

CORPORATE ALERT

THE NEW FRANCHISING LEGAL REGIME IN CHINA



In May 2007 the Chinese government adopted a new legal regime for franchising. The new regime consists of three pieces of law and regulations: the *Regulations on the Administration of Commercial Franchises* promulgated by the State Council on January 31, 2007, and effective May 1, 2007 (the Franchise Regulations), and the *Administrative Rules on Commercial Franchise Filing* (the Filing Rules) and the *Administrative Rules on Commercial Franchising – Information Disclosure* (the Disclosure Rules), both of which were issued by the Ministry of Commerce (MOC) on April 30, 2007, and effective May 1, 2007. This new legal regime replaces the previous franchise rules issued by MOC in 2005 (the MOC Measures).

The new legal regime has significantly changed the Chinese legal landscape for franchising and should contribute to making mainland China a much more accessible market for international franchisors. This client alert is intended to introduce the key provisions of this new franchising legal regime, which may impact any international franchisor's business in mainland China.

WHAT ARE THE KEY PROVISIONS OF THE FRANCHISE REGULATIONS AND WHAT WAS CHANGED COMPARED TO THE OLD LAW?

The Franchise Regulations apply to franchise business carried out in mainland China. Compared to the MOC Measures, the new law makes it clear that it applies to cross-border franchise business as well.

Under the Franchise Regulations, “franchise” shall have the following elements: (1) a franchisor confers to its franchisee the right to use its business resources, such as the trademark, trade name, patent and know-how, etc.; (2) the franchisee operates its business with the uniform operation system pursuant to the franchise contract(s); and (3) the franchisee pays royalties to the franchisor. No matter what name the concerned parties try to create for their business arrangement, as long as the above-listed elements are present, the relevant transaction shall be regulated as a franchise under the Franchise Regulations.

If a commercial arrangement is a franchise, among others, the famous “2+1 Rule” will kick in and apply to the franchisor. Compared to the MOC Measures, the new law greatly relaxes the “2+1 Rule” because it is no longer a statutory requirement that the “two directly operated outlets” be **in mainland China**. Furthermore, under the new law, failure of the franchisor to

meet the “2+1 Rule” does not now entitle the Chinese government to issue an administrative order to stop the concerned franchise business.

The exceptions to the application of the “2+1 Rule” exist in the case of “inter-company license” arrangements and the amnesty treatment offered to certain franchisors. The so-called “inter-company license” means that if a foreign franchisor licenses trademarks and/or other resources to its China subsidiary for the purpose of operating the statutorily required two outlets, the concerned license shall not be deemed as “franchising,” but rather as “inter-company licensing,” which will not trigger the application of the “2+1 Rule.” The new law offers amnesty treatments to franchisors selling and operating franchises in mainland China before May 1, 2007, regardless of whether or not they comply with the “2+1 Rule.”

Unlike under the MOC Measures, the franchisor is not now required to bear joint and several liability for the quality of products provided by its designated suppliers. This means that the Franchise Regulations recognize the independent relationship between the franchisor and the suppliers that it designates to the franchisee.

The new law requires that the franchisor and the franchisee stipulate a certain time period in the franchise agreement during which the franchisee can unilaterally rescind the franchise agreement. The law is silent, however, on the length of such time period. Our informal consultation with the relevant legislators indicates that the legislative intention for this requirement is to protect franchisees, and it is up to the franchisee and the franchisor to agree on the length of such time period and up to the franchisee to decide whether it agrees not to have the time period during which it can rescind the franchise agreement.

The new law imposes a filing requirement on franchisors. A franchisor must file with MOC or its provincial level counterparts (depending upon whether the franchising takes place in more than one province) for record within 15 days of the execution of the initial franchise contract. Without due filing, franchisors may be subject to penalties, including orders for rectification, fines and public criticism. But, failure to file with the Chinese government will not lead to the concerned franchisor losing its legal capacity to sell franchises in China.

While the disclosure obligations under the new law are substantially similar to the MOC Measures, the new law imposes some new obligations, e.g., the opportunity for the franchisee to rescind the franchise contract if the franchisor conceals relevant information or provides false information. Another important change is that the government reserves the authority to request additional disclosures. The new law explicitly prohibits a franchisor from disclosing the revenues earned by its franchisees in advertisements.

WHAT ARE THE KEY PROVISIONS OF THE FILING RULES?

The Franchise Regulations require that a franchisor file with MOC or its provincial level counterpart. The filing must be done with MOC if the franchisor is a foreign franchisor or if the franchisor carries out franchise business in more than one province. Otherwise, the filing shall be done with the provincial level counterpart of MOC. For ease of discussion here, MOC and its local counterparts are collectively referred to as “MOC.”

The Filing Rules mainly address the requirements and formalities for franchisors to make the franchise filings. There are three types of filing obligations imposed on a franchisor under the Filing Rules.

First, within 15 days after the initial franchise contract is signed, the franchisor must make the filing with MOC. For the purposes of this filing, a franchisor must submit the following documents to MOC: (1) basic information on the franchisor’s franchise business; (2) the locations of all the franchisees’ stores in mainland China; (3) the market plan of the franchisor; (4) a photocopy of the enterprise legal person business license or a photocopy of any other entity

qualification certificate (if the franchisor is a foreign company, it should submit a copy of its Certification of Incorporation or a similar type of document); (5) photocopies of the registration certificate(s) of the trademark(s), patent and other operation resources that are relevant to the concerned franchise activities; (6) samples of the franchise agreement; (7) table of contents for the franchise operation manual (the pages of each chapter and the total pages of the whole manual should be noted; where such manual is provided on the internal Web site of the franchise system, the approximate number of printed pages should be noted); (8) an undertaking signed by the franchisor's chairman of the board in which the franchisor agrees that it will abide by the franchise laws of China and submit all of the documents and materials in relation to its operation in a timely manner; (9) if the franchisor started its franchise business in China before May 1, 2007, it must provide the initial franchise agreement signed by the franchisor and its franchisee. Otherwise, it must provide documents to prove that it has two outlets which have operated under the franchise brands for at least one year. If the outlets are within China, the evidential document must be the one issued by MOC at the place where the outlets are located; if the outlets are outside mainland China, the franchisor shall provide documents that evidence the operation of such outlets, and such documents must be consularized by the Chinese consulate of the concerned foreign country.

An exception to this 15-day filing requirement exists for those franchisors who started franchising before May 1, 2007; they are allowed to file no later than May 1, 2008.

So long as the franchisor submits all the required documents, the filing should be granted by MOC within 10 days, and it remains effective indefinitely. MOC will publicize the relevant filing of a franchisor on the official Web site of MOC upon its acceptance of the filing by the relevant franchisor.

The filing may be revoked by MOC under certain statutorily stipulated circumstances, which include two basic situations: 1) the franchisor loses its legal capacity to operate as a franchisor (e.g., its business license is revoked by the government, or judicial institutions suggest that MOC revoke the filing as a result of the illegal operation of the franchisor, or the franchisor applies to discontinue its existence), or 2) the franchisor conceals relevant information when it files with MOC or the information that it files turns out to be false upon verification. It is noteworthy that, under the new franchise legal regime, the revocation of the filing will not lead to a loss of the legal capacity under Chinese law for the franchisor to continue its franchising business in China.

After the initial filing, the franchisor must update its filing each year with MOC by March 31. The franchisor must report to MOC any changes to its franchise contracts, specifically, how many franchise contracts were signed, rescinded, extended or amended in the preceding year.

In addition to the initial filing and the annual update filing, if there are any changes to the filed information, the franchisor must update MOC within 30 days after the occurrence of the concerned changes.

Failure to file will lead to such consequences as the franchisor being ordered to rectify, within a certain time period, monetary sanctions up to an amount of RMB0.1M (approximately USD13K), and/or publicly circulated official criticism.

WHAT ARE THE KEY PROVISIONS OF THE DISCLOSURE RULES?

The Disclosure Rules set out detailed disclosure requirements that a franchisor must follow.

A franchisor is obliged to make disclosure of the following 12 types of information to the prospective franchisee at least 30 days before the franchise contract is signed: (1) basic information on the franchisor and the franchise activities;

(2) basic information on the franchisor’s operational resources; (3) basic information regarding franchise fees; (4) prices and conditions of products, services and equipment to be supplied to the franchisee; (5) continuous services to be provided to the franchisee; (6) specific methods and details of guidance and supervision of franchisee’s operation; (7) investment estimate of franchise stores/outlets; (8) relevant information of the franchisee(s) within China; (9) abstract of financial accounting report and abstract of auditing report of the past two years that have been audited by an accounting firm or an auditing firm; (10) any material litigation and arbitration in the past five years related to the franchise activities; (11) record(s) of material illegal operation of the franchisor or its legal representative; a “record of material illegal operation” refers to (a) the imposition of a fine by the relevant authority in charge of administrative enforcement of law in an amount no less than RMB300,000 (approximately USD4,000) and no more than RMB500,000 (approximately USD66,666) and (b) the imposition of criminal liability; and (12) franchise contract text.

In some instances, the Disclosure Rules specify the reach of the Franchise Regulations by limiting disclosure to information that is within China or meets certain materiality standards (e.g., the information of the franchisees is limited to those in mainland China), while in other instances the information requested to be disclosed is not limited to mainland China (e.g., the litigation and arbitration is not limited to China).

Franchisors making the disclosure are entitled to request that the franchisee enter into a confidentiality agreement.

In the case of a franchisor concealing information that it should have disclosed to the franchisee or providing false information, the concerned franchisee is entitled to rescind the relevant franchise contract by the operation of the new franchise law.

UNCERTAINTIES AND OPPORTUNITIES UNDER THE NEW LEGAL REGIME

It is clear that this new legal regime does not address all outstanding questions. For example, will a franchisor be able to satisfy the “2+1 Rule” requirement based on operations owned by its affiliates? Must an FIE franchisor include franchise business in its “business scope”? But uncertainties are not necessarily bad, because they present flexibilities and potential opportunities to be creative. With the proper structuring of the relevant deals, with the new legal regime, now is the time for international franchisors to enter mainland China.

CONTACT INFORMATION

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