China's New Legal Regime for Franchising

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The Chinese government in May adopted a new legal regime for franchising. The regime is composed of three pieces of legislation: the Regulations on the Administration of Commercial Franchises (Franchise Regulations), promulgated by the State Council on 31 January, 2007, and implemented on 1 May, 2007; the Administrative Rules on Commercial Franchise Filing (Filing Rules); and the Administrative Rules on Commercial Franchising — Information Disclosure (Disclosure Rules). The latter two rules were issued by the Ministry of Commerce (MOC) on 30 April, 2007, and took effect on 1 May, 2007. The new legal regime replaces the previous franchise rules (MOC Measures) issued by MOC in 2005.

The new legal regime significantly changes the China's legal landscape for franchising, and should contribute to making mainland China a much more accessible market for international franchisors. This article is intended to introduce the key provisions of the new franchising regime.

1. What are the Key Provisions of the Franchise Regulations? What has been Changed?

The Franchise Regulations apply to franchise business conducted in mainland China. Compared with the MOC Measures, the new law clearly applies to cross-border franchise business. [1]

Under the Franchise Regulation, a "franchise" shall have the following elements: (1) A franchisor confers to its franchisee the right to use its business resources, such as 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. [2]

Regardless of what name the 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, the famous "2+1 Rule" will apply to the franchisor together with the other requirements in the Franchise Regulations. Compared with the MOC Measures, the new law greatly relaxes the "2+1 Rule," as it is no longer a statutory requirement that the "two directly operated outlets" be in mainland China. [3] Furthermore, under the new law, failure by the franchisor to meet the "2+1 Rule" does not now entitle the Chinese government to issue an administrative order terminating the franchise business in question. [4]

Exceptions to the "2+1 Rule" exist in the event of "inter-company license" arrangements and/or amnesty treatment offered to certain franchisors. "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 legally required two outlets, the license in question shall not be deemed to be "franchising" rather, it will be deemed to be "inter-company licensing," which will not trigger the application of the "2+1 Rule." The new law extends amnesty treatment to franchisors who have sold and operated franchises in mainland China prior to 1 May, 2007, regardless if they have complied with the "2+1 Rule." [5]

Unlike the situation under the MOC Measures, the franchisor is no longer required to bear joint and several liabilities for the quality of products provided by its designated suppliers. This means the Franchise Regulations recognize the independent relationship between the franchisor and its designated suppliers.

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[1] Article 17 of the Filing Rules provides that it applies to franchise business in mainland China carried out by foreign franchisors (including franchisors of Hong Kong SAR, Macau SAR and Taiwan area).


[3] Under the MOC Measures, a foreign franchisor must have two directly operated outlets running in mainland China for one year before being entitled to franchise in mainland China.

[4] Under the MOC Measures the relevant Business License could be revoked in the case of failure to meet with the requirement of "2+1 Rule" (see Article 38 of the MOC Measures). While a foreign franchisor does not have a Business License in mainland China, the above-mentioned Article 38 could be used by the Chinese government to revoke the Business License of the relevant franchisors in mainland China, and as a result of which the concerned franchise business will be jeopardized.

The new law requires the franchisor and franchisee to stipulate a certain time period in the franchise agreement, during which the franchisee can unilaterally rescind the franchise agreement. The law, however, is silent on how long such a period must be. Our informal consultations with relevant legislators indicate the legislative intention for this requirement is to protect franchisees, and it is up to the agreement, between the franchisee and the franchisor, with regard to how long such a time period should be. Also, it is up to the franchisee regarding whether it agrees not to have the time period.

The new law also imposes a filing requirement on franchisors. A franchisor must file with MOC, or one of its counterparts at the provincial level (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 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 franchisor in question 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; for example, the opportunity for the franchisee to rescind the franchise contract if the franchisor conceals relevant information or provides false information.

Another important change is the government reserves the authority to request additional disclosures.

The new law explicitly prohibits a franchisor from disclosing, in advertisements, revenues earned by its franchisees.

2. What are the Key Provisions of the Filing Rules?

The Franchise Regulations require that a franchisor file with MOC or one of its counterparts at the provincial level. 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 one of MOC's counterparts at the provincial level. For ease of discussion, MOC and its local counterparts are collectively referred to as “MOC.”

The Filing Rules mainly address the requirements on and formalities for franchisors when making franchise filings. The following are the three types of filing obligations imposed on a franchisor under the Filing Rules:

Firstly, within 15 days after the initial franchise contract is signed, the franchisor must complete the filing with MOC. For the purpose of this filing, a franchisor needs to submit the following documents to MOC: (1) Basic information on the franchisor’s franchise business; (2) the location(s) of the franchisees’ store(s) in mainland China; (3) the market plan of the franchisor; (4) a copy of the enterprise's legal person business license, or a photocopy of any other entity qualification certificate (if the franchisor is a foreign company, it should be a copy of its Certification of Incorporation or a similar type of document); (5) photocopy(ies) of the registration certificate(s) of the trademark(s), patent(s), and other operation resources that are relevant to the concerned franchise activities; (6) samples of the franchise agreement; (7) table of contents of the franchise operation manual (the pages of each chapter and the total pages of the manual should be noted; if such a manual is provided on the intranet of the franchise system, the approximate number of printout pages should be noted); (8) an undertaking signed by the franchisors' chairman of the board, in which the franchisor undertakes to abide by the franchise laws of China, and the documents and materials that the franchisor submits for the filing are true, complete and accurate; and (9) if the franchisor started its franchise business in China before 1 May, 2007, it must provide the initial franchise agreement signed by the franchisor and its franchisee. Otherwise, it must provide documents to verify that it has two outlets, operated under the franchise brand, for at least one year. If the outlets are within China, such documents must be issued by MOC at the place where the outlets are located; if the outlets are outside mainland China, the franchisor shall provide documents to verify the operation of such outlets, and such documents must be consularized by the Chinese embassy or consulate in the relevant country.

There is an exception to the 15-day filing requirement for franchisors who started franchising before 1 May, 2007: They are allowed to complete the filing no later than May 1, 2008.

Provided the franchisor submits all of the required documents, the filing should be granted by MOC within 10 days, and the filing should remain in effect indefinitely. MOC will publicize, on its official website, the relevant filing of a franchisor upon its acceptance of the filing by the relevant franchisor.

A filing may be revoked by MOC, under certain circumstances.
stipulated by law, which include two basic situations: First, 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); second, the franchisor conceals relevant information when it files with MOC, or the information it files turns out to be false.\[13\]

After the initial filing, the franchisor is obliged, annually, to update the filing with MOC. The annual update must be completed by 31 March each year. The franchisor must report to MOC how many franchise contracts were signed, rescinded, extended or amended in the preceding year.\[14\]

In addition to the initial filing and the annual update filing, if there are any changes to the filed information, the franchisor must file an update with MOC within 30 days after the changes.\[15\]

Failure to file will lead to consequences, such as the franchisor being ordered to rectify the situation within a certain time period, monetary sanctions up to RMB 100,000 (approximately US$ 13,000), and/or publicly circulated official criticism.\[16\]

3. What are the Key Provisions of the Disclosure Rules?

The Disclosure Rules set out detailed disclosure requirements that a franchisor must follow. For example, a franchisor is obliged to disclose the following 12 types of information to the prospective franchisee at least 30 days prior to the franchise contract being 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 a 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, for the past two years, which 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; and (11) record(s) of material illegal operation(s) of the franchisor or its legal representative. A “record of material illegal operation” refers to a fine imposed by the relevant authority in charge of administrative enforcement of law, in an amount no less than RMB 300,000 (approximately US$ 40,000) and no more than RMB 500,000 (approximately US$ 66,666); or conviction of criminal penalty; (12) text of the franchise contract.\[17\]

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

Franchisors making disclosure are entitled to request the franchisee enter into a confidentiality agreement.\[18\]

In the event a franchisor conceals information that it should have disclosed to the franchisee, or provides false information, the franchisee is entitled to rescind the franchise contract under the new franchise law.\[19\]

5. Uncertainties and Opportunities under the New Legal Regime

It is clear that the 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? Does an FIE franchisor have to have franchise business included in its "business scope”? But, uncertainties are not necessarily bad, because they entail 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.

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