franchising, Robert W. Emerson 2015. [Electronic resource]. – Access mode: <http://www.alsb.org/wp-content/uploads/2016/01/NP-2015-An-Intl-Model-for-Vicar-Liab-Emerson.pdf>.

<sup>7</sup> O. V. Velychko Legal nature of franchising // *Ukrainian law*, 2002.

implementation – exchange of information between the parties; review – provides an assessment of the activities of the parties. According to this approach, factors such as interaction, completeness and sufficiency of the information exchanged, ways of resolving conflicts, participation of the parties in decision-making, the use of useful strategies and the competence of the parties can influence on successful cooperation of the parties.

The third approach is relational, which, in our opinion, does not differ significantly from the previous one. In this approach, franchising relationships should be based on the following components: concentration of attention, solidarity, restraint, integrity, flexibility and mutual benefit.<sup>8</sup> We consider that none of analysed approaches is perfect, because they reflect only the formal aspect of the relationship or its abstract elements, which require clarification and detailization in order to uniform understanding.

Investigating the legal nature of the franchise agreement, it can be stated on the whole that this contractual approach is quite widespread practically all over the world, but, unfortunately, there are no known unifications of this sphere at present, which makes it difficult to regulate these relations. It has to be focus on that despite the diversity of the legal regulation of the study area, it is possible to single out some general approaches to understanding the nature of this agreement in the national legislative practices of the states of the world:

- First, the main element of franchising relationships is the right of the franchisee to offer, sell or distribute the goods and services of the franchisor. The essence of such a relationship is that the franchisee carries out activities using the reputation of the franchisor. The independence of the franchisee is of great importance, that is, employees, contractors or/ franchisor agents that offer, sell, distribute goods or services, cannot be considered a franchisee, since the relationship between the franchisor and such persons arises on the basis of other agreements, for example, an employment agreement or a distribution agreement. However, in this case they don't independently carry out their activities, separately from the activities of the franchisor.
- Secondly, the parties to the franchising relations are dependent on each other: the franchisor depends on the effectiveness of the franchisee, the franchisee, in turn, depends on the experience and assistance of the franchisor. In addition, the parties have a common interest – the sale of goods and / or services for profit<sup>9</sup>.
- Thirdly, the existence of an organic connection with the trademark and other objects of intellectual property. This means that there must be a connection between the activity of the franchisee and the trademark of the franchisor. The indicator of compliance with this condition can be the real use of the franchisee's trademark, its investment in business, advertising company expenses and payment for the use of the trademark.
- Fourthly, a paid basis in the form of franchising fees which are paid in exchange for the right to become a party to the franchise agreement. Traditionally, such meetings are called royalties, that is, payment for the use of a registered mark for goods and services or a trademark.<sup>10</sup> Royalties are paid in advance or by making current payments. It should be noted that in some states, franchising collections include initial payments for investment, fees based on a percentage of gross or net, etc., and therefore, in order to protect the interests of the

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<sup>8</sup> Patrick J. Kaufmann, Rajiv P. Dant Franchising: Contemporary Issues and Research, Volume 4, Number 1/2 1995.

<sup>9</sup> Min Aung The Relationship between Franchisee and Franchisor: a qualitative approach study of fast food franchising in Yangon. [Electronic resource]. – Access mode: [http://utcc2.utcc.ac.th/utccijbe/\\_uploads/InProgress/201606/The%20Relationship%20between%20Franchisee%20and%20Franchisor.pdf](http://utcc2.utcc.ac.th/utccijbe/_uploads/InProgress/201606/The%20Relationship%20between%20Franchisee%20and%20Franchisor.pdf)

<sup>10</sup> Concerning the concept of "royalties", the Ministry of Justice of Ukraine; Letter, Extract dated May 05, 2011 No. 289-0-2-11-81 [Electronic resource]. – Access mode: <http://zakon2.rada.gov.ua/laws/show/v0289323-11>].

parties, it is necessary to clearly indicate how the amount of royalties will be calculated, and if this is a certain percentage, then from what it will be charged. After all, in court practice, there are cases when a court refused to the franchisor in a lawsuit to recover these sums because of the impossibility of determining the amount of royalties.<sup>11</sup>

- Fifth, the availability of a marketing plan is not mandatory, but today it is quite common in contractual practice. Such plan is drawn up by the franchisor, which should be brought to the attention of the franchisee, and includes prices, production technology, products that are used and the like. The more restrictions imposed on the franchisee, the more successful the franchisor's plan is.<sup>12</sup>
- Sixth, the presence of penalties. In our opinion, fixation of penalties in agreements provides certain guarantees to the franchisor, for example, for violation of the order or technology of production of certain products and in the presence of consumer complaints about the franchisee's activity, the franchisor bears subsidiary responsibility, and in the presence of complaints to the franchisee as to the manufacturer of products – the franchisor responds together with the franchisee in solidarity.<sup>13</sup>

The question of determining the subject of the agreement under study remains controversial, which is primarily due to the lack of a unified approach to its interpretation in the national doctrinal practices of states. For example, M.M. Agarkov points out that the subject of the agreement is a certain thing, in respect of which the agreement is concluded.<sup>14</sup> O. V. Poltavskiy, in turn, under the subject of the agreement understands the actions that must be performed under the agreement. Another scientist interprets the concept of "subject of the agreement" more broadly and includes in it both the thing about which the agreement is concluded, and the actions that must be performed under the agreement. In our opinion, the subject of the franchise agreement can be defined as the transfer franchising by franchisor to franchisee – a complex of rights to intellectual property objects, over which the parties entered into the agreement. To such objects should be attributed:

- A). Means of individualization (identification) of participants of civil turnover, goods, works and services – the brand name of the rightholder, a trademark;
- B). Products of intellectual activity – invention, industrial designs, know-how;
- C). Objects of copyright as the results of intellectual activity – databases for personal computers, design of premises and the like.<sup>15</sup>

Investigating the legal nature of the franchise agreement, it is worth paying attention to the form of this agreement. So, in Article 1118 of the Civil Code of Ukraine states that the commercial concession agreement (we believe that it is a franchise agreement) should be concluded in written form, non-observance of which entails the recognition of the deal as invalid. That is, contractual relations between the parties arise from the moment of execution of this agreement in written form. In our opinion, if such a position of the domestic legislator is not in doubt, then the provisions of the national legislation on the abolition of the state registration requirement in this category of agreements require detailed analysis, because there are countries where the need for state registration of franchise agreements are established by law. For example, in China, the franchisor must register

<sup>11</sup> Elena Sulima, At the negotiating table: what to look for during conclusion a franchise agreement? // Lawyer and law, analytical publication, No. 35 [http://search.ligazakon.ua/l\\_doc2.nsf/link1/EA010776.html](http://search.ligazakon.ua/l_doc2.nsf/link1/EA010776.html)

<sup>12</sup> Babette Marzheuser-Wood, Bran Baggott Franchise Law in the United States, 2015.

<sup>13</sup> Victor Moroz, License agreement and commercial concession: advantages and disadvantages// Lawyer and law, analytical publication, No. 35.

<sup>14</sup> M.M. Gudyma On the issue of the concept of the subject of a civil agreement // Scientific Bulletin of Uzhgorod National University, 2013.

<sup>15</sup> V.V. Bessarabova. The agreement of a complex entrepreneurial license as the basis for the functioning of a franchising system. [Electronic resource]. – Access mode: <http://www.bseu.by/russian/scientific/herald/2003/3/030316.pdf>;

the franchise agreement within 15 days from the date of its signing.<sup>16</sup> The duty to register is also established in the legislation of the Republic of Lithuania.<sup>17</sup>

In our opinion, the above approach is more expedient than that implemented by the domestic legislator by abolishing the requirement of state registration of franchise agreements, since entering information into the register on transfer of property rights to intellectual property objects provides additional guarantees to the parties in case of disputes, competition other franchisees and the like. However, the provisions on the state registration of the franchise agreement have generally discretionary nature, and in our opinion, the imperative should concern, the registration of provisions on disclosure of information about the franchise.

Delimitation of the franchise agreement from other related agreements is important in the context of this study. In our opinion, the franchise agreement should be separated from the following agreements:

1. ***The franchise agreement and the commercial concession agreement.*** As already noted, the franchise agreement provides for the relationship of custody, control, assistance and interaction between the franchisor and the franchisee. The franchisor provides the franchisee with a certain set of rights for the implementation of the relevant activity, and the franchisee, in turn, undertakes to invest in such activities. As a result, as a rule, a new business entity of a similar profile is created that operates using a brand name, trademark or other intellectual property objects, the franchisor's strategy and under its control, but is managed by the franchisee. By the commercial concession, it is usually applied in trade relations. The rightholder grants the other party the right to sell goods; the latter does not receive the right to use intellectual property objects, to carry out production activities. That is, in the franchising relationship, the volume of transferred rights to the other party is much larger.<sup>18</sup> If You analyze the legislation of Ukraine, then Article 1115 of the Civil Code of Ukraine states that under the commercial concession agreement one party (the rightholder) undertakes to provide to the other party (user) for payment the right to use, in accordance with its requirements, a complex appropriate to this party of rights with the purpose of manufacturing and (or) selling a certain type of commodity and (or) the provision of services.<sup>19</sup> From the above it is clear that in this article we are talking about the franchise agreement, since by its content the party can be given the right to manufacture goods, contradicts the content of the commercial concession.

2. ***The franchise agreement and the license agreement.*** The franchise agreement is considered to a certain extent as copying a particular business model that is regulated and controlled through such an act. In turn, the license agreement is based on the sale or provision of a specific product or service (for example, retail outlets that have a license to sell Apple products). The difference between these agreements is also that the franchisor provides support for the manufacture of the whole franchisee's business, and under the license agreement, support is usually associated with a particular product or service, and not with all the activities of the licensee.<sup>20</sup> It should also be noted that, unlike the franchise agreement, which can be only on a paid-for basis, the license agreement can be both paid and unpaid. In a license agreement, a party may be a natural person or legal entity, and under the franchise agreement, only a legal entity acts as a party. In addition, these

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<sup>16</sup> Regulations on Administering Commercial Franchises, art.8 [http://www.fdi.gov.cn/1800000121\\_39\\_3485\\_0\\_7.html](http://www.fdi.gov.cn/1800000121_39_3485_0_7.html) February 6, 2007

<sup>17</sup>p. 2 art. 6.767 Civil Code of the Republic of Lithuania, dated July 18, 2000, Law No. VIII-1864 (Last amended on April 12, 2011, No XI-1312) [http://www.wipo.int/wipolex/en/text.jsp?file\\_id=202088#LinkTarget\\_7318](http://www.wipo.int/wipolex/en/text.jsp?file_id=202088#LinkTarget_7318)].

<sup>18</sup> V.S. Dmytryshyn The commercial concession agreement and franchise agreements. The Correlation of Concepts and Legal Nature // The Scientific Journal «Chronicles of the Kyiv University of Law 2010/3.

<sup>19</sup> The Civil Code of Ukraine dated January 16, 2003 No. 435-IV [Electronic resource]. – Access mode: <http://zakon5.rada.gov.ua/laws/show/435-15>.

<sup>20</sup> Morné Cronje The difference between a franchising and a licensing agreement, 2015 [Electronic resource]. – Access mode: <https://blog.fnbc.co.za/2015/10/the-difference-between-a-franchising-agreement-and-a-licensing-agreement>.

agreements are distinguished by the duration of the relations that they regulate. Thus, franchising relations are characterized by long-term, while the license agreement is determined with the termination of the exclusive right. The question of responsibility of the parties also is solved in different ways in these agreements. Under the license agreement, when obtaining a license, the licensee is responsible for its activities and possible negative consequences. In turn, the franchisor bears subsidiary responsibility in the presence of complaints about the activities of the franchisee, and jointly – if the consumer challenges the activity of the franchisee as a manufacturer.

3. *The franchise agreement and the joint activity agreement.* Individual researchers (V. Rudavshchyskyi and others) consider the franchise agreement as a kind of a simple partnership agreement (the joint activity agreement). In support of their position, they note that both agreements provide for the establishment of partnerships, building trust, coordination of management.<sup>21</sup> Others (and we sign on to this point of view) consider that this approach is rather questionable, given that, firstly, the parties to the franchise agreement pursue different aims; secondly, the parties to the joint activity agreement may be both legal entities and natural persons; thirdly, the common property is created in the joint activity agreement, and the parties do not act as a creditor and debtor in such relations, but have more or less the same status.<sup>22</sup>

4. *The franchise agreement and the agency agreement.* In accordance with Article 297 of the Commercial Code of Ukraine under the agency agreement, one party (the commercial agent) undertakes to provide services to the other party (the entity represented by the agent) in concluding agreements or to facilitate their conclusion (provision of actual services) on behalf of this entity and at its expense, the person who represents the agent must pay a certain amount of money for the services provided. In our opinion, the situation related to the conclusion of the franchise agreement is somewhat different: the franchisee pays the royalties for using the brand of the franchisor.

5. *The franchise agreement and the investment agreement.* In scientific works, the investment agreement is usually understood as the agreement that mediates investment activity, which is considered as a set of practical actions for the implementation of investments. All kinds of property and intellectual values can be attributed to investments that are invested in objects of entrepreneurial activity, resulting in a profit or social effect is achieved.<sup>23</sup> As already noted under the franchising agreement, the franchisor transfers franchisee its intellectual property rights, which the franchisee uses to produce its business with the purpose of profit. In our opinion, the investment agreement is the general name of agreements that provide for the investment of funds, for example, agreement of purchase and sale of securities, joint activity agreement and others.<sup>24</sup> However, such actions may be mediated by concluding the franchise agreement.

Thus, the legal nature of the franchise agreement is disclosed through clarification of the subject matter of this agreement, its content, and the correlation of this agreement with other related agreements through recourse to national doctrinal and legislative practices. In general, we can state that at present time there is no established approach to understanding the legal nature of the franchise agreement in national legal doctrines and laws of the states of the world, there has been no progressive unification of this sphere both at the international and national levels, which complicates the potential opportunities for franchise participants (especially if they have a foreign element) to

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<sup>21</sup> V. D. Rudavshchyskyi Investments and franchising / V. D. Rudavshchyskyi, M. A. Furshchuk // Investments in Russia. – 1997. No. 9/10. – p. 39-43.

<sup>22</sup> Ya. O. Sydorov, L. I. Shekhovtsova Comparative legal characteristic of the commercial concession agreement (franchising) and related agreements // Scientific Bulletin of the Zaporizhzhya National University No. 4, 2010.

<sup>23</sup> I.V. Kurafieieva. Value of the investment agreement with the agreement for participation in shared construction of housing / I.V. Kurafieieva // Forum of rights. – 2010. – No. 1. – p. 194–200 [Electronic resource]. – Access mode: <http://www.nbu.gov.ua/ejournals/FP/2010-1/10kivubg.pdf>.

<sup>24</sup> O. Chaban. Classification of agreements, which mediate the implementation of investments // Enterprise, economy and law – 7/15 [Electronic resource]. – Access mode: <http://pgp-journal.kiev.ua/archive/v7/4.pdf>.

effectively refer to this category of agreements for the purpose of their conclusion and further proper execution.

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