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China

Franchise & Licensing

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This country-specific Q&A provides an overview of franchise & licensing laws and regulations applicable in China.

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China: Franchise & Licensing

1. Is there a legal definition of a franchise and, if so, what is it?

The Commercial Franchise Administration Regulation (Shangye Texujingying Guanli Tiaoli, Ordinance No. 485 31 January 2007) (CFAR) sets out three aspects for a franchise. There must be an agreement between the franchisor and the franchisee which regulates the franchisee's right to use the franchisor's business operating resources. This includes intellectual property such as registered trademarks and patents, as well as resources such as logos and proprietary technology. The agreement regulates the way that the franchisee conducts business, which is in accordance with a uniform mode of business, and how the franchisor receives franchise fees from the franchisee in accordance with the agreement.

2. Are there any requirements that must be met prior to the offer and/or sale of a franchise? If so, please describe and include any potential consequences for failing to comply.

The starting point is conformity with the basic contractual principles set out in the People's Republic of China's Civil Code. In addition to contractual principles, there are regulations applicable to franchising, including the CFAR, which must be complied with. The parties must ensure that they meet the requirements in the Commercial Franchise Registration Administrative Measures (CFRAM); the Commercial Franchise Information Disclosure Administrative Measures (CFIDAM) and the Administrative Measures for Foreign Investment in Commercial Fields (AMFICF). The starting point is for parties to act in good faith and to disclose all material facts during negotiations. Article 23 of the CFAR provides that a franchisor shall not conceal any relevant information and Article 21 to 23 of the CFAR requires the franchisor to disclose to the franchisee the information set out in Article 5 of the CFIDAM, within 30 days before the franchise agreement is signed, which is also mandatory where there is a sub-franchisee. It is, however, insufficient to merely comply with the disclosure regulations. The franchise agreement must be able to offer the franchisee a mature business model, accompanied by training, guidance and other support services, as well as the completed registration of at least

one form of intellectual property, such as a trademark, patent or copyright. Finally, there is the '2+1' rule, whereby the franchisor must have owned and operated at least two outlets for at least one year. There are consequences for failure to comply with the disclosure requirements, which allows for the franchisee to terminate the contract. In addition, the franchisee may apply for damages under the Chinese Civil Code, or an administrative penalty of up to RMB 100,000 under the CFAR. Article 24 of CFRAM also deals with this issue. However, damages are relatively low and do not reflect any substantial negative impact upon the franchisee. The information that should be disclosed includes matters such as corporate information; details of IP rights; payment of franchise fees; any bankruptcy orders against the franchisor or non-compliance with any regulations; estimated budgets and geographical distribution of products.

3. Are there any registration requirements for franchisors and/or franchisees? If so, please describe them and include any potential consequences for failing to comply. Is there an obligation to update existing registrations? If so, please describe.

Yes, there are registration requirements under the CFRAM. These provide the franchisor with 15 days from the date that the initial franchise agreement is signed, to submit documentation with MOFCOM, with any changes to be registered within 30 days of the changes. This documentation must comply with Article 8 of the CFRAM. The requirement for registration also applies to international franchise agreements operating in China, and these must be registered with MOFCOM in Beijing, with trademark licences being registered with the China National Intellectual Property Administration (CNIPA). Within 15 days of signing the agreement, the franchisor must comply with Article 8 of the CFAR, submitting documentation, including a copy of the incorporation certificate or business licence; the original franchise agreement; the contents of the Operations Manual; the marketing proposal; proof of compliance with the 2:1 requirement and any other material or information required by MOFCOM. The failure to register a franchise will not have any material effect upon the validity of the franchise agreement, but the consequences are

administrative fines of RMB 10,000 to RMB 100,000, as well as public announcements: CFAR Article 25.

4. Are there any disclosure requirements (franchise specific or in general)? If so, please describe them (i.e. when and how must disclosure be made, is there a prescribed format, must it be in the local language, do they apply to sales to sub-franchisees) and include any potential consequences for failing to comply. Is there an obligation to update and/or repeat disclosure (for example in the event that the parties enter into an amendment to the franchise agreement or on renewal)?

The general disclosure provisions are set out in the answer to question 2 above. The disclosure should be made in conformity to general contractual provisions, as well as in compliance with the CFIDAM and in accordance with the provisions of the CFAR. There is the same mandatory requirement for pre-disclosure from a sub-franchisor to a sub-franchisee. While disclosure must be in writing, there is no prescribed format, although Article 5 of the CFIDAM provides an example of the order in which the disclosure may be presented. It is not mandatory to disclose the documentation in Chinese, although it must be translated into Chinese before it is submitted to MOFCOM and for the courts and administrative authorities if adjudication on a dispute is required. Surprisingly, there is no requirement for repeat disclosure, but there is a requirement to update it, prior to the signing of the agreement and following any significant change in the information or if the franchise is renewed on different terms and conditions, when the CFIDAM requires the franchisor to undertake disclosure at least 30 days before the agreement is signed. There is no automatic right for the franchisor to renew or extend the agreement, nor is compensation available for their failure to do so. The consequences following non disclosure are as set out in question 2 and they consist of damages or an administrative penalty.

5. If the franchisee intends to use a special purpose vehicle (SPV) to operate each franchised outlet, is it sufficient to make disclosure to the SPVs' parent company or must disclosure be made to each individual SPV franchisee?

The disclosure should depend on who is the subject of the franchise agreement. If the SPV is the subject of the franchise agreement, the franchisor should disclose the

relevant information to it, otherwise the commercial authority will impose a fine of more than RMB 10,000 and less than RMB 50,000.

6. What actions can a franchisee take in the event of mis-selling by the franchisor? Would these still be available if there was a disclaimer in the franchise agreement, disclosure document or sales material?

The franchisee is entitled to rescind the agreement if the franchisor has provided false information, has not complied with full disclosure, or has induced the agreement by fraudulent means. The franchisee can report the breach of Article 23 of the CFAR to the Commercial Administrative Department, who can order the franchisor to rectify the breach, as well as imposing a fine of between RMB 10,000 and RMB 50,000 on the franchisor. Under Article 58 of the Contract Law, the franchisee can also sue the franchisor for damages for any loss arising out of the franchisor's conduct.

7. Would it be legal to issue a franchise agreement on a non-negotiable, "take it or leave it" basis?

As well as the specific Franchise Measures, franchise agreements are regulated by the general contract law of the PRC, which provides that the parties to an agreement must abide by the principle of fairness. There has to be an offer and acceptance of the agreement, with consensus on the material terms, with both parties having the legal capacity to enter into it. A party asserting that they were unfairly persuaded to sign the agreement, may apply to the court to rescind the contract. The court will then consider the respective bargaining power of the franchisor and the franchisee. It would not be lawful to issue an agreement on a take it or leave it basis.

8. How are trademarks, know-how, trade secrets and copyright protected in your country?

In China, as in many jurisdictions, the country is now compliant with international conventions, such as the TRIPS Agreement, and it adheres to the international minimum standard of enforcement. Trademark protection is afforded to the first to file, although since 2013, there has been greater protection for trademark owners, as new and evolving legislation has been implemented to defeat bad faith filings and squatting. Trademarks will not be protected in China, unless they have been registered

locally. Registration is valid for ten years and may be renewed. The application process is 12 to 15 months for an uncomplicated application without an opposition or invalidation proceedings. A franchisor may take infringement proceedings against a franchisee who registers trademarks without the franchisor's permission, under Article 15 of the Trademark Law, and in order to avoid the situation where the franchisee registers the franchisor's trademark, the franchisor should consider registering it in Chinese characters. In China, trade secrets are protected under Anti-Unfair Competition Law, which was amended in 2019. A trade secret is defined as technology or business information unknown to the public and of commercial value for which the owner (or franchisor) has taken corresponding confidentiality measures. The information may be contained in the franchise agreement and may include customer lists, recipes or pricing plans. The starting point is for the franchisor to ensure that there is a non-disclosure agreement in place, which sets out with clarity the nature of the information that has been disclosed to the franchisee, when it was disclosed, as well as prohibiting disclosure of that information by the franchisee to third parties or to deal with the information outside the purposes of the franchise. The Copyright Law of China, defines copyright as works of literature, art, natural science, social science, or engineering technology that can be reproduced in tangible form. It arises automatically upon its creation and the franchisor is entitled to copy, reproduce and licence their work and this can be utilised by the franchisee. It is open to a franchisor to register their copyright with the National Copyright Administration (NCA), which provides a public record, serving as prima facie evidence of ownership, should a dispute arise during the franchise agreement, which leads to litigation.

9. Are there any franchise specific laws governing the ongoing relationship between franchisor and franchisee? If so, please describe them, including any terms that are required to be included within the franchise agreement.

There is a general obligation on the parties to act in good faith and to act fairly and reasonably during the currency of the franchise. The Contract Law, Articles 5, 6 and 7, apply and the requirement extends to the terms relating to their rights and obligations and the parties must observe the principles of honesty and good faith when exercising those rights and obligations. The franchisor and franchisee must also comply with these provisions and all administrative regulations, as well as respecting social ethics and the need to adhere to the economic

social order and not to impair the public interest. Article 2 of the Anti-Unfair Competition Law of China also requires the operator of the business to comply with the requirements of free will, equality, fairness and good faith when conducting their production and distribution activities. Article 11 of the CFAR, sets out what terms should be included in the franchise contract of agreement. These include the basic details and terms of the parties and the franchise, the fee structure, including the method of payment; details of services such as business guidance, technical support and training; arrangements for quality control; marketing advertising; protection of consumer rights; circumstances of modification, rescission and termination; liability for breach and dispute resolution.

10. Are there any aspects of competition law that apply to the franchise transaction (i.e. is it permissible to prohibit online sales, insist on exclusive supply or fix retail prices)? If applicable, provide an overview of the relevant competition laws.

Both the Anti-Competition Law and the Anti-Monopoly Law of China apply to the franchise agreement. The Anti-Unfair Competition Law operates to prevent the commercial use of any label which is identical to the name, packaging, decoration or institution name, belonging to another person without consent. It also prohibits the commercial use of the principal part of a domain name, website or webpage without consent. The law also prohibits a party misleading another person by representing that a commodity is owned by or connected to a person other than the actual owner, and disclosure of trade secrets is also prohibited. The purpose of the Anti-Monopoly law is to prevent competitors from entering into agreements that have the potential to undermine the market competition by engaging in certain practices, such as fixing the resale price of products or by restricting their minimum resale price. There are exceptions for franchises, as they may be exempt from these restrictions, if the intention of these policies is to improve or explore the potential of new technology; improve product quality; reduce costs or enhance efficiency; save energy and protect the environment; unify the specifications or standards of products; enhance the competitiveness of small and medium-sized businesses or to protect any legitimate interest in co-operation with foreign entities. The Anti-Monopoly Law of China prohibits market domination, which prevents businesses from blocking the entry of other operators into the relevant market.

11. Are in-term and post-term non-compete and non-solicitation clauses enforceable and are there any limitations on the franchisor's ability to impose and enforce them?

There are no formal in-term restrictive clauses and the parties are free to negotiate and agree on reasonable terms in this respect. However, post-term restrictive covenants, such as non-complete agreements, are usually enforceable for a maximum period of two years. There is an exception for confidentiality and trade secret agreements which may be permitted in perpetuity.

12. Is there an obligation (express or implied) to deal in good faith in franchise relationships?

This has been dealt with in response to question 9. There is a general obligation upon the parties to act in good faith in relation to the franchise term. The practical effect of this requirement is that the relationship between the parties is on a more equal basis, as both the franchisor and franchisee are required to protect the legitimate business interests of the other.

13. Are there any employment or labour law considerations that are relevant to the franchise relationship? Is there a risk that the staff of the franchisee could be deemed to be the employees of the franchisor? What steps can be taken to mitigate this risk?

The Labour Law of China provides that an employee is a natural person, whereas a franchisee is a legal person and not an employee of the franchisor, who will not be vicariously liable for any acts undertaken by the franchisee. The best step to take to minimise any risk that an employer/employee relationship is present, is to explicitly define the relationship between the parties when the franchise agreement is drafted and clarify the franchisor's independence from the franchisee.

14. Is there a risk that a franchisee could be deemed to be the commercial agent of the franchisor? What steps can be taken to mitigate this risk?

The relationship between the franchisor and franchisee in China is primarily contractual. Most franchise agreements will expressly state that the franchisee is an independent contractor of the franchisor and is an independent entity accountable for their own human

resources and finance. There is generally little risk of confusion, as commercial agency or 'entrustment contracts' as they are known, are regulated by a separate chapter in the Civil Code and are distinct from franchise. The Chinese courts have operated on this basis, but it is prudent to ensure that the agreement specifically refutes the existence of commercial agency.

15. Are there any laws and regulations that affect the nature and payment of royalties to a foreign franchisor and/or how much interest can be charged? Are there any requirements for payments in connection with the franchise agreement to be made in the local currency?

China has implemented a foreign exchange control regime, under which the purchase of foreign currency with Chinese currency is subject to an annual quota, beyond which level the approval of the State Administration of Foreign Exchange (SAFE) is required. The practical effect of this is that the local administration of foreign exchange, as well as the banks, are vested with the powers to approve different kinds of foreign exchange remittance and the parties will have to provide the banks with supporting documents, such as tax records, which underly contracts such as the franchise agreement, and invoices must be provided to the remitting banks. Therefore, no payment can be made before the conclusion of a contract and it often takes several weeks to secure approval, so this should be taken into account in the franchise agreement and may have an impact on the payment of interest. There are no requirements for payments in connection with the franchise agreement to be made in the local currency.

16. Is it possible to impose contractual penalties on franchisees for breaches of restrictive covenants etc.? If so, what requirements must be met in order for such penalties to be enforceable?

In-term and post-term restrictive covenants are enforceable in the Chinese courts, but these must not be overbroad or they will not be enforced based on the doctrine of good faith, as set out in the Civil Code.

17. What tax considerations are relevant to franchisors and franchisees? Are franchise royalties subject to withholding tax?

In China, there are various taxes that affect royalties and other payments, including value added tax (VAT) and

customs duty. Payments are subject to a withholding tax when fees are payable to foreign franchisors. The rate of withholding tax is about 10% and is payable on service fees or other payments if there is a suggestion that any payments are designed to reduce royalties. It is important that each franchise payment is described appropriately.

18. How is e-commerce regulated and does this have any specific implications on the relationship between franchisor and franchisee? For example, can franchisees be prohibited or restricted in any way from using e-commerce in their franchise businesses?

China has experienced rapid e-commerce growth and the E-Commerce Law of the People's Republic of China of 31 August 2018, which came into force on 1 January 2019, is the first law to regulate e-commerce business, provide consumer protection, and ensure the development of the industry. E-commerce is defined in law as all business activities conducted on an information network to sell commodities or offer services within the territory of the People's Republic of China.

19. What are the applicable data protection laws and do they have any specific implications for the franchisor/franchisee relationship? Does this have any specific implications in the franchising context? Is the franchisor permitted to restrict the transfer of (a) the franchisee's rights and obligations under the franchise agreement or (b) the ownership interests in the franchisee?

Franchises are E-commerce operators, operating as legal business entities who must adhere to the relevant laws and administrative regulations required to conduct business in China, obtaining the appropriate business and administrative licences and fulfilling tax obligations. The law does not prohibit franchising in the form of e-commerce, and franchisors and franchisees are free to agree on terms to deal with this issue in the agreement.

20. Does a franchisee have a right to request a renewal on expiration of the initial term? In what circumstances can a franchisor refuse to renew a franchise agreement? If the franchise agreement is not renewed or it if it terminates or expires, is the franchisee entitled to compensation? If so,

under what circumstances and how is the compensation payment calculated?

There is no automatic entitlement for the franchisor to renew the franchise agreement at the end of the initial term and there are no minimum notice periods. The agreement should include a detailed termination clause to avoid this issue arising. The concept of good faith must be adhered to. There is no right to compensation.

21. Are there any mandatory termination rights which may override any contractual termination rights? Is there a minimum notice period that the parties must adhere to?

There are no statutory termination provisions that would override the terms of a franchise agreement, nor are there any minimum notice periods that must be given in order to bring a business relationship to an end and which would override the franchise agreement. However, there is still the overriding requirement for the franchisor to deal with the franchisee in good faith and to act fairly in their dealings with the franchisee: Articles 7 and 509 of the Civil Code and Article 4 of the CFAR. The agreement should contain a clause under which, the franchisee can unilaterally terminate the agreement within a fixed period from the date that the agreement is entered into: Article 12 CFAR. In the absence of such a clause, the franchisee is entitled to terminate the agreement within one year of signing it. There is a minimum initial term of three years for a franchise agreement, but this can be excluded by the parties.

22. Are there any intangible assets in the franchisee's business which the franchisee can claim ownership of on expiry or termination, e.g. customer data, local goodwill, etc.

Both parties may agree terms on the issues in the franchise agreement.

23. Is there a national franchising association? Is membership required? If not, is membership commercially advisable? What are the additional obligations of the national franchising association?

The relevant agencies are the China Chain Store & Franchise Association:
<http://www.chinaretail.org.cn/enwebsite/index.jsp> and
 the China (Hong Kong) Franchise Association:

<http://www.chkfa.com/home.html>, where detail of membership and the roles of the associations are set out.

24. Are foreign franchisors treated differently to domestic franchisors? Does national law/regulation impose any debt/equity restrictions? Are there any restrictions on the capital structure of a company incorporated in your country with a foreign parent (thin capitalisation rules)?

There are no rules or restrictions that apply in this context.

25. Must the franchise agreement be governed by local law?

The parties are generally free to select a foreign law to govern the franchise agreement, without any requirement to adopt local law. However, it is more expedient and cost effective to use Chinese law, if the Chinese courts are selected to determine any dispute resolution. The enforcement of foreign judgments and awards can be difficult and costly, and the judges are likely to apply Chinese law, as that is well understood. China is also ranked fifth in the World Bank Group's Enforcing Contracts, with a good reputation for the enforcement of commercial contracts.

26. What dispute resolution procedures are available to franchisors and franchisees? Are there any advantages to out of court procedures such as arbitration, in particular if the franchise agreement is subject to a foreign governing law?

The parties to a franchise agreement may utilise dispute resolution, in addition to civil law and administrative actions. Parties may be advised to engage in voluntary mediation before or during civil proceedings, but parties to international franchising usually engage in arbitration, as any awards can be enforced more easily in countries who are parties to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (June 10, 1958). Using arbitration disposes of the dispute at an earlier stage than litigation and China has adopted court ordered interim measures such as injunctive relief

to preserve assets pending the arbitration process.

27. Must the franchise agreement and disclosure documents be in the local language?

There is no requirement for franchise documents to be translated into the local language, but all documentation submitted to MOFCOM for registration must be translated into Chinese, as well as for any court or administrative proceedings.

28. Is it possible to sign the franchise agreement using an electronic signature (rather than a wet ink signature)?

In practice, a 'wet ink' signature is the preferred method of signing franchise agreements. However, provided that the signature complies with the reliability requirements of the PRC's Electronic Signature Law, it is recognised as a valid method of signing a franchise agreement.

29. Do you foresee any significant commercial or legal developments that might impact on franchise relationships over the next year or so?

The State Council has announced that VAT rates that are applicable to the supply of certain goods and services would be reduced. The reduction from 17% to 16% came into force on 1 May 2018 and applies to the sale and importation of goods, the leasing of tangible moveable property and repair and processing services. A reduction from 11% to 10% applies to transportation services, the sales and leasing of immovable property, basic telecommunications services, construction and postal services, agricultural products and water and gas supplies. These changes will encourage business activities and assist with business expansion. The threshold for payment of VAT has been amended so that both goods and services sectors will have a threshold of RMB 5 million per annum. In August 2017, a business called Rainbow Department Store Co. Ltd launched the first grocery store run entirely by artificial intelligence, under the name "Well GO" in Schenzhen, China, which could be the beginning of franchising 'humanless' businesses in China. This could have major impact on the franchising model in the future.

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