

Franchise

in 32 jurisdictions worldwide

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Overview

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

A typical franchisor is in the form of a company. Administration of Commercial Franchise Operations regulations (promulgated by the State Council on 6 February 2007 and effective as of 1 May 2007) state that a franchisor must be in the form of an enterprise which owns a registered trademark, logo, patent, proprietary technology or other business resources. Organisations or individuals other than enterprises shall not engage in a franchise operation in the capacity of a franchisor.

In China, enterprises include companies, partnership enterprises, joint-stock cooperative enterprises, sole proprietorship enterprises, state-owned enterprises, collective-owned enterprises, Sino-foreign equity joint ventures (EJVs), Sino-foreign cooperative joint ventures (CJVs), wholly foreign-owned enterprises (WFOEs) and foreign-invested joint stock limited companies.

Under Chinese company law, a company is classified into limited liability companies (LLCs) and limited joint-stock companies. LLCs include two unique types of companies: wholly stated owned companies and one-person limited liability companies (one-person LLCs). If the owner of a one-person LLC fails to separate company assets from his own personal assets, he will be required to take joint responsibility for the company's liabilities.

To establish a partnership enterprise, which can be either a normal partnership enterprise or a limited partnership enterprise, two or more individual persons shall enter into a partnership agreement, jointly make an equity contribution and complete the due process of registration. A partner in a normal partnership enterprise will assume unlimited liabilities for the enterprise's debts, whereas a partner in a limited partnership will only be responsible for the enterprise's debts up to the amount of equity that he contributed.

A joint-stock cooperative enterprise is a unique type of enterprise in China, which is invested in mainly by its employees. The investors bear liabilities up to the amount of their investment.

A sole proprietorship enterprise is a business entity invested in and owned by a sole individual person. The investor assumes unlimited responsibility for the enterprise's liability based on his or her personal assets.

EJVs, CJVs, WFOEs and foreign-invested joint stock limited companies are the major forms of foreign invested enterprises in China.

2 What laws and agencies govern the formation of business entities?

For Chinese domestic franchisors, different laws and regulations will apply depending on the nature of the enterprises of the franchisors. Specifically, if the franchisor is in the form of a company, the Company Law (promulgated by the Standing Committee of the National People's Congress with latest amendments effective on 1 January 2006) will apply and govern the formation of the entity;

if the franchisor is a sole proprietorship enterprise, the Law of Sole Proprietorship Enterprises (promulgated by the Standing Committee of the National People's Congress and effective on 1 January 2000) will govern the formation of the enterprise; if the franchisor is a partnership enterprise, the formation of the enterprise must follow the rules set forth in the Law of Partnership Enterprises (promulgated by the Standing Committee of the National People's Congress with latest amendments effective on 1 June 2007); and if the franchisor is a joint-stock cooperative enterprise, as the lawmakers have not yet enacted a uniform law in this regard, the Guidance on the Development of Municipal Joint-Stock Cooperative Enterprises (promulgated by the National Development and Reform Commission and effective in June of 1997), along with the relevant local regulations, are treated as the major governing law and regulations.

Likewise, for foreign franchisors, based on their specific company nature, the Sino-Foreign Equity Joint Venture Law (promulgated by the National People's Congress with latest amendments effective on 15 March 2001), the Sino-Foreign Cooperative Joint Venture Law (promulgated by the National People's Congress with latest amendments effective on 31 October 2000), and the Law of Wholly Foreign Owned Enterprises (promulgated by the National People's Congress with latest amendments effective on 31 October 2000) will govern the formation of the entity. Administration of Foreign Investment in Commercial Sectors Procedures (promulgated by the Ministry of Commerce (MOFCOM) on 16 April 2004 and effective as of 1 June 2004) and its supplemental rules are also important.

The government agency in charge of establishing Chinese domestically invested companies, sole proprietorship enterprises, partnership enterprises and other types of enterprise is the State Administration for Industry and Commerce (SAIC). A foreign investment enterprise (FIE) is subject to the approval of MOFCOM or its local counterparts. If the FIE is engaged in a particular sector which is subject to special approval, the government agencies relevant to said approval will also be involved.

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

Except in sectors discouraged by central or local governments as provided in their investment policies, the statutory requirements to form a business entity in China are not generally high: as far as a company is concerned, the minimum initial registered capital that the shareholders shall contribute is 30,000 renminbi or 100,000 renminbi for a one-person LLC, while Chinese law does not prescribe a minimum capital requirement for a partnership enterprise or a sole proprietorship enterprise.

For an entity to maintain its legality, it should comply with various applicable laws in respect of registration, taxation, labour, foreign exchange, customs, and so on, among which the Regulations of the People's Republic of China on Administration of Registration of Company promulgated by the State Council on 24 June 1994 with

its latest amendment effective on 18 December 2005 ('Regulations of Company Registration') is worthy of special notice. In accordance with the Regulations of Company Registration, from March 1st to June 30th the registration office (normally SAIC's local counterparts) will conduct annual examinations of the companies registered with them. In order to pass the annual examination, companies shall submit an annual examination report, audited financial statements and other documents. If the company successfully passes the examination, the registration office will certify it on the company's business licence; if any significant violation is identified during the examination, the company's business licence could be revoked. Such violations include, but are not limited to, falsifying a capital injection report or other application documents in order to secure approval of establishment or pass the annual examination certification, failing to operate (without good cause) within six months of being granted a business licence, or voluntarily ceasing to operate for more than six months after establishment of the company.

4 What restrictions apply to foreign business entities and foreign investment?

The Chinese domestic market has not been entirely opened up for foreign investors, although a considerable amount of progress has been made since its entry into the World Trade Organization. Foreign investment in China is classified into four categories based on the sectors concerned: encouraged, permitted, restricted and prohibited. Details can be found in the Industry Category Guide for Foreign Investors, which is issued and updated by MOFCOM. Foreign franchisors must ensure that their investment does not fall into the 'prohibited' category.

Foreign investors are not allowed to set up partnership enterprises in China.

Apart from the above, there are no restrictions that particularly apply to foreign franchisors.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

From the perspective of the Law of PRC on Enterprise Income Tax (Adopted at the 5th Session of the 10th National People's Congress on 16 March 2007, promulgated by Order No. 63 of the President of the People's Republic of China and effective as of 1 January 2008), enterprises are classified as resident or non-resident enterprises. Resident enterprises are those that are set up under Chinese law or that are set up in accordance with the law of other jurisdictions and have their actual administration centre located in China. Non-resident enterprises are those that are set up in accordance with the law of foreign countries (regions) and have their actual administration centre outside of China, but have establishment in China, or have income originating from China without establishment in the territory of China.

Franchisors who are considered as resident enterprises, regardless of the investor's nationality, are subject to income tax at a rate of 25 per cent on income originating from inside and outside of China.

Non-resident franchisors must pay withholding income tax at a rate of 10 per cent pursuant to the Implementation Rules of Enterprise Income Tax for passive income originating from China (eg, franchise fees, royalties), unless provided otherwise in the tax treaty between China and the home country or region of the franchisor. Non-resident franchisors must also pay enterprise income tax on active income (eg, service fees) generated from China through its establishment. Depending upon the tax law of the home country or region of the franchisor, the withholding tax or enterprise income tax, or both, that is paid in China by the franchisor, may be creditable to the income tax payable in its home country.

In addition to the above-mentioned enterprise income tax, franchisors shall pay business tax at the rate of 5 per cent for the franchise fees (also known as 'service fees').

Article 8 of Enterprise Income Tax provides that de facto expenditure incurred in connection with operational activities is deductible to a reasonable extent when computing taxable income. According to interpretation by officials from the General Tax Bureau, such provision does not apply to non-resident franchisors' franchise fee income. Such interpretation has led to announcement of the abolishment of the Notice of General Tax Bureau and Financial Ministry regarding Enterprise Income Tax Levying on Foreign Enterprise after Receiving Franchise Fee and Paying off Business Tax (promulgated by the General Tax Bureau and Financial Ministry and effective as of 19 March 1998), which specifically allowed foreign enterprises to deduct business tax before paying enterprise income tax.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Franchise business owners must give special attention to the statutory requirement that employers shall pay social security for their regular employees (ie, pension, unemployment insurance, medical insurance and employment injury insurance). The enactment of the China Labour Contract Law (adopted at the 28th Session of the Standing Committee of the 10th National People's Congress on 29 June 2007 and effective as of 1 January 2008) has increased the overhead costs and legal risks for franchise business such as fast-food chain restaurants, which engage a significant number of part-time employees or non-employee workers: the labour contract law provides that the daily working hours of a part-time employee cannot exceed four hours and the weekly working hours cannot exceed 24 hours. Non-employee workers will have to be dispatched from sourcing companies, which legally are the employers of the dispatched employees. Otherwise, the non-employee workers will be deemed as regular employees of the franchise owners.

Although the risk that a franchisee or employees of a franchisee are deemed to be the franchisor's employees is not high in practice, it is advisable for the franchisor to set up a well-drafted relationship clause in the franchise contract to clarify the relationship between franchisor, franchisee and the franchisee's employees.

7 How are trademarks and know-how protected?

A trademark will be protected under Chinese law if it has been registered with the China Trademark Office. Know-how is protected in China as a trade secret if such know-how, which has not been in the public domain, may bring about economic benefits, has practical utility, and is protected by the owner under non-disclosure measures.

A franchisor can protect its trademarks and know-how by the following means:

- contractual protection, specifying each party's rights and obligations in respect of how the franchisee may use the franchisor's trademarks and know-how in the franchise agreement, specific trademark licence agreement or non-disclosure agreement;
- seeking protection from the administrative agency (State Administration for Industry and Commerce (SAIC)) and its local counterparts, which may impose administrative sanctions – in most cases warnings or monetary fines, or both – on the infringer. It may be quicker to seek protection from the administrative agencies than to litigate, especially if the trademark has been certified as a well-known trademark in China; and
- seeking protection through the courts.

- 8 What are the relevant aspects of the real estate market and real estate law?

Under Chinese real estate law, unlike domestic franchisors, a foreign franchisor is not allowed to directly purchase real estate property located in China unless it is for his or her own use. One solution is for the franchisor to set up a presence in China through which the purchase can be handled.

In addition, if a franchisor sets up certain standards for the properties to be used by a franchisee, or recommends a property to the franchisee, the franchisor should make sure the contract explicitly states that the franchisor is not responsible for any losses caused by fluctuations in the property market. Furthermore, as the overall Chinese economy is developing quickly and urban redevelopment is a prevalent trend, it is advisable for the franchise agreement to take into consideration a scenario in which the property used by the franchised business will be forcibly redeveloped and the franchisee will have to be relocated.

Laws and agencies that regulate the offer and sale of franchises

- 9 What is the legal definition of a franchise?

As provided by Chinese law, a franchise refers to a business activity whereby the franchisor, by virtue of performance of contract, licenses the franchisee to use the operational resources inter alia, the registered trademark, enterprise logo, patent and know-how, and the franchisee undertakes business under the unified business format set up in the franchise agreement and pays franchise fees to the franchisor in return.

- 10 Which laws and government agencies regulate the offer and sale of franchises?

The provisions governing franchise activities can be found primarily in the following laws and regulations:

- Administration of Commercial Franchise Procedures (promulgated by the Ministry of Commerce on 30 December 2004 and effective as of 1 February 2005);
- Administration of Commercial Franchise Operations Regulations (promulgated by the State Council on 6 February 2007 and effective as of 1 May 2007);
- Administration of Commercial Franchise Operations Registration Procedures (promulgated by the Ministry of Commerce on 30 April 2007 and effective as of 1 May 2007);
- Administration of Information Disclosure for Commercial Franchise Operations Procedures (promulgated by the Ministry of Commerce on 30 April 2007 and effective as of 1 May 2007);
- Administration of Foreign Investment in Commercial Sector Procedures (promulgated by the Ministry of Commerce on 16 April 2004 and effective as of 1 June 2004).

The government agency in charge of administration of franchises is MOFCOM and its local counterparts.

- 11 Describe the relevant requirements of these laws and agencies.

The principal requirements include the following:

- The franchisor shall have the necessary business resources (such as trademarks) that it will license to its franchisees in order for the franchisees to carry out the franchised business.
- The franchisor shall satisfy the '2+1' requirement, ie the franchisor must already have at least two existing stores and must have been engaged in the franchised business for more than one year.

- The franchisor shall make registration with MOFCOM or its local counterpart (starting from 1 May 2009, foreign franchisors shall make registrations with MOFCOM, and Chinese franchisors (including FIEs) shall make registrations with MOFCOM's provincial-level counterpart in the province in which the franchisor is established). The franchisor shall also update MOFCOM on an annual basis regarding the number of franchise agreements that it signed or renewed or terminated with its Chinese franchisees during the previous year.
- The franchisor shall disclose information to its franchisees in accordance with Administration of Information Disclosure for Commercial Franchise Operations Procedures.
- The franchisor shall enter into the franchise agreement in writing with the franchisee, and the term of the franchise agreement shall be no less than three years (unless the franchisee agrees otherwise). Additionally, the franchisor shall give the franchisee a cooling-off period: that is, the franchisee has the right to unilaterally terminate the franchise agreement within a certain time frame as agreed by the franchisor and franchisee after the franchise agreement is signed.
- The franchisor shall provide a manual, training and support to its franchisees in accordance with the agreement between the franchisor and the franchisee.

- 12 What are the exemptions and exclusions from any franchise laws and regulations?

There is no exemption or exclusion under current Chinese franchise laws and regulations.

- 13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

The franchisor must satisfy the '2+1' requirement, ie the franchisor must already have at least two existing stores and must have been engaged in the franchised business for more than a year. The two existing stores can be anywhere in the world – they do not have to be in China. The franchisor must have the necessary business resources, such as a registered trademark, enterprise logo, patent or proprietary technology.

- 14 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?

Under a sub-franchising structure, the sub-franchisor is obligated to disclose to the sub-franchisee that it is a sub-franchisor, that it has obtained the necessary operational resources (eg, trademarks) from the original franchisor, and that it has obtained (or will obtain) permission from the original franchisor to grant a sub-franchise to the sub-franchisee. In addition, it should disclose to the sub-franchisee all other information disclosed to it by the original franchisor. The sub-franchisee may also have to disclose certain information to the original franchisor where it is stipulated in the original franchise agreement or the original franchisor is directly involved: for instance, whether the original franchisor will provide training to the sub-franchisees, or whether the sub-franchisees must purchase certain goods or services from the suppliers designated by the original franchisor.

- 15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

In light of the Administration of Information Disclosure for Commercial Franchise Operations Procedures and Administration of Commercial Franchise Operations Regulations, the franchisor shall

disclose in writing the information required by these regulations at least 30 days before the parties execute the franchise agreement. In addition, the franchisor shall provide a sample of the franchise agreement to the franchisees. If there is any material change to the information after the pre-contractual disclosure, the franchisor shall notify the franchisee of such in a timely fashion.

16 What information must the disclosure document contain?

According to the Administrative of Information Disclosure for Commercial Franchise Operations Procedures and Administration of Commercial Franchise Operations Regulations, a franchisor shall disclose the following to its franchisees:

- Basic information about the franchisor and the franchising activities, such as:
 - name, correspondence address, contact information, legal representative, general manager, amount of registered capital and business scope of the franchisor, as well as the number, addresses and contact numbers of existing direct-owned stores;
 - an overview of the franchisor's commercial franchising activities;
 - basic information regarding the franchisor's franchise registration (with MOFCOM or its local counterpart);
 - basic information regarding the franchisor's affiliates shall be disclosed if such affiliates provide products or services to the franchisee; and
 - information on whether the franchisor or any of its affiliates has been declared bankrupt or has filed for bankruptcy during the past five years.
- Basic information on the business resources owned by the franchisor, such as:
 - a written indication to the franchisee regarding the available registered trademarks, corporate logo, patents, proprietary technologies, business model and other business resources that the franchisor can provide;
 - basic information regarding the franchisor's affiliates shall be disclosed if the business resources are owned by such affiliates, and the franchisor shall also explain how the franchise operations will be dealt with if the licence (regarding such business resources) from the franchisor's affiliates to the franchisor is terminated; and
 - information on whether the franchisor's (or any of its affiliates') registered trademarks, corporate logo, patents, proprietary technologies or any other business resources are involved in legal proceedings or arbitration.
- Basic information about franchise operations fees, such as:
 - the types, amounts, standards and payment method of fees charged by the franchisor and on behalf of third parties. Where the franchisor is unable to disclose such information, the reasons shall be given. Where there is no uniform fee standard, the highest and lowest standard shall be disclosed and the reasons shall be given;
 - collection of security deposits and the conditions, time and manner of the refund thereof; and
 - where the franchisee is required to make payment before entering into the franchise operations agreement, a written explanation of the usage of such fees and the conditions and manner of the refund thereof shall be given to the franchisee.
- Price and conditions for provision of products, services and equipment to the franchisee, such as:
 - whether the franchisee is required to purchase any product, service or equipment from the franchisor (or its connected company) and the related price and conditions thereof;
 - whether the franchisee is required to purchase any product, service or equipment from suppliers designated (or approved) by the franchisor; and

- whether the franchisee is allowed to choose other suppliers, and the requirements for such alternative suppliers.
- Continuous provision of services to the franchisee, such as:
 - Exact contents, method of provision and implementation plan of training programme, including location, method and duration of training; and
 - exact contents of technical support, table of contents of the franchise operations manual and the relevant number of pages.
- Method and content of guidance and supervision on the franchisee's business activities, such as:
 - the method and content of the franchisor's guidance and supervision on the franchisee's business activities, as well as the obligations of the franchisee and the consequences for failure to fulfil such obligations; and
 - whether the franchisor shall assume joint liability for consumer's complaint or claim, as well as the arrangements thereof.
- The investment budget status of franchise operations units:
 - the investment budget may include the following expenses: joining fee; training fee; property and renovation expenses; purchase fees of equipment, stationery and furniture; initial inventory; water, electricity and gas fees; fees required to obtain a licence and other government approvals; and initial working capital; and
 - the source of data and basis used in the estimation of the aforementioned expenses.
- Information about franchisees in China, such as:
 - the number, geographical distribution, scope of authorisation and individually authorised district (if there is any, the estimated area should be described) of existing and expected franchisees; and
 - an evaluation of the operating performance of franchisees, including the actual or projected average sales volume, costs, gross profit and net profit, as well as the source of aforesaid data, period of data used, and the geographic distribution of franchised outlets shall be disclosed by the franchisor; in the case of estimated information, the basis used shall be explained and a statement that the estimate may differ from the actual operating performance of the franchisees shall be made.
- A summary of the past two years' financial and accounting reports and audit reports of the franchisor, audited by a firm of accountants or audit firm.
- Material litigations or arbitrations of the franchisor related to the franchise operations in the past five years. Material litigations and arbitrations refer to those with a subject amount exceeding 500,000 renminbi. The basic circumstances, location of the proceedings and outcome of such litigation shall be disclosed.
- Historical records of unlawful business operation conducted by the franchisor or the legal representative thereof, namely:
 - any fine of more than 300,000 renminbi but less than 500,000 renminbi imposed by a relevant administrative or law enforcement department; and
 - any criminal liability imposed.
- The franchise operations agreement, including:
 - a sample of the franchise operations agreement; and
 - a sample of other franchise-related agreements to be entered into between the franchisee and the franchisor (or its connected company) at the request of the franchisor.

17 Is there any obligation for continuing disclosure?

According to the Administration of Information Disclosure for Commercial Franchise Operations Procedures and Administration of Commercial Franchise Operations Regulations, in the case of any

material change to the disclosed information, the franchisor shall notify the franchisees of such change in a timely manner.

18 How do the relevant government agencies enforce the disclosure requirements?

If a franchisor violates the disclosure requirements, its franchisee may report the violation to MOFCOM or its local counterpart. Upon verifying the violation, MOFCOM (or its local counterpart) will request that the franchisor remedies it and a monetary fine of between 10,000 and 50,000 renminbi will be imposed on the violating franchisor. In the case of a serious violation, a fine of between 50,000 and 100,000 renminbi will be imposed and MOFCOM will make a public announcement regarding the violation.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

A bona fide franchisee is entitled to rescind the franchise agreement if its franchisor has been found in violation of an information disclosure requirement: specifically, if the franchisor failed to disclose information that it should have disclosed or the franchisor provided false information to the franchisee.

Franchise-related laws and regulations do not specifically provide for how the parties can dispose of a franchise agreement in the event that the franchisee rescinds the franchise agreement in such a way as that mentioned above. However, the parties may follow the rules and principles of contract law and the Civil Code. Principally, the franchisor and franchisee will not perform the outstanding part of the franchise agreement that has not yet been performed, while the franchisee may request to return to status quo for the part of the franchise agreement that has been performed. As a critical part of so doing, the franchisee will return the franchisor's manual and other materials, stop using the franchisor's business resources, and seek indemnification from the franchisor to cover the franchisee's necessary expenses for entering into the franchise agreement, performing the franchise agreement and returning to status quo.

20 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?

The sub-franchisor is legally obligated to disclose the required information to the sub-franchisee. There is no statutory requirement for the original franchisor to disclose any information to the sub-franchisee, nor will the original franchisor be held jointly and severally liable for the sub-franchisor's default on its disclosure obligation. Nonetheless, if a judge or arbitrator ultimately determines that the sub-franchisor's default is partially caused by the original franchisor, the original franchisor will undertake the liabilities commensurate with its mistake at the discretion of the adjudicator.

In light of current Chinese franchise-related laws and regulations, the individual officers, directors and employees of a franchisor or sub-franchisor will not usually be held personally responsible for civil liability as a result of disclosure violation, unless the related individual is found to have engaged in any fraudulent or deceptive practices which could be construed as a crime under criminal law.

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

As a written franchise agreement must be signed, the PRC Contract Law (promulgated by the National People's Congress and effective as of 1 October 1999) and relevant judicial interpretations will apply to formation, interpretation, performance and liabilities related to the franchise agreement.

In addition, as mentioned in question 19, the PRC Civil Code (adopted at the Fourth Session of the Sixth National People's Congress, promulgated by Order No. 37 of the President of the People's Republic of China on 12 April 1986, and effective as of 1 January 1987) is another critical source of law: adjudicators frequently refer to its doctrines and principles when the specific franchise statutory provision is in absence.

22 Are there any general obligations for pre-sale disclosure that would cover franchise transactions?

Apart from the information that the franchisor is mandatorily required to disclose under the Administration of Information Disclosure for Commercial Franchise Operations Procedures and Administration of Commercial Franchise Operations Regulations, the franchisor generally does not have to disclose any other information. However, in compliance with the rules and doctrines under the Civil Code and the Contract Law, a franchisor should answer the questions of a prospective franchisee in good faith.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

In accordance with Administration of Commercial Franchise Operations Regulations, the franchisor shall not include any fraudulent, deceptive or misleading information in its promotional or marketing activities. In particular, its advertisement cannot contain any propaganda regarding franchisees' earnings. Violating this requirement will lead to a fine of 30,000 to 300,000 renminbi.

Furthermore, if a franchisor committed fraudulent or deceptive practices in the course of the offer and sale of franchises, the franchisee as a bona fide victim may pursue the dispute resolution provided in the franchise agreement and seek the relief available under contract law and the Civil Code. Specifically, the franchisee may request that the franchise agreement is modified or nullified. If the franchise agreement is nullified, it will become retroactively invalid from its very beginning, meaning that to some extent, the parties shall return to status quo. All costs and losses incurred by the franchisee in so doing shall be compensated by the franchisor. A one-year statute of limitation applies: in other words, the franchisee must file the case within a year of the time at which it knew or should have known of the fraud or deception.

If the fraud or deception is very serious in terms of the amount of damages, the magnitude of the negligence or the effect of such fraud or deception on the public and society, it will fall under the Criminal Law. In that case, the franchisor or its directors, officers or employees, as the case may be, will be prosecuted for committing a crime.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The Administration of Commercial Franchise Operations Regulations ('Administration') is a major regulation that governs the

relationship between franchisor and franchisee once the contract has come into effect. It deals with major obligations between the parties, quality control of the franchised business, assignment of contracts, and so on. For instance, in accordance with the Administration, a franchisor shall provide an operating manual, continuing operational guidance, technical support, business training and other services to the franchisee pursuant to the franchise contract. Furthermore, where a franchisor collects advertising and promotion fees from a franchisee, it shall use the collected monies pursuant to contractual stipulations. The usage of advertising and promotion fees shall be disclosed to the franchisee promptly. In addition to the foregoing, the Administration also provides that a franchisee shall not transfer the rights of its franchise operation to others, nor shall he or she divulge or allow others to use the commercial secrets of the franchisor that the franchisee has access to.

25 Do other laws affect the franchise relationship?

In addition to the Contract Law and the Civil Code, which govern the validity, interpretation, performance and other areas of a franchise agreement, the franchisor and franchisee shall also comply with several other laws, including advertisement law (in respect of advertising), trademark law (in respect of trademark protection and licensing), and some regulatory requirements, such as Regulations on Prohibition of Pyramid Selling.

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

MOFCOM and its local counterparts are the governmental authority in charge of approval, filing and administration of franchise activities. The other government agencies that regulate different perspectives of business activities do not have the authority per se to act on the franchise relationship between the parties. For example, the police or SAIC and its local branches will be involved if there is found to be fraud or deception relating to the sale of franchised business. Neither does any trade association have such authority per se.

27 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?

A franchisor may terminate a franchise relationship pursuant to the franchise contract's provisions regarding the early termination of the contract. In absence of such express contractual provisions, the franchisor may terminate the franchise relationship in accordance with Contract Law in the following circumstances:

- the purpose of the franchise contract is not able to be realised due to force majeure;
- the franchisee explicitly expresses or indicates through its acts that it will not perform its principal debt obligations;
- the franchisee delays performing its principal debt obligations and still fails to perform them within a reasonable timeframe of being urged to do so; or
- the purpose of the franchise contract cannot be realised because the franchisee delays performing its debt obligations or commits some other act in breach of the contract.

28 In what circumstances may a franchisee terminate a franchise relationship?

According to Chinese law and regulation, a franchisee may terminate a franchise relationship under the following circumstances:

- based upon the contractual stipulations in the franchise agreement or under the provisions of the PRC Contract Law;

- during the cooling-off period as mutually agreed by the franchisor and the franchisee in the franchise contract; or
- if the franchisor violates its disclosure obligation.

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

It is not mandatory for the franchisor to renew the franchise agreement. The franchisor has sole discretion over whether or not to renew, unless the initial franchise agreement contains any provisions to the contrary.

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

In accordance with Administration of Commercial Franchise Operations Regulations, a franchisee must obtain the franchisor's prior consent before assigning the franchise agreement. One point to note is that, from the perspective of Chinese law, transfer of ownership interests will not be deemed as assignment of a franchise agreement. The franchisor must expressly stipulate in the franchise agreement if he wishes to have the power to prevent the franchisee transferring its ownership interests in a franchisee entity.

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

In light of Administration of Commercial Franchise Operations Regulations, if the franchisor requests that the franchisee pay initial franchise fees before the execution of a franchise agreement, the franchisor must explain to the franchisee in writing the purpose of the payment, as well as the conditions and manners of refund. With regard to the funds paid by the franchisee pursuant to the franchise agreement for the advertisement and promotion of the franchise business, the franchisor shall ensure that the fund is spent for the exact purpose agreed in the franchise agreement and update the franchisee on the status of the same.

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

The franchisor is entitled to interest for overdue payments which, however, should not be excessively higher than the actual damage suffered by the franchisor. To this end, the adjudicator may adjust the interest rate provided in the franchise agreement.

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

China adopts a foreign exchange control system according to which all outbound payment, except for settlement with Hong Kong, Macao and ASEAN (Association of Southeast Asian Nations) countries which could be denominated in renminbi, shall be in foreign currency against various supporting documents. Accordingly, a franchisee must present the agreements (franchise agreement, licence agreement, etc) which have been filed with MOFCOM's local counterpart, the tax certificate evidencing that the franchisee has fulfilled its obligation in respect of withholding tax (if any) and other documents which might be required by the payer bank in accordance with foreign exchange control regulations.

34 Are confidentiality covenants in franchise agreements enforceable?

It is enforceable in general. However, the owner of the proprietary information must be able to prove that the information in discussion:

- has never been in the public domain;
- may bring about economic benefits;
- has practical utility; and
- is protected by the owner under non-disclosure measures.

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

Yes, both the PRC Civil Code and the PRC Contract Law provide that commercial transactions should be conducted in good faith, and this is also applicable to franchise contracts. Notwithstanding the disclosure requirements underneath Administration of Commercial Franchise Operations Regulations and Regulations Administration of Information Disclosure for Commercial Franchise Operations Procedures, if the information disclosed by the franchisor is not in good faith, it could still be misleading or unreliable. For example, the aforementioned regulations require that the franchisor provides its record and speculation about existing and potential franchisees and assesses the operation status of the franchisee. As the franchisor is legally obliged to provide this information in good faith, it must be reasonably diligent and careful in the course of its calculations; thus, the credibility of the provided information will be significantly increased.

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

No. As provided by the laws and regulations in respect of consumer protection, 'consumers' in China usually means people who purchase materials or services for their own consumption. With regard to consumer protection, a franchisee, who provides materials or services to its end-user consumers is not a consumer.

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

Chinese law does not specifically require that franchise agreements and disclosure documents be made in Chinese. For the convenience of making registration with government agencies and in order to avoid potential disputes with local Chinese-speaking franchisees, in practice bilingual versions of the documents are recommended.

38 What restrictions are there on provisions in franchise contracts?

As provided by Administration of Commercial Franchise Operations Regulations, the term of a franchise contract shall not be less than three years. In the case of a foreign franchisor, according to the Measures for The Administration on Foreign Investment in Commercial Fields (promulgated by the Ministry of Commerce and effective as of 1 June 2004), the term of operation of a foreign-funded commercial enterprise shall not exceed 30 years in general, and the term of operation of a foreign-funded commercial enterprise that is established in the middle and western areas shall not exceed 40 years in general. Although for the time being there is no specific statutory restriction on franchise contracts providing exclusive territory, designated suppliers for franchised business, conditional sales or tied sales, in accordance with the Anti-Unfair Competition Law (promulgated by the Standing Committee of the National People's Congress and effective as of 1 December 1993) and the Anti-Monopoly Law (promulgated by the National People's Congress and effective as of 1 August 2008), these provisions shall not be involved with abuse of market position, impairment to the public interest, or interference in a franchisee's lawful business activities. The motive of these clauses is to protect the goodwill, quality and safety of the franchised business.

Update and trends

Franchising has been developing in China for more than 10 years, and is rapidly growing. Before the start of the recession in 2008, statistics show there were 3,500 franchised businesses and more than 300,000 franchisees across over 60 sectors in the country. The total revenue of the top 100 franchised businesses was over 220 billion renminbi and franchised businesses employed more than one million people. Overall franchise business in China warmed up again in 2009. One important event for Chinese franchise business operators was the country's long-awaited NASDAQ-style second board, which was started in September 2009. In response to this change, franchise business owners started to assess this as a new resource for financing that can help expedite expansion, so as to take advantage of the low cost of acquisitions resulting from the recession. From the fourth quarter of 2009 through 2010, the top 20 franchised business operators have seen a collective increase of 1,200 franchised outlets.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

The Anti-Unfair Competition Law (promulgated by the Standing Committee of the National People's Congress and effective as of 1 December 1993) and the Anti-Monopoly Law (promulgated by the National People's Congress and effective as of 1 August 2008) are two major statutes governing competition activities in China, according to which the following will be prohibited in business activities: a monopoly agreement which fixes prices for resale, restricts the lowest price for resale, limits the output or sales of the products, allocates the sales markets or the raw material purchasing markets, or limits the purchase of new technology or new facilities or the development of new products or new technology. In order to ensure the franchisees carry on a franchised business in a uniform business format, the franchisor must set forth a lot of standards in the franchise contract that seemingly fall into the above-mentioned prohibited areas, such as fixed prices for franchised services or products, designated raw material suppliers and conditional sales. However, franchising will not be considered to be in violation of the above competition regulations as long as there is no abuse of market position, no impairment to the public interest and no interference in the franchisee's lawful business activities (eg., if the purpose of the conditional sale is to protect the quality and then the goodwill of the franchised business, or the conditional sale is the only way for the franchisor to safeguard his know-how, proprietary technology or other commercial confidential information). On the other hand, if the conditional sale's purpose is to create market barriers, sell unmarketable goods or other unreasonable causes, such a conditional sale will be construed as a violation of unfair competition law and shall be punished.

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

The court system in China consists of four levels of court: the basic people's court; the intermediate people's court; the high court (which is the highest court in each province, autonomous region and municipality under direct administration of the central government); and the Supreme People's Court (which is the highest court in China). The judgment of the court of the second instance is usually final, and only in rare cases (such as new evidence being found which leads to the judgment being overruled) can the parties bring the case to a retrial.

China is not a case law country, so case precedents are not one of the legal resources used. However, in practice, previous judgments on similar cases can be used as reference, especially if the judgments were made by a superior court.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

It is always recommended for foreign franchisors to select arbitration as a mechanism to solve their dispute and to choose a reputable arbitration centre for the arbitration tribunal. The core advantage is that a foreign franchisor may nominate its own arbitrator from the arbitration centre's arbitrators list and does not need to be concerned about local protectionism or the bias which is still fairly rampant in local courts. However, if the arbitration centre selected by the parties is located outside China, it is likely to become very cumbersome to serve notice to the Chinese party if said party refuses to sign to accept the notice. In addition, in comparison with the procedures of the Chinese court system, the proceedings needed for an arbitration

heard in a foreign arbitration centre could be much more time-consuming and expensive; and even if the foreign franchisor receives a favourable award from the foreign arbitration centre, the local court will be called upon to enforce it.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

From both a Chinese law and a practical perspective, in general, a foreign franchisor is treated the same as a domestic franchisor. In other words, no discriminatory treatment in particular is implied for foreign franchisors.

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