

FRANCHISE

China



Franchise

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Quick reference guide enabling side-by-side comparison of local insights, including franchise market overview; key considerations when forming and operating a franchise; offer and sale of franchises; franchise contracts and the franchisor/franchisee relationship; and recent trends.

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MARKET OVERVIEW

Franchising in the market

How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

Franchising as a business model is developing rapidly in China. The first pilot franchise regulations in the People's Republic of China (PRC) were adopted in 1997. Since then, domestic franchises have taken off, particularly as Chinese consumers gained more purchasing power. At the end of 2020, the top 100 franchise systems in China operated more than 299,000 franchise units – 16 per cent more than the 2019 figure.

Western brands are often viewed favourably by Chinese consumers, as they are associated with high quality and superior customer service. Before the covid-19 pandemic, the sectors where international franchises were particularly successful in China included academic and personal development services such as adult education, early childhood education, language classes, fitness classes and skills development. Elderly care and hospitality services were also in demand.

While the pandemic initially brought significant disruption and economic restrictions, China managed to curb the spread of the virus quickly, enabling its economy to begin rapidly recovering while other countries are experiencing economic decline. However, international brands may struggle with their expansion to China due to ongoing travel restrictions and the resulting difficulties in recruiting, vetting and training franchisees, particularly in the cases of multi-unit operators and master franchisees.

Law stated - 15 May 2022

Associations

Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

The Chinese business association for the franchise industry, the China Chain Store and Franchise Association, has more than one thousand members, including domestic and foreign franchisors, retailers, and suppliers. It was formed in 1997 to promote education and training in the retail and distribution industries, and participates in policy-making related to the operation of chain retail stores and franchises.

Law stated - 15 May 2022

BUSINESS OVERVIEW

Types of vehicle

What forms of business entities are relevant to the typical franchisor?

Under the Commercial Franchise Administration Regulation (the Franchise Regulation), individuals cannot offer franchises in the People's Republic of China (PRC). Generally, domestic franchisors prefer to incorporate as either a limited liability company or a company limited by shares.

International franchisors typically prefer to operate in China without establishing a local entity. It is not necessary to open a local subsidiary to grant franchises in China, unless the foreign franchisor wishes to engage in other commercial activities (including leasing or subleasing premises to franchisees), and particularly if the franchisor

wishes to exercise the right to take over the franchisee's location in China. Franchisors who decide to incorporate in China no longer need to establish a wholly foreign-owned enterprise or a joint venture company with a Chinese partner, as these types of legal entities were abolished when the new Foreign Investment Law came into force on 1 January 2020. Under the new law, legal entities incorporated in the PRC by foreigners are governed by the same rules as domestic entities, under the Company Law of the PRC (the Company Law).

Forming a joint venture company with a Chinese partner is possible, but generally should be avoided unless there is no other way to establish a franchise in China. Forming a joint venture in any jurisdiction is comparable to entering into a marriage and dissolving a marriage is more complicated than winding down a contractual relationship. Additionally, in the PRC, the day-to-day control of the company's legal representative (similar to a general manager) and company chop is equally – if not more – important than having a majority share in the capital of the joint-venture company. Such control may impede operational efficiency, which in turn may frustrate the purpose of establishing a joint venture with a local partner in the first place.

Law stated - 15 May 2022

Regulation of business formation

What laws and agencies govern the formation of business entities?

The formation of limited liability companies and companies limited by shares is governed by the Company Law and its regulations. The State Administration for Market Regulation (SAMR) and local bureaus for market regulation are responsible for company registrations.

Foreign investors incorporating in China need to file a foreign investor information report with the Ministry of Commerce (MOFCOM) through the corporate filing system maintained by SAMR. If the industry of the target business is on the Negative List, the foreign investor should also obtain approval from MOFCOM.

Law stated - 15 May 2022

Requirements for forming a business

Provide an overview of the requirements for forming and maintaining a business entity.

Each business entity must meet certain requirements of the Company Law with respect to the number of shareholders, capital contributions, articles of association, name, and domicile of the company.

For franchisors, the company's scope of business should include offering franchises and the business activities covered by the franchise model.

Upon completion of the registration, the company will obtain a business licence with a unique unified social credit code. Within 30 days after obtaining the business licence, the company should register with the local state tax administration. The company may need to obtain additional licences issued by other government agencies depending on the industry of the business. For example, a restaurant must obtain a food operation licence from the China Food and Drug Administration.

To maintain a business entity, companies must submit an annual report to SAMR by 30 June of the next calendar year. The company must register certain changes (such as changes of name, domicile, place of business, scope of business, etc) with SAMR within 20 days of the change taking place.

Law stated - 15 May 2022

Restrictions on foreign investors

What restrictions apply to foreign business entities and foreign investment?

International franchisors who decide not to open a local subsidiary are restricted in certain activities, such as purchasing or leasing real estate for purposes other than self-use.

Most franchising activities are not restricted to foreign investment, but certain industries – including publishing, the wholesale and resale of tobacco, and compulsory school education – remain closed to foreign investment.

Foreign investors should consult the Special Administrative Measures for Access of Foreign Investments (Negative List), updated by the National Development and Reform Commission and MOFCOM, which came into effect on 1 January 2022. The catalogue categorises industries either as 'restricted' (foreign investment is subject to certain restrictions, such as restrictions on shareholding structures) or 'prohibited' (no foreign investment is allowed).

Foreign investors investing in industries that are not on the Negative List will enjoy national treatment.

Law stated - 15 May 2022

Taxation

What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

If the foreign franchisor sells franchises in the PRC without establishing a local entity, all remittances of royalties by a Chinese franchisee to the overseas franchisor will be subject to value added tax at a rate of 6 per cent and the withholding tax. The rate of withholding tax on royalties is 10 per cent, unless reduced by a treaty. Management fees and other active income sourced in China are also taxable.

Chinese tax authorities may consider service fees and other payments to be subject to withholding tax if they suspect that these payments are designed to reduce royalties. As Chinese franchisees are better suited to liaise with Chinese tax authorities, franchisors should consider gross-up clauses to shift the burden of dealing with tax authorities to the local franchisees.

If there is no gross-up clause, the franchisor may be able to credit withholding taxes paid in China against the income tax of the franchisor in its home country.

Franchisors selling franchises via a local subsidiary are charged an enterprise income tax at a rate of 25 per cent.

Law stated - 15 May 2022

Labour and employment

Are there any relevant labour and employment considerations for typical franchisors?

Employment relationships are governed by the Labour Law and the Labour Contract Law. If the relationship between the parties satisfies the definition of a 'franchise' under the Franchise Regulation, the risk of the franchisee being deemed an employee of the franchisor is very low.

There is currently no indication from the Chinese courts or the Ministry of Human Resources and Social Security that a franchisor may be considered a joint employer of the franchisee's employees, provided that the franchisee maintains a business operation separate from the franchisor.

Intellectual property

How are trademarks and other intellectual property and know-how protected?

China is a first-to-file jurisdiction and trademarks registered abroad are generally not protected. Trademark registration with the National Intellectual Property Administration takes between 12 and 15 months, assuming that the application passes the examination without any amendment notification, official rejection or third-party opposition. The registration is valid for 10 years with an option to renew.

Franchisors should consider registering their trademarks in the PRC as soon as possible and before entering the Chinese market. In addition to any English or other non-Chinese language marks and logos, franchisors should create and register a trademark in Chinese characters before a squatter can register it. Having a Chinese language trademark also mitigates the risk of a franchisee registering the mark in its own name and breaking away from the franchise system. Localising a foreign brand is important to increase the recognition and reputation of the brand among Chinese customers, as English is not widely spoken in mainland China.

Trade secrets are protected contractually as well as under the Anti-Unfair Competition Law and the Criminal Law.

Law stated - 15 May 2022

Real estate

What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

Land title and real estate leases are governed by the Civil Code .

The land in urban centres belongs to the state and can be leased only for a certain period. Businesses can own commercial units in buildings, but not the land on which the building is built.

To be able to purchase or lease real estate for purposes other than self-use, a foreign entity should incorporate a Chinese company and obtain approvals from the local MOFCOM. With respect to self-use real estate, the branch or representative office of the foreign entity may purchase properties according to its needs. As such, if sub-leasing or lease assignment is part of the franchise system, it is recommended that the foreign franchisor incorporates in China and obtains the government's approval because such practice may be considered as operating a real estate business.

If the franchisee leases the premises directly from a landlord, the franchise agreement should address possible relocation where the franchisee's lease expires before the end of the franchise agreement term, as commercial leases in the PRC are relatively short (between three and five years).

Law stated - 15 May 2022

Competition law

What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

Article 17(4) of the Anti-Monopoly Law prohibits the establishment of exclusive geographical areas without justifiable cause for players with a dominant market position. Franchisors in China rarely have a market share that is significant enough to constitute a dominant market position.

Price-fixing and minimum resale prices are prohibited in vertical agreements or horizontal monopoly agreements between competitors. However, the Anti-Monopoly Law provides some exceptions for horizontal agreements. The practice of setting recommended prices may attract scrutiny from the anti-monopoly authorities if the franchisor enforces the recommendation. The Anti-Monopoly Bureau of the State Administration for Market Regulation is the primary anti-monopoly authority in the PRC.

Franchisors should observe the price-fixing restrictions under the Anti-Monopoly Law. The authorities actively enforce the law, including against certain industries such as car dealerships.

The courts and government authorities are debating whether a negative effect on competition is required to secure a conviction for a resale price maintenance offence. While the government considers resale price maintenance as a *per se* offence, which does not require proof of intent or a negative effect on competition, the courts would consider whether price-fixing has lessened or restricted competition on a case-by-case basis.

Article 17 of the Anti-Monopoly Law prohibits tie-in sales clauses imposed by parties with a dominant market position without justification.

Law stated - 15 May 2022

OFFER AND SALE OF FRANCHISES

Legal definition

What is the legal definition of a franchise?

The Commercial Franchise Administration Regulation (the Franchise Regulation) defines a franchise as an arrangement in which:

- the franchisor through an agreement grants a franchisee the right to use the franchisor's business operating resources, including registered trademarks, logos, patents and proprietary technologies;
- the franchisee conducts business under a uniform mode of operation; and
- the franchisee pays franchise fees according to the agreement.

The Chinese definition of a franchise is quite broad. The Chinese term for franchising includes both business format franchises (as in the United States) and product distribution arrangements. Further, licensing of non-trademark intellectual property rights – such as a trade secret or patented technology – can also fall under the definition of a franchise if a fee is paid and the licensee conducts business under a uniform mode of operation.

Law stated - 15 May 2022

Laws and agencies

What laws and government agencies regulate the offer and sale of franchises?

The People's Republic of China (PRC) (excluding Hong Kong and Macao) is a civil law jurisdiction, heavily based on the German model. All contracts in the PRC must conform to the general principles set out in the Civil Code. Franchise relationships are governed by the following regulations and administrative measures:

- the Franchise Regulation;
- the Commercial Franchise Registration Administrative Measures; and
- the Commercial Franchise Information Disclosure Administrative Measures (the Information Disclosure

Measures).

The Ministry of Commerce (MOFCOM) is the government body that enforces franchise regulations.

Other laws that may affect franchisors include:

- the Labour Contract Law;
- the Anti-Unfair Competition Law;
- the Anti-Monopoly Law;
- the Trademark Law; and
- the Copyright Law.

Law stated - 15 May 2022

Principal requirements

What are the principal requirements governing the offer and sale of franchises under the relevant laws?

Under the Franchise Regulation, franchisors must meet certain eligibility requirements, offer pre-sale disclosure and comply with mandatory content requirements for franchise agreements. Franchise agreements must include, among others:

- provisions regarding fees;
- the term of the agreement and the nature of the franchise business;
- the standards of operation;
- details of the assistance and training provided by the franchisor;
- the standards of quality of the products or services and quality guarantees;
- the protection of consumer rights;
- the allocation of liability for consumer rights violations between the franchisor and franchisee;
- provisions regarding the promotion and advertising of the products or services; and
- provisions regarding amendment, cancellation and termination of the franchise agreement.

There is no requirement to register a franchise agreement or franchise disclosure document. However, franchisors are required by law to register with MOFCOM or local MOFCOM departments within 15 days of the first franchise agreement being signed. The list of documents required for registration with MOFCOM usually includes, but is not limited to:

- the franchisor's standard form of franchise agreement;
- the franchise agreement signed with the first franchisee in China;
- the corporate registration certificate;
- the market plan;
- registration certificates for trademarks or copyright (eg, logo) used in the franchise system; and
- evidence of compliance with Article 7(2) of the Franchise Regulation (the 2+1 Rule).

All documents must be translated into Chinese. Documents that are prepared abroad must be notarised and either legalised at the Chinese embassy in the country of origin or certified according to the Hague Convention on Abolishing the Requirement of Legalisation for Foreign Public Documents.

International franchisors should register with MOFCOM's head office in Beijing, rather than with local MOFCOM departments. The franchisor should register any changes in the information submitted to MOFCOM within 30 days of that change taking place.

Law stated - 15 May 2022

Franchisor eligibility

Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

All franchisors in China must have a mature business model and demonstrate compliance with the requirements of article 7 of the Franchise Regulation. The 2+1 Rule contained in this article requires that a franchisor must have owned and operated at least two outlets for at least one year. According to the practice developed by MOFCOM officials, the outlets may be owned and operated by the franchisor's subsidiaries or, in some cases, other affiliates; the outlets may also be located outside China if they are operated under the same franchise brand. If the outlets are located outside China, franchisors may use statements issued by trade organisations (eg, the International Franchise Association) to show compliance with the 2+1 Rule. Chinese courts generally agree that it is possible to have a mature system without complying with the 2+1 Rule, which in practice means that the franchise agreement will be valid (assuming non-compliance with the 2+1 Rule is properly disclosed), but registering with MOFCOM will be problematic.

Law stated - 15 May 2022

Franchisee and supplier selection

Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

There are no such regulations specifically targeting franchising.

Law stated - 15 May 2022

Pre-contractual disclosure – procedures and formalities

What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

Franchisors should provide prospective franchisees with a franchise disclosure document at least 30 days before signing the franchise agreement. There is no prescribed format; franchisors may choose to follow the format of the disclosure documents prepared for other jurisdictions or follow the order set out in article 5 of the Information Disclosure Measures. There is no requirement to register a franchise agreement or franchise disclosure document; however, franchisors should register with MOFCOM within 15 days of the first franchise agreement being signed.

There is no obligation to make continuing disclosure, but disclosure must be updated before signing the franchise agreement if there is a significant change in the information provided by the franchisor.

Pre-contractual disclosure – content

What information is the disclosure document required or advised to contain?

According to article 5 of the Information Disclosure Measures, information that must be disclosed to a potential franchisee includes:

- basic information about the franchisor and its management;
- basic information regarding the operational resources of the franchisor, such as the franchisor's registered trademarks, logos, patents, proprietary technology and operational or business format model;
- basic information about franchise fees, such as the type, amount and payment method for franchise fees, any required security deposits, and the conditions and method of refund;
- the terms and conditions for supplying products, services and equipment by the franchisor;
- a description of the continuous services to be provided to the franchisee, including operating guidance, technical support and training;
- the components and method for the operational guidance and supervision provided to the franchisee;
- the investment budget for a franchise location;
- the list of existing franchise outlets within the PRC and an assessment of their business performance (an earnings claim);
- summaries of the financial statements and audit reports for the past two years;
- a description of the franchisor's franchise-related lawsuits and arbitrated matters in the past five years, and of any bankruptcies in the past two years;
- information regarding any record of material illegal operations with respect to the franchisor or its legal representative; and
- a copy of the franchise agreement.

Article 23 of the Franchise Regulation prohibits franchisors from concealing any relevant information, even if not specifically listed. Further, article 500 of the Civil Code prohibits a party from intentionally concealing key facts relating to contract creation. These provisions can be interpreted as a requirement to disclose all material facts, even if this information is not listed in the regulations.

Law stated - 15 May 2022

Pre-sale disclosure to sub-franchisees

In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

The obligation to provide pre-sale disclosure to the sub-franchisee rests with the sub-franchisor.

Following the principle of good faith in negotiating and performing contracts, the sub-franchisor should disclose all material facts regarding the franchisor and the relationship between the franchisor and sub-franchisor, for example:

- the ownership of any intellectual property rights used in the franchise system;

- the term of the master franchise agreement;
- if the franchisor is the supplier of products, services or equipment, the terms and conditions of the supply arrangement;
- a description of services (training, marketing, operational support) provided by the franchisor, if any, and franchisor's oversight rights; and
- a description of lawsuits and arbitral proceedings related to the franchise system.

Law stated - 15 May 2022

Due diligence

What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

Conducting due diligence on a prospective franchisee is an essential step in a franchise transaction in China. In major urban centres, a lot of information about a corporation can be obtained online (in Chinese), including:

- its shareholders;
- its registered capital;
- its management;
- its affiliates; and
- any past litigation.

At the very least, a franchisor should start by obtaining a copy of the individual's passport or identity card. If the prospective franchisee is a domestic company, the franchisor's lawyers should obtain a copy of the business licence. Business licences disclose the Chinese character name of the corporation that must be used in the contract (even if the contract is in English) to ensure that the contract may be enforced against the franchisee. The business licence also discloses the name of the legal representative, who is the only person who can sign for the company unless he or she issues a power of attorney to another person to sign the agreement.

On the other hand, it is also advisable for the potential franchisee to conduct necessary due diligence checks on the franchisor and the franchise business. In addition to the franchise disclosure document provided by the franchisor to the potential franchisee, the potential franchisee should consider checking the status of the franchisor company and its franchise business, past and ongoing litigations and administrative penalties and the status of its operational resources, such as trademarks.

Law stated - 15 May 2022

Failure to disclose – enforcement and remedies

What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

MOFCOM has the authority to charge an administrative penalty of up to 100,000 yuan for failure to comply with disclosure obligations, but rarely exercises this authority.

If a franchisor conceals relevant information, fails to provide disclosure or provides false information, the franchisee

may rescind the franchise agreement.

Damages can be claimed under the Civil Code; however, damages awards are generally low in franchise cases.

Law stated - 15 May 2022

Failure to disclose – apportionment of liability

In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

There are no statutory rules or guidance from MOFCOM or the courts regarding the liability of the franchisor for non-disclosure or misrepresentation by the sub-franchisor.

General principles set out in the Civil Code, including the principle of good faith in negotiation and performance of contracts, apply to contractual indemnity for disclosure non-compliance or pre-contractual misrepresentation. Under domestic laws, limitation of liability for bodily injuries or death, or exclusion of liability on the grounds of negligence or gross negligence, are unenforceable.

Law stated - 15 May 2022

General legal principles and codes of conduct

In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

The law in the PRC is based on the principle of good faith in negotiating and performing contracts (culpa in contrahendo), which is the opposite of the common law doctrine of caveat emptor ('buyer beware'). Further, article 500 of the Civil Code prohibits a party from intentionally concealing key facts relating to contract creation. These provisions support the pre-sale disclosure obligation (including all material facts disclosure) and the obligation to perform a franchise agreement in good faith, which is part of PRC law.

Law stated - 15 May 2022

Fraudulent sale

What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

Franchisees can apply to court to revoke a franchise agreement that was concluded as a result of fraud or complain to the authorities of fraud. Article 224 of the Criminal Law provides a special charge for fraud in connection with contracts.

Law stated - 15 May 2022

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

After entering into the franchise agreement, the parties must perform their contractual obligations in good faith. The Commercial Franchise Administration Regulation (the Franchise Regulation) requires the franchisor to provide ongoing operational guidance, technical support and business training in accordance with the franchise agreement, and to disclose to the franchisee any promotional and marketing expenses.

Law stated - 15 May 2022

Operational compliance

What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

Franchisors typically reserve inspection and audit rights to monitor compliance with the franchise agreement. International franchisors should factor in the costs of site visits to the franchisee's location when determining royalty or other fees. In addition to the audit rights, franchisors should require franchisees to provide copies of tax returns. Monitoring franchisees' Chinese websites is also important.

While having access to the franchisee's computer systems and point-of-sale data is useful to monitor compliance with financial obligations, complete access to franchisees' computers and data is difficult to achieve in the People's Republic of China (PRC), including for privacy law reasons.

Law stated - 15 May 2022

Amendment of operational terms

May the franchisor unilaterally change operational terms and standards during the franchise relationship?

If the franchise agreement allows the franchisor to change operational terms and standards unilaterally, the franchisor may exercise such contractual rights in good faith.

Law stated - 15 May 2022

Policy affecting franchise relations

Do other government or trade association policies affect the franchise relationship?

Members of the Chinese business association for the franchise industry, the China Chain Store and Franchise Association, must abide by its code of ethics.

Law stated - 15 May 2022

Termination by franchisor

In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

The grounds for terminating a franchise agreement must be set out in the franchise agreement. Except for the cooling-off period set out in article 12 of the Franchise Regulation, there are no prescribed grounds of termination.

Law stated - 15 May 2022

Termination by franchisee

In what circumstances may a franchisee terminate a franchise relationship?

If a franchisor conceals relevant information, provides false information or fails to provide a disclosure document, the franchisee may rescind the franchise agreement. Franchisee must exercise its right of rescission within one year after they knew or ought to have known the cause for rescission, unless the franchise agreement provides for a longer rescission period (article 564 of the Civil Code). Some Chinese courts have recently denied rescission claims where there was no substantial negative impact on the franchisee caused by failure to disclose, or where the franchisee failed to prove that the failure to disclose had substantially affected its decision to join the franchise system.

Other grounds for terminating a franchise agreement must be set out in the franchise agreement. Except for the cooling-off period set out in article 12 of the Franchise Regulation, there are no prescribed grounds of termination.

Law stated - 15 May 2022

Renewal

How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

Renewal of the franchise agreement must be evidenced in writing. All formal or substantive requirements for the renewal must be set out in the franchise agreement. A new disclosure is not required if the franchise agreement is renewed on the same terms and conditions. Renewal of a trademark licence must be recorded with the National Intellectual Property Administration.

Law stated - 15 May 2022

Refusal to renew

May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Subject to any contrary provisions in a franchise agreement, a franchisor is not obliged to comply with a request for renewal.

Law stated - 15 May 2022

Transfer restrictions

May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Franchisees may transfer or sell their franchise only with the franchisor's consent (article 18 of the Franchise Regulation).

Law stated - 15 May 2022

Fees

Are there laws or regulations affecting the nature, amount or payment of fees?

Fees charged by international franchisors in China typically include:

- royalties;
- initial franchise fees;
- development fees;
- advertising fund fees; and
- interest on late payments, or all of the above.

The type, amount and method of payment of franchise fees are not prescribed by the franchise regulations and must be negotiated between the parties. However, international franchisors should consider some practical aspects when negotiating franchise fees:

- Due to foreign currency exchange regulations, weekly or biweekly payments by a local franchisee to an overseas recipient are difficult to administer. For example, a domestic entity needs State Administration for Foreign Exchange approval to purchase foreign currency exceeding the US\$50,000 annual limit. Chinese payors transferring money overseas must submit certain paperwork to the bank, including a tax authority-issued tax recordal form. Therefore, royalty and other regular payments are usually charged on a monthly or quarterly basis.
- As English is not widely spoken in mainland China, adverts targeting Chinese consumers must be in Chinese and adapted to local customs and culture. If an international franchisor charges advertising fund fees, a separate fund for Chinese advertising should be considered.
- If the franchisor charges a pre-contractual deposit, the purpose of this payment and conditions of refund (if the deposit is refundable) must be evidenced in writing.
- Chinese parties are rarely comfortable providing personal guarantees. Instead, domestic franchisors charge a security deposit, which may be returned to the franchisee on the expiration of the franchise agreement if the franchisee has complied with the obligations under the agreement.

Law stated - 15 May 2022

Usury

Are there restrictions on the amount of interest that can be charged on overdue payments?

Generally, interest charged on overdue payments is considered liquidated damages. Article 585 of the Civil Code

provides that if the agreed-upon amount of liquidated damages is excessively higher than the actual loss incurred by the creditor, parties (generally, the debtor) may request the court to make an appropriate abatement.

The Judicial Interpretation of Private Lending (JIPL), issued by the Supreme People's Court in June 2015, provides that courts must accept and enforce claims of interest under 24 per cent, allow but not enforce claims of interest under 36 per cent and void interest above 36 per cent. Although the JIPL only applies to private lending contracts, in practice courts apply it to other types of contracts.

Law stated - 15 May 2022

Foreign exchange controls

Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

Yes. Chinese yuan is still not freely exchangeable, although controls have loosened over the past decade.

Chinese residents must obtain State Administration of Foreign Exchange approval to purchase foreign currency above the annual quota of US\$50,000. Foreign exchange controls are primarily enforced by the banks, which monitor all overseas payments made by customers. Chinese franchisees should submit documents evidencing their payment obligations (eg, a franchise agreement) to make the overseas payment. To facilitate payments, franchisors should ensure that all registration requirements (eg, registration with MOFCOM and recording of trademark licences with the National Intellectual Property Administration) are completed in good time.

Further, banks require payors to submit a tax recordal form issued by the tax authorities. Many tax departments will not issue tax recordal forms until all withholding taxes are paid.

Law stated - 15 May 2022

Confidentiality covenant enforceability

Are confidentiality covenants in franchise agreements enforceable?

Yes. Franchisors should ensure that their agreements with Chinese franchisees are properly initialled, signed and sealed, and reference the franchisee's legal name in Chinese. Franchisors should collect evidence of the information that has been disclosed and the time of disclosure. Identifying a clear scope of information that is subject to a confidentiality covenant enhances the chances of enforcement.

Law stated - 15 May 2022

Good-faith obligation

Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

Yes, the law in the PRC is based on the principle of good faith in negotiating and performing contracts. Article 7 of the Civil Code and article 4 of the Franchise Regulations require the parties to act fairly, honestly and in good faith.

Law stated - 15 May 2022

Franchisees as consumers

Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

The authors are not aware of any such laws.

Law stated - 15 May 2022

Language of the agreement

Must disclosure documents and franchise agreements be in the language of your country?

There is no such requirement. In practice, providing a Chinese language version is highly recommended to avoid a franchisee's claims that the English version was not understood. Chinese translation of the franchise agreement is also required for registration with MOFCOM and enforcement.

Law stated - 15 May 2022

Restrictions on franchisees

What types of restrictions are commonly placed on the franchisees in franchise contracts?

Subject to the duty of good faith, which does not support overbroad restrictive clauses, non-compete and non-solicitation covenants are enforceable.

The franchisor may set recommended prices for franchisees, although this may attract scrutiny from the anti-monopoly authorities if the franchisor enforces the recommendation.

Law stated - 15 May 2022

Courts and dispute resolution

Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

Franchising disputes usually fall under the jurisdiction of either the basic or intermediate people's courts. Specialised intellectual property (IP) courts in some major cities also have jurisdiction over major franchise cases. The level of court that will hear a dispute is determined by the amount of the claim and the status of the party (ie, a domestic litigant or a foreigner). The monetary thresholds differ between provinces. Generally, foreign-related disputes have a lower monetary threshold to be heard by an intermediary people's court or specialised IP court. In other words, it is easier for a foreign party to obtain more sophisticated judges at the trial level and get an appeal heard by higher people's courts.

Domestic franchise disputes are typically heard by local courts. There are few reported court decisions that involve international franchisors, even though international claimants have a good track record of prevailing in local courts. Contrary to popular belief, Chinese courts are efficient and generally friendly to foreign parties.

Law stated - 15 May 2022

Governing law

Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

Subject to the provisions of the Law of the Application of Law for Foreign-Related Civil Relations of the PRC, there are no restrictions on the parties to a foreign-related transaction to select foreign law to govern their franchise agreement. However, the choice of foreign governing law must be considered against the advantages and disadvantages of choosing a foreign dispute resolution forum.

If the franchisee's or guarantor's assets are in the PRC, enforcing a foreign judgment in China may be either difficult or impossible, as China enforces foreign court decisions only on the basis of a treaty or reciprocity with the respective jurisdiction. But China has been undertaking to liberalise the rules on recognising and enforcing foreign judgments, in order to better adapt to the trend of market opening. There is currently no such treaty or reciprocity with the United States, Canada, Australia or the United Kingdom; in such cases, litigation in China is the preferred route. If litigating or arbitrating domestically, Chinese law should govern the agreement to avoid the costs and inconvenience of explaining foreign law to the judge or arbitrator.

Law stated - 15 May 2022

Arbitration – advantages for franchisors

What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

The PRC is a party to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958). While Western companies overwhelmingly prefer arbitration to litigation in Chinese courts, arbitral awards must still be approved by a local court for enforcement. This process is as expensive and time consuming as a trial. Further, certain issues (eg, ownership of a Chinese-registered trademark) are unlikely to be eligible for arbitration. Arbitration tends to be more expensive and time-consuming than litigating directly in a Chinese court. However, arbitration may be an effective tool if the franchisee has assets outside China, as arbitral awards are more portable across borders than court judgments.

Law stated - 15 May 2022

National treatment

In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

Subject to the real estate restrictions and restrictions on foreign investment in certain industries, foreign franchisors are not treated differently from domestic franchisors.

Law stated - 15 May 2022

UPDATE AND TRENDS

Legal and other current developments

Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

At this time, no significant reforms of the franchise regulations have been announced by the government. However, judicial approaches to franchise disputes continue to evolve. One of the recent trends seen in court decisions is that courts expect the franchisee seeking termination of the franchise agreement for failure to provide a franchise disclosure document (FDD) to explain how the absence of the FDD or a particular piece of information affected the franchisee's decision to buy the franchise. This is different from the approach in some other jurisdictions such as Canada, where failure to provide an FDD or certain information leads to the rescission regardless of the impact on the franchisee.

Law stated - 15 May 2022

Jurisdictions

	Australia	Norton Rose Fulbright
	Canada	Lapointe Rosenstein Marchand Melançon LLP
	China	Jones & Co
	Finland	ADVOCARE Law Office
	France	Bersay
	Germany	Taylor Wessing
	India	G&W Legal
	Israel	Gilat Bareket & Co, Reinhold Cohn Group
	Italy	Rödl & Partner
	Japan	Anderson Mōri & Tomotsune
	Malaysia	Wong Jin Nee & Teo
	Mexico	Gonzalez Calvillo SC
	Netherlands	Parker Advocaten
	New Zealand	Stewart Germann Law Office
	Norway	CLP
	South Africa	Spoor & Fisher
	South Korea	Lee & Ko
	Switzerland	Kellerhals Carrard
	Turkey	Özdağıştanlı Ekici Attorney Partnership
	United Kingdom	Ashtons Legal
	USA	Lathrop GPM