

GETTING THE
DEAL THROUGH 

Franchise 2016

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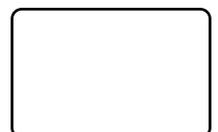


Published by
Law Business Research Ltd
87 Lancaster Road
London, W11 1QQ, UK
Tel: +44 20 3708 4199
Fax: +44 20 7229 6910

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No photocopying without a CLA licence.
First published 2007
Tenth edition
ISSN 1752-3338

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Printed and distributed by
Encompass Print Solutions
Tel: 0844 2480 112



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Overview

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

The business entity structures typically used by franchisors that set up a China based system are either a domestic company (if a domestic franchisor) or a foreign-invested company (if a foreign franchisor).

Entities or individuals other than enterprises may not assume the role of franchisor to conduct franchising activities in China.

Listed below are the types of legal entities that a franchisor can set up in China.

Domestic enterprises

- Company;
- limited liability company;
- limited joint-stock company;
- partnership enterprise;
- joint-stock cooperative enterprise;
- sole proprietorship enterprise;
- state-owned enterprise; and
- collective-owned enterprise.

Foreign-invested enterprises (FIEs)

- Sino-foreign equity joint venture (EJV);
- Sino-foreign cooperative joint venture (CJV);
- wholly foreign-owned enterprise (WFOE); and
- foreign-invested joint stock limited company (FISC).

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

The laws governing the formation of business entities in China vary based on the nature and the type of business entity.

Domestic enterprises

- Companies: governed by the Company Law (promulgated by the Standing Committee of the National People's Congress with the latest amendments effective from 1 March 2014) (the Company Law).
- Partnership enterprises: governed by the Partnership Enterprise Law (promulgated by the Standing Committee of the National People's Congress with latest amendments effective on 1 June 2007).
- Sole proprietorship enterprises: governed by the Law on Sole Proprietorship Enterprises (promulgated by the Standing Committee of the National People's Congress with latest amendments effective on 1 January 2000).
- Joint-stock cooperative enterprises: there are no uniform laws in this area and we rely mainly on the Guidance on the Development of Municipal Joint-Stock Cooperative Enterprises (promulgated by the National Development and Reform Commission and effective on 1 June 1997), along with relevant local regulations.

Foreign-invested enterprises

The following types of FIEs are regulated by specific legislation in addition to the Company Law. In case of conflict, the specific legislation would prevail.

- EJV: governed by the Law on Chinese-Foreign Equity Joint Ventures (promulgated by the National People's Congress with latest amendments effective on 15 March 2001);
- CJV: governed by the Law on Sino-foreign Cooperative Enterprises (promulgated by the National People's Congress with latest amendments effective on 31 October 2000);
- WFOE: governed by the Law Concerning Enterprises with Sole Foreign Investment (promulgated by the National People's Congress with latest amendments effective on 31 October 2000); and
- FISC: governed by the Law on Wholly Foreign-owned Enterprises (promulgated by the Standing Committee of the National People's Congress with latest amendments effective on 31 October 2000).

In addition to the above, the Administration of Foreign Investment in Commercial Sectors Procedures (promulgated by the Ministry of Commerce (MOFCOM) and effective as of 1 June 2004) and its supplemental rules are also very important to FIEs.

Domestic and foreign enterprises are also regulated by different government agencies. The State Administration for Industry and Commerce (SAIC) governs the establishment and registration of Chinese domestic companies, sole proprietorship enterprises, partnership enterprises and other types of domestic enterprises. An FIE needs to seek approval from MOFCOM or its local counterparts. Other relevant government agencies are also involved if the FIE is engaged in business sectors that require special approvals or permits.

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

As listed above, different types of business entities are governed by different laws and regulations that impose different requirements. In setting up a specific type of business entity, a franchisor must carefully follow the requirements of the appropriate laws and regulations.

The Company Law was amended in 2013 (with effect from 1 March 2014). The amendments were meant to simplify the process of setting up a company in China and to stimulate the private sector.

One of the most important amendments is that the registered capital requirements have been abolished by the SAIC, which greatly reduces the upfront cost for incorporating a company. The amendments directly reduce execution costs and expenses, while streamlining structuring considerations. Notwithstanding, in practice, registered capital is still applicable for FIEs and is still subject to approval by MOFCOM (or its counterparts). Also, MOFCOM or its counterparts still require application documents related to the registered capital amount and the capital injection plan.

In order to maintain the legality of a business entity, compliance with applicable laws in respect to, inter alia, registration, taxation, labour, customs and consumer protection is required. More specifically with regards to companies, a franchisor needs to pay attention to the Administrative Regulations on Company Registration (promulgated by the State Council, which entered into effect on 1 March 2014). Between 1 January and 30 June every year, a company must submit an annual report for the previous year to the company registration department of the SAIC. The annual report is available to the public. The contents of the annual report are subject to supervision and inspection by the SAIC.

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

MOFCOM has divided foreign investment business sectors into four categories: encouraged, permitted, restricted and prohibited. The classification details can be found in the Industry Category Guide for Foreign Investors (revised in 2015). Therefore, foreign investors who are considering investing in China should first ensure that their intended business does not fall under the prohibited category (and to a lesser extent, under the restricted category).

In terms of business structure, foreign investors are not allowed to set up partnership enterprises in China.

If a foreign franchisor is looking to expand its business into China, two specific regulations issued by MOFCOM need to be considered. First, in order to conduct franchise activities in China, all foreign franchisors must follow the measures set out in the Administrative Measures for the Record Filing of Commercial Franchises (promulgated by MOFCOM and which entered into effect on 1 February 2012). Second, the Administrative Measures for Foreign Investment in Commercial Fields (promulgated by MOFCOM and which entered into effect on 1 June 2004) (the Measures for Foreign Investment) must be taken into consideration when a foreign franchisor establishes foreign-funded commercial enterprises within the territory of China and engages in business activities. Furthermore, when an enterprise with foreign investment invests in commercial sectors within the territory of China, it must comply with the Interim Provisions on Investment of Foreign-funded Enterprises in China. It is important to note that the Measures for Foreign Investment provides that the term of operation of a foreign-funded commercial enterprise shall not exceed 30 years (40 years if established in the central and western areas of China).

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

The major legal regime governing franchisors is the Law on Enterprise Income Tax, which came into effect on 1 January 2008 (Enterprise Income Tax Law). Pursuant to the Enterprise Income Tax Law, taxpayers are classified in two categories: resident taxpayers, who shall pay enterprise income tax on their income earned inside and outside China; and non-resident taxpayers, who shall pay enterprise income tax on their income earned by agencies or offices in China, and its income earned outside China but which is in substance associated with such agencies or offices. Resident taxpayer status refers to enterprises established in China according to Chinese law, or established according to the law of a foreign country (region) with its actual management body in China. Non-resident taxpayer status refers to enterprises established according to the law of a foreign country with its actual management body located outside of China, but that have established agencies or offices in China, or have income earned in China.

Usually, a foreign franchisor selling its franchise system in China through its local franchisee will be deemed as a non-resident taxpayer, and it will be subject to income tax (withholding tax) at the rate of 10 per cent of the income generated in China (ie, franchise fee, royalty, service fee and trademark licence fee (transaction amount)), unless otherwise provided by the tax treaty between China and the country where the franchisor is located. If the foreign enterprise establishes a Chinese entity to sell franchises in China, then such Chinese entity would be the franchisor and the resident taxpayer. In this scenario, the profit of the franchisor will be subject to enterprise income tax set (at the time of writing) at the rate of 25 per cent.

In addition to enterprise income tax, the franchisor's business sales will be subject to VAT. Taxpayers in China for VAT purposes are divided into categories of 'general taxpayers' and 'small-scale taxpayers' according to the scale of their business operations and the degree of sophistication of their accounting systems. The VAT payable by general taxpayers is calculated using the output tax or input tax crediting system at the rate of 17 per cent for sale of products (or at the rate of 6 per cent for provision of VAT-taxable services). For small-scale taxpayers, a simplified VAT calculation formula applies under which no credit or deduction is allowed for input tax, but tax is calculated at a lower rate of 3 per cent. The VAT is applicable regardless of whether the franchisor is a resident taxpayer or a non-resident taxpayer.

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?

For a typical franchisor, it will enter into a franchise agreement with franchisee and the franchisee is in charge of the business established according to the franchise agreement. The franchisor typically is not directly in contact with employees of a franchisee. Thus, there is little to no risk that employees of a franchisee could be deemed employees of the franchisor. Moreover, the risk of recognising the franchisee as the franchisor's employee is low provided that there is a well drafted relationship clause in the franchise agreement to clarify the relationship between the two parties.

7 How are trademarks and know-how protected?

China is a signatory to all of the major international trademark conventions or treaties. In 1982, the Standing Committee of the National People's Congress promulgated the Trademark Law (the latest amendments became effective on 30 August 2013) that protects registered trademarks and in some cases, unregistered 'famous marks'. As China is a first-to-file, first-in-right jurisdiction, the owner of a trademark will, in most cases, not be able to protect use of the trademark in China unless the owner registers the trademark with the China Trademark Office in the applicable classes. Therefore, a foreign franchisor should register its trademarks with the China Trademark Office before entering into commercial franchise agreements with local franchisees.

Know-how is usually protected as a contractual obligation of the receiving party. Unlike trademarks or patent, there is no registration regime for know-how. Some know-how, such as software, can be protected under the copyright regime. However, registration of know-how with authorities is not a mandatory requirement for copyright protection.

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

The legal regime governing real estate imposes strict restrictions on foreign entities entering the Chinese real estate market. Without a Chinese establishment, a foreign franchisor is not able to purchase or lease commercial real estate. In order to avoid this issue, a foreign franchisor can establish a Chinese enterprise and such Chinese enterprise will be the franchisor and it may purchase or lease commercial real estate for its business operations.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

A franchise refers to a business activity where an enterprise that possesses registered trademarks, enterprise logos, patents, proprietary technology or any other business resources allows such business resources to be used by another business operator through contract and the franchisee follows a uniform business model to conduct business operation and pays franchising fees according to the franchise agreement (Administrative Regulations on Commercial Franchising promulgated by the State Council, which came into effect on 1 May 2007 (the Franchising Regulation)).

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

The following laws primarily regulate the offer and sale of franchises:

- Administrative Regulations on Commercial Franchising (promulgated by the State Council on 6 February 2007 and effective as of 1 May 2007);
- Administrative Measures for the Record Filing of Commercial Franchises (promulgated by MOFCOM and effective as of 1 February 2012);
- Administrative Measures for Information Disclosure of Commercial Franchises (promulgated by MOFCOM and effective as of 1 April 2012) (Measures for Information Disclosure); and
- Administrative Measures for Foreign Investment in Commercial Fields (promulgated by MOFCOM and effective as of 1 June 2004).

MOFCOM and its local counterparts are the government agencies that primarily regulate the offer and sale of franchises.

11 Describe the relevant requirements of these laws and agencies.

The principal requirements are the following.

- The 2+1 requirement: franchisors shall have owned and operated at least two units under the franchise brand for at least one year. Administrative practice in the years following the promulgation of the relevant regulations has further clarified this requirement allowing the two units to be either directly owned by the franchisor or, for foreign franchisors, by an affiliate, provided the affiliate is a direct subsidiary of the franchisor and the franchisor holds a majority equity interest in the subsidiary.
- Franchisor filing and annual filing: within 15 days of signing its first franchising agreement in China, the franchisor shall file as a franchisor with MOFCOM or its counterparts (foreign franchisors shall file with MOFCOM, while Chinese franchisors shall file with MOFCOM's provincial-level counterpart in the province where the franchisor is established). In the first quarter of each year, the franchisor shall file with MOFCOM or its counterparts an annual report that notes the following: the number of franchise agreements in the preceding annual report filed with MOFCOM, that were signed, terminated after the previous annual report and total franchise agreements in performance; the number of franchised units and turnover of such units; and the number of directly owned units and turnover of such units.
- Modification of filing information: if there are any changes in the following filing information of a franchisor, the franchisor shall, within 30 days of the date on which the change occurs, apply to the filing authority to modify its information on file:
 - information concerning the industrial and commercial registration of the franchisor;
 - information concerning business resources; or
 - the location of stores of all franchisees within the territory of China.
- Contract term: Franchisors and franchisees shall sign written franchising having an initial term of not less than three years, unless the franchisee consents to a shorter term.
- Disclosure: 30 days before the franchisor and franchisee sign a franchising contract, the franchisor shall disclose to the franchisee the information in accordance with Administrative Regulations on Commercial Franchising and Measures for the Administration of Information Disclosure of Commercial Franchises and provide a sample of the franchising agreement to the franchisee.
- Cooling-off period: the franchisor shall give franchisees a cooling-off period to allow franchisees to unilaterally terminate the franchise agreement within a certain period of time after signing of the contract (the franchise regulations do not specify the length of the cooling-off period).
- Manual: the franchisor shall provide a franchise practice manual to the franchisee and shall comply with stipulations of the franchise agreement related to operational guidance, technical support and service training.

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

There are no exemptions or exclusions under the current legal regime governing franchises.

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

The Franchising Regulation together with two supporting regulations known as the Measures for Record Filing and the Measures for Information Disclosure impose several requirements on a franchisor before offering franchise in China, including the requirement to:

- have the capability of providing continuing services to franchisees, which include operational instructions, technical support and business training etc;
- have a mature business model;
- have owned and operated two units for at least one year somewhere in the world ('2+1' requirement); and
- provide a disclosure statement to the prospective franchisee at least 30 days before the franchisee signs the franchise agreement.

In addition to the above, the franchisor shall have at least one registration certificate issued by China for trademark rights, patent rights or other business operation resources related to franchise activities.

14 Are there any laws, regulations or government policies that restrict the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers?

There are no restrictions imposed on franchisors when recruiting franchisees.

If the franchisor requires the franchisee to purchase supplies from the franchisor's affiliated or designated suppliers, the franchisor shall inform the franchisee of such requirement in the disclosure documents and include such requirement in the franchise agreement (such a requirement may be affected by Chinese anti-competition laws, depending on the circumstances of the obligations).

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

Pursuant to article 21 of the Franchising Regulation, the franchisor is required to comply with the information disclosure requirements 30 days before signing the franchise contract. Furthermore, the Measures for Information Disclosure provides that compliance with required information disclosure must be no later than 30 days before the signing of the franchise agreement, unless the franchise agreement is a renewal under the original terms.

Updates to the disclosures are required to be ongoing. If there is any material change to the information disclosed, the franchisor shall notify the franchisee of such change in a timely manner.

16 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, it is the sub-franchisor who is obliged to provide the pre-sale disclosure. The sub-franchisor must disclose to the sub-franchisee that it has obtained the necessary operational authorities from the original franchisor to grant sub-franchises. The disclosure will normally also contain some information disclosed by the original franchisor, such as the ownership of the trademarks.

17 What information must the disclosure document contain?

Article 22 of the Franchising Regulation and article 5 of the Measures for Information Disclosure both set out the information required in the disclosure documents. Although the requirements under the two legal pronouncements are very similar, the provisions under the Measures for Information Disclosure are more detailed.

In summary, the franchisor must disclose the following to its franchisees at least 30 days before the franchisor and franchisee sign the franchise agreement.

Basic information concerning the franchisor and its commercial franchise business

- Name, mailing address, contact information, legal representative, general manager, registered capital and scope of business, and information of its directly managed stores;
- general situation and overview of the franchisor's engagement in the commercial franchise business;
- basic information on the filling by the franchisor;
- basic information on a related party of the franchisor that will provide products or services to the franchisees; and
- information concerning the franchisor's or its related party's bankruptcy or applications for bankruptcy within the past two years.

Basic information concerning the franchisor's business resources

- Written descriptions of the franchisor's registered trademarks, corporate logo, patents, proprietary technology, business models and other business resources;
- If a related party to the franchisor owns a business resource of the franchisor, basic information on the related party and the contents of the authorisation made by the related party to the franchisor should be provided to the franchisee, and the franchisor needs to explain how the franchise system will be dealt with if the authorisation agreement between the franchisor and the related party regarding the business resource is suspended or terminated ahead of schedule; and

- information regarding any legal proceedings or arbitration involving the franchisor's registered trademarks, corporate logo, patents, proprietary technology or any other business resources.

Information about franchise fees

- Types of charges, amounts, rates collected by the franchisor for itself or for a third party and the method of payment. If the franchisor is unable to disclose such information, an explanation must be provided. Where there is no uniform fee standard, a range should be provided, along with an explanation;
- conditions for the collection and refund of security deposits, when and how to refund the deposits; and
- where the franchisee is required to make payments before entering into the franchise contract, an explanation indicating usage, purpose of such fees and the conditions and manner of a refund shall be given to the franchisee.

Information on the prices and conditions of the products, services and equipment provided for the franchisee

- Whether franchisees must purchase products, services or equipment from the franchisor (or from a related party) and if so, the relevant prices and conditions;
- whether franchisees must purchase products, services or equipment from suppliers designated by the franchisor and if so, the relevant prices and conditions; and
- whether franchisees have the right to choose other suppliers and if so, the requirements for such suppliers.

Franchisor's continuous provision of services to the franchisee

- Specific business training content, provision method and implementation, including where, how and when such training is to be held; and
- the specific content of technical support provided and the method of provision and implementation, including the name and type of business resources and the type of products or equipment.

Method and content of guidance and supervision on the business operations of franchisees

- The content of the guidance to be provided for the business operations of the franchisees, how it is provided and implemented, including site selection, decor, store management, advertising, promotion and product configuration;
- the method and terms of supervision, obligations of the franchisees and liabilities of the franchisees in event of failure to fulfil its obligations; and
- the division of responsibility and liability between the franchisor and the franchisee for complaints by consumers and for compensation paid out to consumers.

Investment budget for the franchise business

- An investment budget could include the following items: franchise fees, training expenses, expenditures for real estate and decoration, equipment, office supplies, furniture, starting inventory, hydro, electric or gas fees, expenses to obtain a valid business licence or other governmental approvals, and working capital for start-up; and
- the basis for the budget estimate and the sources for the above data.

Information on the franchise business in China

- The quantity, geographical location and scope of authorisation of existing and expected franchisees; and whether there is exclusive authorisation for franchisees in a specific geographical region (if yes, provide details); and
- the operating status of existing franchisees, including actual investment amount, average sales volume, costs, gross and net profit; and the sources of the data provided.

Financial statements

Abstracts of the franchisor's financial and audit statements for the past two years, which have been audited by an accounting or audit firm.

Litigation and arbitration history

Information on litigations or arbitrations involving the franchisor within the last five years in relation to the franchise business, including cause of action, location of the proceeding, pleadings and outcome.

Records of unlawful business operation by the franchisor or its legal representative

- Records of any fine of more than 30,000 renminbi; and
- any criminal liability investigated by the authorities.

The franchise agreement

- A sample of the agreement; and
- a sample of other franchise-related agreements to be entered into between the franchisor and the franchisee at the request of the franchisor.

18 Is there any obligation for continuing disclosure?

Pursuant to the Franchising Regulation and the Measures for Information Disclosure, there is a continuing disclosure requirement imposed on the franchisors. In situations where there are any material changes to the disclosed information, the franchisor must notify the franchisee of such changes in a timely manner.

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

The Measures for Information Disclosure indicates that if the franchisor violates the disclosure requirements, the franchisee has the right to report the violations to MOFCOM or its counterparts. Once the alleged violations are verified to be true, punishments will be imposed pursuant to provisions of the Franchising Regulation. More specifically, MOFCOM or its local counterparts shall order the franchisor to make necessary corrections to the disclosure information and impose a monetary fine of between 10,000 and 50,000 renminbi on the franchisor. In cases of a serious violation, the fine will be between 50,000 and 100,000 renminbi and MOFCOM or its local counterparts will make a public announcement regarding the violation.

20 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?

The interpretation and undertakings related to the franchise business set out in the disclosure document which would affect franchisee's decision to enter into the franchise agreement would be deemed as part of the representations set out in the franchise agreement. If the representations are misleading, the franchisee could look to rescind the franchise agreement. Damages may be applicable depending on the negative effect of such misleading information or failure to disclose, in which scenario, the franchisor shall compensate the franchisee for its direct loss resulted thereafter.

21 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?

Only the sub-franchisor, not the original franchisor, is required by the regulation to provide disclosure to sub-franchisees. Sub-franchisor would be liable for disclosure violations. Without any clear judicial or regulatory guidance, it is difficult to say whether the original franchisor would be liable at all, and to what extent it would be liable, for defects in the disclosure documents, in particular with regard to the information that originated from the original franchisor.

The current regime does not provide that individual officers, directors or employees of either the original franchisor or the sub-franchisor shall be liable for the violation of the disclosure requirement, provided that there is no intentionally fraudulent or deceptive practice by such individual.

22 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?

In addition to laws and government agencies that specifically regulate offering and selling franchises, the following general principles of law affect the offer and sale of franchises as well:

- Principle of Fairness (PRC Contract Law promulgated on 15 March 1999 and the Civil Code promulgated on 12 April 1986): Contract

parties shall observe the principle of fairness in defining their respective rights and obligations and avoid fraudulent conduct, for example, if the franchisor provides standard terms in the contract, it is required to draw the attention of the other party in a reasonable manner to the terms that exclude or restrict the other party's liabilities, and explain the standard terms to the other party at the request of the other party.

- Principle of Good Faith (PRC Contract Law promulgated on 15 March 1999 and the Civil Code promulgated on 12 April 1986): Contract parties shall observe the principle of good faith in exercising their rights and performing their obligations. Parties shall, observing the principle of good faith, perform such obligations as notification, rendering assistance and maintaining confidentiality based on the nature and purpose of the contract and in accordance with trade practices. A party shall be liable for damages if it falls under any of the following circumstances which are against the principle of good faith when concluding a contract, thereby causing any losses to the other party:
 - negotiating the contract in bad faith under the pretext of concluding a contract;
 - deliberately concealing important facts relating to the conclusion of the contract or providing false information; and
 - performing any other acts against the principle of good faith.
- Principle of Voluntariness, Equal Value Exchange (The Civil Code promulgated on 12 April 1986).

In addition to the Franchise Regulation, the following laws are also applicable to the offering and selling of franchises:

- as the franchise relationship between franchisor and franchisee is also a contractual relationship, the Contract Law (promulgated on 15 March 1999) together with its interpretations are also applicable;
- the Civil Code (promulgated on 12 April 1986) is generally applicable; and
- the Anti-Unfair Competition Law (promulgated on 2 September 1993) and the Anti-Monopoly Law (promulgated on 30 August 2007) may also be applicable.

23 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

As some of the disclosure information may be regarded as advertising by the franchisor, general advertising rules may be applicable. Pursuant to the Advertising Law, the content of the advertising must be true and lawful. In addition, the advertisements shall not resort to any falsehood to deceive or mislead the public. In a situation where a description for a patent is required, the patent number and patent category should also be clearly outlined.

24 What 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 franchise sales disclosure laws?

The Franchising Regulation provides the following sanctions for fraudulent or deceptive activity by the franchisor during the offer and sale of franchises:

- a fine of between 30,000 and 300,000 renminbi depending on the severity of the offence;
- a public announcement of such violation; and
- if a crime has been committed, the offending party will be subject to criminal penalties.

The guiding opinions of the Higher People's Court of Beijing Municipality on several issues concerning the application of law in the trial of disputes over commercial franchise contracts (the Notice) further provides that if the information or business resources directly related to the essential contents of the franchised business are concealed, falsified or exaggerated by the franchisor, the franchisee may request cancellation or rescission of the franchise agreement.

In addition to the sanctions provided in Franchising Regulation, fraudulent or deceptive activities are also subject to the provisions of the Contract Law, pursuant to which, the franchisor may be liable to

compensate the franchisee for its losses that resulted from such fraudulent or deceptive activities.

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

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

In China, the Franchising Regulation and the Measures for Information Disclosure are the two major regulations governing the ongoing relationship between franchisor and franchisee.

The Franchising Regulation deals with the main components of a franchise relationship. The provisions govern the rights and obligations of both franchisor and franchisee. Some of the specific rules on the franchise relationship are:

- a franchisor shall provide an operations manual to its franchisees, and shall provide ongoing business guidance, technical support and business training, to the franchisees according to the stipulated contents and methods noted in the franchise agreement and operations manual;
- a franchisor must use the funds for promotion and publicity activities that it collects from a franchisee for the purposes stipulated in the franchise agreement. Details concerning the use of funds collected from the franchisee for promotion and publicity shall be timely disclosed to by the franchisor to the franchisee; and
- without the consent of the franchisor, a franchisee shall not transfer the franchise to a third party.

Information disclosure requirements, as discussed above, are also part of the ongoing relationship between franchisor and franchisee.

26 Do other laws affect the franchise relationship?

In addition to the Franchising Regulation, the Contract Law and the Civil Code are the main laws that may affect the franchise relationship as such legal pronouncements govern the validity, interpretation and performance of the franchise agreement.

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

MOFCOM and its local counterparts are the government authorities in charge of the administration of franchise activities. MOFCOM is responsible for cross-border franchise activities while its local counterparts are in charge of the domestic franchise activities. General commercial matters are supervised by the SAIC.

The China Chain Store & Franchise Association (CCFA) and its local counterparts are the industry association for the franchise business sector. CCFA and its local counterparts are not government bodies and do not have supervising authority, but provide input to MOFCOM concerning industry issues.

28 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 early termination of the franchise agreement by a franchisor can be allowed based on the provisions of the franchise agreement. An early termination clause can be included, upon the mutual consent of both franchisor and franchisee. In absence of contractual provisions, the franchisor may terminate the franchise agreement according to the Contract Law in the following circumstances:

- it is impossible to achieve the purpose of the franchise agreement due to an event of force majeure;
- prior to the expiration of the period of performance, the franchisee expressly states, or indicates through its conduct, that it will not perform its main obligation;
- the franchisee delayed performance of its main obligation after such performance has been demanded, and fails to perform within a reasonable period; or
- the franchisee delays performance of its obligations, or breaches the franchise agreement in some other manner, rendering it impossible to achieve the purpose of the franchise agreement.

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

The Franchising Regulation provides a mandatory cooling-off period during which the franchisee may terminate the franchise relationship without cause; the Franchise Regulation does not set out the length of the cooling-off period.

After the cooling-off period, the franchisee may only terminate a franchise agreement in accordance with any early termination provisions in the franchise agreement. In addition, the franchisee may also be able to terminate the franchise relationship in the following circumstances, which are provided for in the Contract Law:

- it is impossible to achieve the purpose of the franchise agreement owing to an event of force majeure;
- prior to the expiration of the period of performance, the franchisor expressly states, or indicates through its conduct, that it will not perform its main obligation;
- the franchisor delayed performance of its main obligation after such performance has been demanded, and fails to perform within a reasonable period; or
- the franchisor delays performance of its obligations, or breaches the franchise agreement in some other manner, rendering it impossible to achieve the purpose of the franchise agreement.

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

There is no mandatory requirement on the franchisor to renew the franchise agreement. The franchisor has sole discretion to renew a franchise agreement unless the franchise agreement provides otherwise.

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

The Franchising Regulation expressly prohibits franchisees from transferring its franchise to a third party without the franchisor's consent. Under China's legal regime, transferring an equity ownership interest in the franchisee legal entity is not deemed as a transfer of the franchise. However, the franchisor can restrict such equity ownership interest transfer if there is a provision expressly to this effect in the franchise agreement.

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

The parties are free to negotiate the amount and terms of payment of the initial franchise fees, royalties and any other payments to be made by the franchisee to the franchisor. If the franchise arrangement is between the franchisor and an affiliated company, the amount of the fees must not be more than the industry standard for the region.

However, the Franchising Regulation provides that if a franchisor requests a prepayment of the 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 for a refund. In addition, the amount collected by a franchisor for promotion or advertising shall be used only for the purpose agreed in the franchise agreement and the franchisor is required to update the franchisee on the status of such usage.

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

It is possible to charge interest for overdue payments if the franchise agreement has expressly provided for such interest payment.

If there is dispute over the interest rate in court or in arbitration, the adjudicator may adjust the interest rate provided in the franchise agreement if the adjudicator believes the interest rate was excessive and not in compliance with legal requirements.

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

In case the franchisor is a foreign entity, the payments for royalties, franchise fees or service fees, shall be converted into foreign currency before remittance to the franchisor. Although China imposes foreign exchange restrictions for cross-border transactions, remittances based on legitimate

commercial transactions are possible. The franchisee can convert and remit foreign currency to the franchisor provided that certain formalities are fulfilled by providing supporting documents of the transaction to the bank, such as franchise agreement and the tax certificate evidencing that the applicable tax has been paid.

With effect from 1 September 2013, the Chinese authorities issued additional rules affecting the remittance of fees offshore. The changes appear to reflect Chinese regulators' willingness to relax their grip on the remittance of funds outside of China. Most importantly to foreign franchisors, franchise fees are expressly mentioned as payment under trade in services, and therefore can be remitted outside of China based on the franchise agreement.

See the following for details:

- the announcement of the State Administration of Taxation and the State Administration of Foreign Exchange on issues concerning the record-filing of the taxation on external payments for trade in services and other items;
- the Guidelines for Foreign Exchange Administration of Trade in Services; and
- the Detailed Rules of Implementation of the Guidelines for Foreign Exchange Administration of Trade in Services.

35 Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants in franchise agreements are enforceable. In addition, even if the franchise agreement was terminated or later rescinded, such confidentiality covenant will still be valid and the franchisee will be obligated to keep confidential the information it obtained from the transaction.

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

The Franchising Regulation expressly provides that the principles of free will, fairness, honesty and good faith shall be followed in franchise activities.

The Contract Law provides a general obligation for parties to deal with each other in good faith. This general principle is applicable to franchise agreements as well.

If a party is found to be deliberately concealing important facts, providing false information, or performing other acts which violate the principle of good faith, such party shall be responsible for all damages caused to the other party thereof. In addition, if a contract is concluded by one party against the other party's true intentions through the use of fraud, the other party is entitled to rescind the contract.

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

No, the Consumer Protection Law defines 'consumer' as one who purchases goods or services for his or her own consumption. As a franchisee purchases materials or services from the franchisor for business purposes (not for its own consumption), a franchisee will not be deemed as a consumer.

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

Chinese law does not require the franchise documents to be in Chinese. However, to avoid potential disputes with local franchisees and for the purposes of registration with the local authorities, a Chinese version of the franchise documents is recommended. In addition, for franchisor filing purpose, the Chinese version of the franchise agreement or the Chinese translation of the franchise agreement should be prepared and submitted to MOFCOM as part of the franchisor filing documents.

39 What restrictions are there on provisions in franchise contracts?

At this time, there are no specific restrictions on provisions in franchise agreements. The Contract Law rules still apply and there are also general principles of free will, fairness, honesty and good faith to keep in mind. Moreover, when entering into a franchise agreement, the Anti-Unfair Competition Law and the Anti-Monopoly Law must always be considered in the same general manner as any other commercial enterprises operating in China.

Update and trends

Proposal for new regulation

Last year, MOFCOM posted an online questionnaire on the Regulations on the Administration of Commercial Franchise dated 1 September 2015 on China's Commercial Franchise website – the government's official website for commercial franchising – to gather opinions on amending the Franchising Regulation. According to the statement provided by a MOFCOM officer at the end of 2014, the Franchising Regulation would be amended and the amendment or new Franchising Regulation (New Regulation) was aiming to be issued in 2016.

Current developments or trends of note

The MOFCOM recently changed its policy on the '2+1' requirement

In accordance with the Franchising Regulation, a franchisor conducting franchise business in China should meet the '2+1' requirement. According to recent practice, MOFCOM has been allowing foreign franchisors to use 2+1 owned by an affiliate which could either be a direct parent company (which owns more than 50 per cent shares of the franchisor) or a direct subsidiary of the franchisor where the franchisor holds a majority equity interest in the subsidiary. However, around May 2015 MOFCOM changed this policy, requiring that only the franchisor or its direct subsidiary (and no longer a parent entity) qualify for 2+1. A constructive dialogue is, however, being undertaken by stakeholders (foreign franchisors associations in particular) with MOFCOM and it

is possible that MOFCOM will provide greater flexibility by accepting 2+1 owned by other affiliates of the franchisor besides its controlled subsidiary, provided that such other affiliate can provide a suitable guarantee or as otherwise deemed appropriate on a case-by-case basis.

The MOFCOM recently changed its requirement on the trademark certificate in relation to franchisor filing

In accordance with the Administrative Measures for the Record Filing of Commercial Franchises, a company shall provide registration certificates issued by China for trademark rights, patent rights or other business operation resources related to franchise activities in order to file as a franchisor in China. As noted, MOFCOM requires at least one certificate from a potential franchisor when it applies for franchisor filing. In the event that a potential franchisor has no such certificate, it is sufficient for MOFCOM if the potential franchisor can provide a trademark licence agreement or equivalent document which indicates its authorisation to use certain trademarks and sub-licence to its franchisees (at least one trademark relating to the franchise business). Such trademark licence did not have to be exclusive until recently, but MOFCOM changed its policy and requires the trademark licence document to indicate that only the licensor and the potential franchisor can use the licensed trademarks and that the potential franchisor can sub-licence the trademarks to its China franchisees.

However, article 11 of the Franchising Regulation does stipulate that franchise agreements contain the following:

- basic information about the franchisor and franchisee;
- contents and duration of the franchise;
- type, amount, and payment method of the franchise fees;
- specific details and methods for the provision of guidance, technical support, training and other services by the franchisor;
- quality, standard and measures for the product or service;
- sales promotion, advertising and publicity about the product or service offered;
- protection of rights and interests of consumers and the assumption of liability by the franchisor and franchisee;
- alteration, rescission and termination of the franchise;
- liability for breach of the franchise agreement;
- dispute resolution methods; and
- other matters as stipulated by the franchisor and the franchisee.

Furthermore, pursuant to article 12 of the Franchising Regulation, the franchise agreement must include a provision for a mandatory cooling off period during which the franchisee may terminate the franchise agreement.

Moreover, a franchise contract shall not be less than three years in duration, unless agreed by the franchisee. This requirement does not apply when a franchise agreement is renewed.

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

The legal regime for competition law is primarily covered by the Anti-Unfair Competition Law and the Anti-Monopoly Law. These two laws provide the following restrictions on price and use of intellectual property, which are related to typical franchise transactions:

Price

The Anti-Monopoly Law prevents the following activities:

- a monopoly agreement which fixes prices for resale;
- limits on the output or sale of products; and
- limits on the developments of new products or new technology.

Intellectual property

The Anti-Unfair Competition Law prevents the following activities:

- using another party's registered trademark;
- inducing confusion by using the same or a similar name, packaging or distinctive characteristics of a well-known product;
- using the name of another business to confuse consumers; and
- using the certificate of another business on merchandise.

A franchisor will not be considered to be in violation of the Anti-Unfair Competition Law and the Anti-Monopoly Law unless there is an abuse

of market position, impairment of public interest and interference of a franchisee's lawful business activities. Conversely, if a franchising transaction's purpose is to create market barriers, sell unmarketable goods or abuse a position of power, then it will be construed as a violation of unfair competition legislation. The offending franchisor can be punished by fines or other penalties as set out in the legislation.

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

The court system in China consists of four levels: basic people's courts, intermediate people's courts, the High Courts (the highest court in each province) and the Supreme People's Court (the highest court in China). China has a civil law system and thus case precedents are not binding.

In some areas of China, the government has established intellectual property courts, which can handle franchisor-franchisee disputes related to intellectual property issues if there is no arbitration arrangement between parties to the dispute.

In terms of dispute resolution procedures, franchise transactions are treated no differently from other commercial disputes. Besides the court system, parties are also able to resolve disputes through arbitration.

Pursuant to the Arbitration Law, the parties may select arbitration as the dispute resolution mechanism as long as they enter into a valid arbitration agreement or if there is an arbitration clause in the mutually agreed agreement. The arbitration body shall be properly accredited and may be located in any jurisdiction. Moreover, the arbitration body must be expressly identified for the arbitration agreement or arbitration clause to be valid.

In some cases, administrative action may also be involved. The SAIC is the supervising authority of companies registered in China. Before going to dispute resolution, a franchisor or a franchisee may also choose to make a claim with the competent SAIC authority for administrative action, which may include: a disciplinary warning; a fine; confiscation of illegal gains or confiscation of unlawful property or things of value; an order for the suspension of production or business operation; the temporary suspension or rescission of permits or temporary suspension or rescission of licences; or administrative detention.

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

For foreign franchisors, it is recommended to resolve legal disputes through the arbitration process as arbitration allows them to bypass the local court system where bias based on protectionism and corruption is a legitimate concern.

The main disadvantage of this process occurs if the arbitration centre chosen is outside of China. Should there be a favourable award from the arbitration decision, the foreign franchisors will still need to enforce it

in local Chinese courts. The enforcement process is complicated and also time-consuming.

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

In general, foreign franchisors are treated similarly to domestic franchisors from a legal standpoint.

From a regulatory standpoint there are some minor differences in how foreign franchisors are handled. One example is that the record-filing requirements are slightly different. Domestic franchisors must file with the local MOFCOM counterpart, whereas foreign franchisors are required to file with MOFCOM itself. In addition, application and filing documents submitted by foreign franchisors must be notarised and certified.



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Franchise
ISSN 1752-3338



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