



COLIBRILAW

**DISTRIBUTION AGREEMENTS
IN KAZAKHSTAN
RISK MINIMISATION ROUTES**

DISTRIBUTION AGREEMENTS
IN KAZAKHSTAN
RISK MINIMISATION ROUTE



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INTRODUCTION

Kazakhstan's strong economy, continuous financial growth, welfare expansion, political stability and a highly comfortable business environment all contribute to the continuous inflow of large international players interested in distributing their products on the local market.

Numerous FMCG manufacturers and suppliers established themselves within the Kazakh market a long time ago, and they continue to expand their sales and distribution networks by engaging with local distributors.

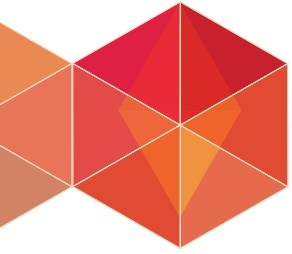
International status, a global market presence, world-famous products and strict corporate policies protecting trademarks and trade names encourage global manufacturers and suppliers to make every effort to protect their interests in contracts with local distributors of their products.

The abovementioned objectives make distribution agreements the most preferable choice for manufacturers as they enable companies to cover most issues that may arise out of distribution relationships and provide maximum protection for the interests of manufacturers and suppliers.

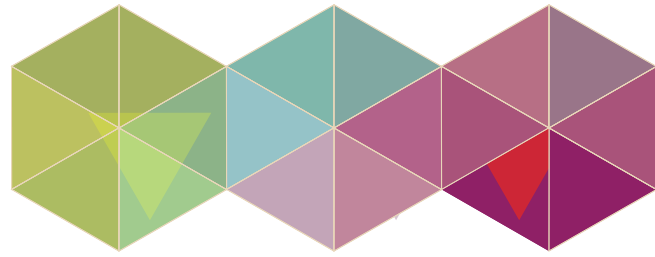
Although distribution agreements are widely used within international trade practice as a legal instrument for protecting product manufacturers, they may involve a number of special features and region-specific risks for manufacturers who enter into such agreements in Kazakhstan.

This article will address the key features of distribution agreements in Kazakhstan, along with the ways in which product manufacturers can minimise risk when entering into distribution agreements with local distributors.

The findings and proposals outlined in this article are based on legal practice in Kazakhstan as per judgments handed down by Kazakhstan's courts.



LEGAL NATURE OF DISTRIBUTION AGREEMENTS



The current laws of the Republic of Kazakhstan do not classify distribution agreements as a separate type of contract, and therefore reference should be made to legal relations established on the basis of other types of contracts provided by the current laws in order to understand how the distribution agreement should be treated within the local legal framework.

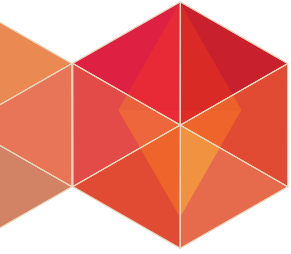
It should be noted that, in accordance with Article 380 of the Civil Code of the Republic of Kazakhstan (hereinafter "Civil Code"), parties may enter into both contracts that are provided for by law and contracts that are not covered by local laws. This allows us to conclude that the absence of the concept of a distribution agreement within the laws of the Republic of Kazakhstan does not prevent the negotiation and execution of such agreements or the recognition of such agreements by the local courts.

A review of most distribution agreements negotiated in Kazakhstan shows that product manufacturers usually try to include in distribution agreements as many issues relating to product distribution as possible, which allows the distribution agreement to be treated as a mixed contract as it includes a number of legal relations.

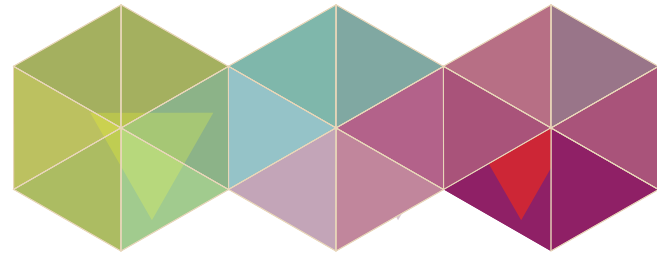
In accordance with the laws of the Republic of Kazakhstan mixed contracts are permitted, with their status firmly established in Article 381 of the Civil Code.

A thorough review of each specific distribution agreement is required in order to understand which legal relations derive from the contract. However, in most cases the legal nature of a distribution agreement is determined by its subject matter.

In most cases the subject of a distribution agreement provides for the sale of goods by the manufacturer to the distributor and the subsequent distribution of these goods by the distributor within a specific territory, subject to the terms and conditions of the distribution agreement.



LEGAL NATURE OF DISTRIBUTION AGREEMENTS



As such, a distribution agreement implies two key elements, namely the transfer of the ownership of the goods from the manufacturer to the distributor and the payment of the purchase price by the distributor to the manufacturer.

The above steps, which determine the legal nature of this part of the distribution agreement, allow us to conclude that the distribution agreement has elements of sale and purchase agreements, as well as supply contracts.

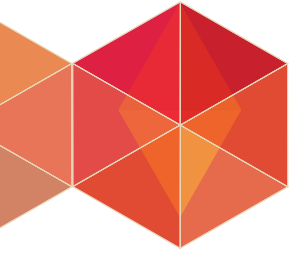
A detailed analysis of the applicable laws of the Republic of Kazakhstan and legal practice allows us to conclude that legal relations involving the transfer of goods from a manufacturer to a distributor under a distribution agreement involve, in essence, the same legal relations that arise out of supply contracts.

This finding is based on the fact that Article 458 of the Civil Code states that legal relations involving the delivery of goods from one corporate entity to another, together with the subsequent use of such goods in the context of commercial activities, constitute the subject of a supply contract. Furthermore, Article 460 of the Civil Code provides for the long-term status of such relations.

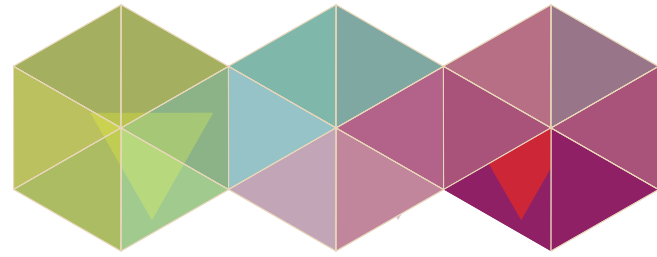
The conditions outlined above entirely correspond to the nature of relations arising out of a distribution agreement where a distributor, as the buyer of the goods, undertakes to pay for the delivered goods and to distribute them within the specified territory.

Consequently, the terms and conditions of supply contracts shall apply to the part of a distribution agreement that governs the delivery of and payment for the goods.

A distinctive feature of such relations is the fact that the terms of payment for the delivered goods provide, in most cases, for a payment on a deferred basis with a grace period of up to 30 calendar days, subject to the terms and conditions of each specific distribution agreement.



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This provision triggers certain risks for product manufacturers or suppliers as the distributor's failure to pay for the delivered goods may put the manufacturer in a position where it has neither the goods nor the payment due.

As a consignment of goods delivered by the manufacturer to the distributor may cost anything up to hundreds of millions of tenge, and in anticipation of the potential risk of the distributor failing to perform its payment obligations, manufacturers attempt to minimise such risk. They do this by using financial products available on the market aimed at ensuring the fulfilment of obligations under a distribution agreement.

Bank guarantees appear to be the most efficient and widely available instrument for securing payment obligations under a distribution agreement. This financial product is widely promoted by Kazakh banks.

The next section of this article will tell you more about bank guarantees and their effectiveness for securing payment obligations under distribution agreements.

DISTRIBUTION AGREEMENTS & BANK GUARANTEES

As mentioned above, bank guarantees are one of the most popular methods for securing payment obligations. The wide availability of bank guarantees on the financial market makes this instrument very attractive and easy to use.

However, let us focus on the legal aspects of using bank guarantees within this context.

Depending on the type of banking product, bank guarantees provided by local banks are often governed by the Uniform Rules for Demand Guarantees, ICC Publication (hereinafter "URDG").

The URDG apply to any demand guarantees that expressly indicate that they are covered by them.

In accordance with Clause A, Article 5 of URDG "A guarantee is by its nature independent of the underlying relationship and the application, and the guarantor is in no way concerned with or bound by such relationship. A reference in the guarantee to the underlying relationship for the purpose of identifying it does not change the independent nature of the guarantee. The undertaking of a guarantor to pay under the guarantee is not subject to claims or defences arising from any relationship other than a relationship between the guarantor and the beneficiary."

In the context of the applicable law we may, with a due level of confidence, treat URDG as the customary business practices that may govern the civil relations of the parties in accordance with Article 3 of the Civil Code.

Thus, a review of bank guarantee conditions and regulations allows us to conclude that a bank guarantee provided by Kazakh banks may be governed by both the URDG and by the laws of the Republic of Kazakhstan. The URDG stipulates that guarantee is, by its nature, independent from the underlying obligation, which indicates that the modification of the underlying obligation may not affect the validity of the guarantee.

When referring to the laws of the Republic of Kazakhstan governing guarantee obligations, we should note that guarantees are regulated by Chapter 18 of the Civil Code and that bank guarantees, including issuing procedures, are

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regulated by Bank Guarantee Issuing Rules No. 55 dated 28 April 2008, as approved by the Financial Supervision Agency.

It should be noted that the current laws of the Republic of Kazakhstan do not stipulate the independent nature of bank guarantees from the underlying obligations, but the bank guarantee itself is subject to the general legal rules provided for in Chapter 18 of the Civil Code.

In particular, under Article 336 of the Civil Code a guarantee may be terminated if the underlying obligation is modified without the guarantor's consent in a way that increases liability or creates other unfavourable consequences for the guarantor.

An analysis of the above article enables us to conclude that any modification to the underlying obligation that leads to an increase in the guarantor's liability without the latter's consent will constitute grounds for the termination of the guarantee, including a bank guarantee, under the laws of the Republic of Kazakhstan.

Case law shows that courts strictly adhere to the provisions of this article and terminate bank guarantees on the grounds of an increase in the bank's liability if the material terms of the agreement secured by bank guarantees have been amended.

With regards to distribution agreements, it should be noted that in the course of their execution they may be subject to frequent amendments to the terms of payment and the price of goods due to the nature of the relationships arising from these agreements.

As a rule, most distribution agreements entitle manufacturers and suppliers to modify the price of goods unilaterally and, with respect to FMCG suppliers, such prices may be modified several times per year.

In practice, distribution agreements are usually amended with addendum agreements through which the manufacturer may extend the payment terms for certain consignments of goods compared to the initial payment term stipulated in the distribution agreement. In addition, upon agreement by both the

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manufacturer and the distributor, a distribution agreement may be subject to other amendments, including amendments to the delivery terms and type of goods.

It should be noted that prices, terms of payment and terms of delivery may be recognised by the court as the material terms of a distribution agreement and amendments to such material terms may lead to an increase in the bank's liability or the occurrence of other unfavourable consequences for the bank as the guarantor that secures the performance of the payment obligations of the distributor under a distribution agreement.

To demonstrate this, we may refer to a case in which the court terminated the bank guarantee on the ground that the manufacturer and distributor made amendments to the payment terms of the distribution agreement without the bank's consent.

The court declared that the extension of the payment terms of the distribution agreement following the issuance of the bank guarantee resulted in the bank missing an opportunity to demand additional security and higher bank fees from the distributor, whose payment obligations were secured by the bank. The court did not accept the argument that as the bank guarantee was governed by URDG it is independent of the underlying obligation.

The court's findings were entirely supported by the courts of appeal.

Hence, we may reasonably conclude that bank guarantees issued in accordance with Kazakh laws are contingent on the underlying obligations secured by such guarantees even if reference to URDG is contained in such guarantees.

It should therefore be noted that amendments made to the material terms of a distribution agreement secured by the bank guarantee without the bank's consent may be deemed by the court as grounds for an increase in liability and the occurrence of other unfavourable consequences for the bank as the guarantor, which may lead to the termination of the bank guarantee under the claim of the interested party.

DISTRIBUTION AGREEMENTS & PENALTY

Another potential way to secure a distributor's payment obligations under a distribution agreement is to impose a penalty, which is usually set at a percentage of the total amount of outstanding financial obligations.

In most cases the parties to a distribution agreement decide upon the penalty amount at their own discretion, which means that it is difficult to identify a trend in terms of such amounts. However, practice indicates that penalties may vary between 0.1% and 5% of the total outstanding financial obligation for each day of delay.

Case law shows that in the event of a distributor's default on its obligations to pay for the delivered goods, manufacturers willingly exercise their right for accrued penalties and claim such penalties in court when action is brought against a defaulted distributor.

We should also note that claiming a penalty in court is subject to a state duty of 3% of the total amount of the claim.

No sustainable trends are identified in the case law relating to the granting of demands for penalties.

Manufacturers mostly bring action against distributors for the collection of outstanding debt when the outstanding amount becomes material, sometimes totalling tens or hundreds of millions of tenge. This also leads to accrued penalties that can be reduced by the court, both upon the initiative of the defaulted distributor and the court itself.

In a number of cases the court, upon its own initiative, has reduced the penalty on the grounds that, under Article 364 of the Civil Code, the court is entitled to reduce the scope of the debtor's liability if the non-performance or incorrect performance of the obligations was caused by the default of both parties and if the creditor deliberately or through negligence contributed to an increase in the losses caused by the non-performance or incorrect performance or failed to take reasonable measures to mitigate them.



DISTRIBUTION AGREEMENTS & PENALTY

In certain cases the court decided to reduce the penalty on the grounds that the manufacturer's failure to bring action against the distributor immediately upon the distributor's default contributed to the increase in losses. It should be noted that in such cases action was brought as early as three months following the occurrence of the distributor's default.

Nonetheless, it should be noted that in a number of cases the courts delivered judgments for the whole amount of the demanded penalty, regardless of the provisions of Article 364 of the Civil Code.

Thus, the granting of penalty claims is very much at the court's discretion and the court may grant half of the claim amount, or even less, subject to the norms of the applicable laws.



DISTRIBUTION AGREEMENTS & SET-OFF

Due to the nature of distribution agreements, they often provide for bonuses and discounts for distributors in order to stimulate their performance within the specific distribution territory.

In particular, distribution agreements may contain provisions that allow the manufacturer or supplier to grant discounts based on a percentage of the total price of the delivered goods if a distributor exceeds certain sales thresholds, ensures the high quality of the distribution network, employs skilled staff or meets other performance standards.

Subject to the terms and conditions of a distribution agreement, such discounts are usually granted following the delivery of and payment for the goods. Parties to a distribution agreement usually prefer to apply such discounts to the prices of goods supplied in the future.

In this case set-off appears to be a valid legal instrument for settlement between the parties of a distribution agreement in accordance with Article 370 of the Civil Code.

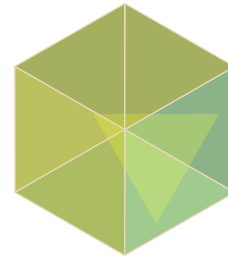
However, it should be noted that if the distributor fails to perform its payment obligations the manufacturer may bring action against the defaulted distributor. In this case, if the distributor has any counterclaims against the manufacturer that arise out of the distribution agreement, namely, claims for the payment of bonuses and discounts, it may claim the set-off of such counterclaims in the court within the framework of the action brought.

Case law shows that the distributor may only claim such set-offs by bringing a counterclaim against the manufacturer.

In one case, the local court disregarded the distributor's argument given in response to a claim in which the latter explained that it had counterclaims against the manufacturer that arose out of the distribution agreement and were subject to set-off. The court declared that such a demand for set-off could only be made by bringing a counterclaim as prescribed by the current procedural laws.

Consequently, if the manufacturer brings action against the distributor any counter demands may only be made by bringing a counterclaim against the manufacturer in the manner prescribed by the applicable civil procedural laws of the Republic of Kazakhstan.applicable laws.

OUR FINDINGS & PROPOSALS



Although the laws of the Republic of Kazakhstan do not address distribution agreements, this legal instrument is now well established in the context of the legal relations of companies operating in Kazakhstan, and default by either party under the distribution agreement is adequately redressed in the local courts.

If the parties to a distribution agreement intend to secure payment obligations with a bank guarantee they should be aware that once the bank guarantee has been issued the bank becomes a party to their legal relations. As such, the bank's rights and obligations may be affected by any amendments made to the material terms of the distribution agreement if such amendments are made without the bank's consent.

In view of the above, if the distributor's payment obligations under the distribution agreement are secured by bank guarantee issued in accordance with the laws of the Republic of Kazakhstan, the parties should refrain from making any changes and amendments to the material terms (and any terms) of the distribution agreement that may lead to an increase in liability or the occurrence of other unfavourable consequences for the bank as the guarantor, unless such changes and amendments are made with the bank's consent.

In terms of determining the size of penalties, both during the negotiation of a distribution agreement and upon the bringing of action against a defaulted distributor, the manufacturer entitled to demand such a penalty must apply common sense and avoid situations in which the outstanding debt becomes material and the manufacturer has reasonable grounds to believe that the distributor may not be able to repay the outstanding amount.

By following the above guidance manufacturers and suppliers may minimise legal risks when entering into and executing distribution agreements in Kazakhstan.



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