

A Primer on Franchising in China

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I. Overview

In the early 1980s, a Chinese family would walk into an American hamburger chain restaurant, one of the first international chain restaurants to ever set its foot onto Chinese soil, dressed up in smart-casual, with their hair combed perfectly, and be impressed by the slick operation of an international franchise brand. To a local Chinese person, such an extraordinary experience was beyond imagination.

The idea of franchising migrated to China as early as 1984. The successful expansion of foreign franchise brands in China quickly inspired the community. Local brands started to adopt similar models to develop their businesses. Franchising had also reportedly given some failing local companies a renewed business vitality. As the number of franchises surged across the country in mid-1990s, the then-Ministry of Domestic Trade of the People's Republic of China (PRC) promulgated the Administrative Measures for Commercial Franchise (for Trial Implementation) in 1997. This was the first prescriptive document about commercial franchising that ever existed in China.

In the mid-2000s, the business of franchising grew rapidly in China, but there was a lack of laws in place to effectively regulate franchising activities. Commercial fraud ran rampant due to the flaws of the franchising system.

In 2007, the State Council of the People's Republic of China promulgated the first comprehensive set of franchise regulations under the Regulations on the Administration of Commercial Franchises,¹ which introduced a compulsory disclosure requirement and filing system. Since then, the 2007 Regulations have played a major role in franchising under the legal system of China.



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1. Regulations on the Administration of Commercial Franchises, promulgated by the State Council of the People's Republic of China, Feb. 6, 2007, May 1, 2007 [hereinafter 2007 Regulations], http://www.fdi.gov.cn/1800000121_39_3485_0_7.html.

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A. *Legal System of the People's Republic of China*

1. The hierarchy of Laws and Regulations

The National People's Congress is the highest organ of state power and legislature of China. It is vested with the power to issue national laws and to interpret those laws, if so required. Under the national laws, the State Council and its departments as well as their local offices are vested with powers to implement regulations and rules at the administrative level on various matters or areas of business that are supervised and regulated by the government. Such governmental supervision is often performed by recorded process and prescribed disclosure of material information. Meanwhile, local rules may exist on the provincial, autonomous-regional, and directly administered municipality level. Theoretically, the national law should be construed as the universal law, which ought to be followed at all times. However, due to the generality of the national laws, one may find more practical guidance from the administrative regulations and local rules.

Interestingly, there are also National Standards issued by the Standardization Administration, authorized by the State Council. Although they do not have the force and effect of laws, they are nonetheless valuable for reference purposes.

In large part, the franchising statutes discussed in this article were promulgated as administrative regulations.

2. The Judiciary

The Judiciary of China, which consists of the Supreme People's Court in Beijing and various local courts (high courts, intermediate courts, and elementary courts), share the same feature of hierarchy. In recent years, specialized courts have been set up in different cities, and some local courts have designated judges to deal with specific areas. For example, some judges in most of the first-tier cities specialize in franchising law.

The Supreme People's Court can issue judicial interpretations, but, so far, there is no standalone judicial interpretation on franchising law, and most of the time one should refer to the general contract law. Beginning about a decade ago, the courts started to encourage judges to issue more elaborate judgments. Although China is not a common-law jurisdiction, and judicial precedents are not binding on the courts, the case law's reference value is emerging.

B. *Main Regulations*

The 2007 Regulations provide the legal backbone for the franchising sector in China by imposing the disclosure and filing requirements as well as the basic rights and obligations of franchisors and franchisees in the franchisor-franchisee relationship. Practice directions are supplemented by administrative measures such as Administrative Measures for Information Disclosure of Commercial Franchises² and Administrative Measures for the Record Filing

2. Promulgated by Ministry of Commerce (MOFCOM) pursuant to the 2007 Regulations and effective Apr. 1, 2012.

of Commercial Franchises.³ Although they are administrative regulations in nature, in practice, they impose civil law obligations on franchisors.

1. Definition of *Franchising*

The 2007 Regulations define a *franchise* broadly as a contractual arrangement whereby (1) an enterprise grants other operators the right to use its operating resources, such as registered trademarks, business logos, patents, and proprietary know-how or technologies;⁴ (2) such operator undertakes business operations under a uniform mode of operations in accordance with such contract, and (3) the operator pays franchise fees to the grantor for the right to run the business.

Various local courts have tried to elaborate further on the definition of *franchising*. For example, the Beijing Second Intermediate People's Court published a research report (albeit non-binding) regarding franchising disputes, which summarized the characteristics of franchising as follows:⁵

- a. Franchisors own the proprietary rights in, and have control over, the franchise rights. Such rights are often substantiated by intellectual property rights, such as registered trademarks, proprietary marks, proprietary or patented technologies, trade secrets, etc.⁶
- b. Franchisors will license the aforesaid rights to the franchise to franchisees. During the franchise terms, franchisors will inevitably manage and monitor the franchise business operated by the franchisees, such as requiring the franchisees to operate the franchise business by way of a specific unified mode of business. Therefore, franchise rights include the rights to license the intellectual property and manage the business.⁷
- c. Franchisors have the right to receive franchise fees from franchisees.⁸

The legal definition does not restrict the type of franchise model that can be used in China. However, there is always a discussion on where to draw the line between franchising and licensing. That being said, one should always note that whether an arrangement is a franchise or license is purely a matter of fact and not a linguistic differentiation, and the elements mentioned above will be adopted to examine if a relationship is a franchising one.

3. Promulgated by MOFCOM pursuant to the 2007 Regulations and effective Feb. 1, 2012.

4. While individuals and enterprises can engage in franchising activities, only an enterprise can conduct the activities as a franchisor in a franchisor-franchisee relationship. However, such enterprise does not have to be incorporated in China.

5. Court No. 5, Second Intermediate People's Court of Beijing Municipality, Research Report Regarding Several Questions on Commercial Franchise Agreement Disputes, J. L. APPLICATION 2-3 (2010).

6. *Id.*

7. *Id.*

8. *Id.*

2. “2+1” Requirement

Franchisors must satisfy the so-called “2+1” requirement,⁹ as stipulated by the 2007 Regulations, before expanding the franchise business in China. The “2+1” refers to two direct-owned stores and one year of operation of the franchise business. In other words, franchisors must own at least two stores of the franchised business and must have conducted the franchised business for at least one year.

First, the requirement has no geographical restriction. The stores can be operated, in principle, anywhere around the globe. Although in practice, when it comes to registration, it would be less cumbersome to provide the relevant proof if the stores were operating in the same country because the proof is usually issued by the national franchise association of the franchisor’s home country. Second, under the current practice, the stores can be owned and operated by the affiliates of the franchisor, including the franchisor’s controlled shareholders (individual or corporate), the franchisor’s parent company or wholly owned subsidiaries, or subsidiaries in which the franchisor has controlling shares.

Each and every franchisor-franchisee relationship in China is subject to the “2+1” requirement. In other words, theoretically, the requirement also applies to Master Franchisees and any subfranchisors in a franchise system.¹⁰

3. Disclosure

Franchisors are required to provide to all prospective franchisees accurate information on certain matters as specified under the Administrative Measures for Information Disclosure of Commercial Franchises at least thirty days before entering into any franchise agreement¹¹ in relation to a franchise in China.¹²

The information to be disclosed includes:¹³

- a. Information of the franchisor, including but not limited to corporate information, descriptions of the franchised business, and goods and services to be offered by it and/or its affiliates;¹⁴
- b. Details of the franchisor’s registered trademarks (including their respective status), business logos, patents, proprietary technology, and business model;¹⁵

9. See 2007 Regulations, *supra* note 2, art. 7. The name “2+1” is not an official term but commonly referred to by local practitioners.

10. *Id.* art. 7.

11. Although not specified in the regulations, as the franchise agreement is part of the documents to be disclosed, a school of thought suggests that if the franchise agreement is amended during the thirty-day disclosure period, the thirty-day disclosure period should restart and run from the date of the amendment. This is certainly the most cautious approach to compliance.

12. 2007 Regulations, *supra* note 2, art. 21.

13. *Id.* art. 22.

14. The information regarding the affiliate is required if the products and services of the franchise business will be offered by the affiliate of the franchisor.

15. Where the proprietary resources are owned by an affiliate, the franchisor must also disclose the details of the affiliate, the scope of license(s), and the arrangements upon termination of license(s).

- c. The type, amount, and method of payment of franchise fees, including but not limited to the deposit and repayment details, if any;
- d. Where the franchisor or its affiliates will supply products, services, or equipment to the franchisee, and their price and trading terms;
- e. The means and plan for the provision of continuous business and operational guidance, supervision, technical support, and training to the franchisee during the term of the franchise;
- f. Estimated budget of investment for franchise outlets;¹⁶
- g. Number, geographical distribution, authorized territory (exclusive or non-exclusive), and business status of existing franchisees in China;¹⁷
- h. Anticipated number, geographical distribution, and authorized territory (exclusive or non-exclusive) of future franchisees in China;
- i. Financial statement and audited report for the franchisor's business in the preceding two years;
- j. Any material non-compliance with any regulations by the franchisor and its legal representative;
- k. Any bankruptcy order or petition against the franchisor or its affiliate in the preceding two years; and
- l. Any claims, motions, litigation, or arbitration with respect to the franchise business in the preceding five years.

In practice, not all of the above required information may be readily accessible by start-up franchisors, and the disclosure document should be carefully drafted in such situation.

Failure to comply with the regulation's disclosure requirements will attract a fine between ¥10,000 and ¥50,000.¹⁸ The governing authority may also request that the franchisor rectify the breach. In the case of a serious breach, the franchisor can be found liable and fined between ¥50,000 and ¥100,000, and the breach will be noted in the public record.¹⁹

If the franchisor discloses false information or conceals any information which frustrates the purpose of the franchise agreement, the franchisee can unilaterally terminate the agreement and claim damages.²⁰

4. Filing

The 2007 Regulations require franchisors to file specific documents within fifteen days of the execution of the first franchise agreement, although

16. Start-up franchisors may find difficulty in achieving this provision. Specific information may be required.

17. "Business status" means the existing franchisees' investment amount, average sales turnover, and gross profit, among other factors.

18. Administrative Measures for Information Disclosure of Commercial Franchises art. 28 (China).

19. 2007 Regulations, *supra* note 2, art. 28.

20. Administrative Measures for Information Disclosure of Commercial Franchises, *supra* note 19, art. 9; 2007 Regulations, *supra* note 2, art. 23.

any failure to complete the process does not nullify any agreement signed.²¹ The filing should be submitted to the relevant local Bureau of Commerce in the province, autonomous region, or municipality in which the franchise business will be conducted pursuant to the first franchise agreement, or to the Ministry of Commerce (MOFCOM) if the franchise business will be conducted in more than one province, autonomous region, or municipality.

Specifically, the franchisor must file the following documents:²²

- a. The basic information of the commercial franchise (e.g., business nature, field of industry, date of commencement of the franchise business, etc);
- b. The distribution of all franchise stores in China (exclusive of Taiwan, Hong Kong, and Macau);
- c. The marketing plan of the franchisor;
- d. The business license or any other proof of corporate identity of the franchisor;
- e. The registration certificate of trademarks, patents, and any other franchise operational resources;
- f. Proof of compliance with the “2+1” requirement;
- g. The first franchise agreement entered into between the franchisor and the franchisee in relation to the franchise in China;
- h. A sample of the relevant franchise agreement;
- i. The table of contents of the operations manual for the franchise business (the page number of each chapter and the total page number of the manual must be expressly stated); and
- j. An undertaking signed by the authorized representative of the franchisor (undertaken to comply with the 2007 Regulations).

Of course, the governing authority has the power to request the franchisor provide additional documents.²³

Failure to meet the filing requirements will attract a fine of between ¥10,000 and ¥50,000.²⁴ The governing authority will impose a deadline for the franchisor to rectify the breach; and, upon further failure, it will be liable for a fine between ¥50,000 and ¥100,000.²⁵ Further, the breach will be noted on public record.²⁶

In the international franchising context, the filing is subject to examination by MOFCOM. This process may take months due to the immense amount of applications handled by MOFCOM as well as possible back and

21. The filing requirement was supplemented by the Administrative Measures for the Record Filing of Commercial Franchises.

22. 2007 Regulations, *supra* note 2, art. 8.

23. *Id.*

24. 2007 Regulations, *supra* note 2, art. 25.

25. *Id.*

26. *Id.*

forth following any requests for information. As a result, the fifteen-day deadline is practically very challenging. If genuine reasons exist, an explanation should be given to MOFCOM to explain any delay.

In addition, international franchisors are also required to report the following information to MOFCOM prior to March 31 each year:²⁷

- a. Number of new franchise agreements concluded during the preceding year;
- b. Number of franchise agreements terminated during the preceding year;
- c. Number of franchise agreements being carried out as of the date of report;
- d. Total number of franchise stores;
- e. Total sales turnover of all franchise stores;
- f. Total number of direct stores (if any); and
- g. Total sale turnover of all direct stores (if any).

5. Essential Contents and Compliance with Contract Law

The 2007 Regulations include a few mandatory contractual requirements, such as the franchisee's right of rescission²⁸ and refund of deposit in case of rescission.²⁹ Usually, other specific provisions relate to foreign-exchange control, withholding tax, intellectual property rights, and other practical aspects to address certain issues arising from the local regulatory environment.

Apart from the 2007 Regulations, franchise agreements are also subject to the Contract Law of the People's Republic of China (Contract Law). Under the Contract Law, franchisors and franchisees must abide by the principle of fairness in prescribing their respective rights and obligations under the contract, as well as the principle of good faith in exercising their rights and performing their contractual obligations.³⁰ The party not at fault can apply to the local courts to rescind the contract if such party was caused to enter into the relevant contract under unfair circumstances.³¹

The Contract Law also provides the contractual formalities requirement, which provide that an agreement is valid and legally binding if (1) there is an offer and an acceptance of the offer,³² (2) there is consensus on the material terms of the agreement,³³ and (3) the contracting parties have the legal capacity to be bound by the agreement.³⁴

27. *Id.* art. 19.

28. *Id.* art. 12.

29. *Id.* art. 16.

30. Contract Law art. 5 (China).

31. *Id.* art. 54.

32. *Id.* arts. 13, 14.

33. *Id.* art. 14.

34. *Id.* art. 9.

Franchise agreements do not have to be written in Chinese to be legally binding. The Contract Law allows the agreement to be drafted in any language and in more than one language.³⁵ If there is any inconsistency, the agreement will be interpreted in accordance with the purpose of the agreement in the absence of a prevailing language clause.³⁶

C. *Taxation and Customs Duty*

Taxation plays a big part in the business plan in how the franchise should be structured. In China, royalties and other payments are subject to various kinds of tax, such as the value-added tax, and the withholding tax if such fees are payable to foreign franchisors. Given the tax treaty between China and the United States, the withholding tax rate is ten percent, and the value-added tax and the surcharges thereon are usually around six percent for U.S. franchisors.³⁷ There is judicial support of allocating the tax payment responsibility without altering the respective statutory tax liabilities of the parties in a franchise agreement,³⁸ and “gross up” provisions are widely used.

Chinese tax laws require service fees and other payments to be subject to withholding tax if they form the view that any such payments are designed to reduce royalties.³⁹ Therefore, franchisors are encouraged to carefully define the nature of each kind of payment. Meanwhile, the location of service and how the invoices are prepared are also relevant when the tax authority makes an assessment.

If products, ingredients, and/or equipment will be imported into China, there are customs duty and value-added taxes to be paid.⁴⁰ A thorough study of the customs duty and tax exposure should be conducted as it affects the profitability of both sides, especially given that the trade environment has been constantly changing in recent years. The supply chain and any local subsidiaries should also be taken into account to fully evaluate the corporate income tax and transfer pricing consequences.

D. *Competition*

The competition law in China neither specifically regulates franchise activities, nor does it have a block-exemption regulation as in European Union countries. Meanwhile, franchisors are usually advised to consider the Anti-Monopoly Law of the People’s Republic of China (Anti-Monopoly

35. *Id.* art. 125.

36. *Id.*

37. For example, the rate of VAT and surcharges in Shanghai is about 6.12 percent.

38. Hainan Liufu Fenglin Shiye Ltd. & Ors v. Qionghai Boao Huacheng Real Estate Dev. Ltd., Hainan First Intermediate People’s Ct., Hainan No.1 Civil Case Second Instance Ruling No. 29 (2015) (China).

39. *Id.* art. 47.

40. See Regulations of the People’s Republic of China on Import and Export Duties (issued on Nov. 23, 2003; effective on Jan. 1, 2004 and further revised by Decision of the State Council on Amending Some Administrative Regulations in 2011, 2013, 2016 and 2017) and Interim Regulations of the People’s Republic of China on Value-Added Tax (2008 Revision) (issued on Nov. 10, 2008; effective on Jan. 1, 2009).

Law), and the Anti-Unfair Competition Law of the People's Republic of China (Anti-Unfair Competition Law). In a franchisor-franchisee relationship, in spite of very limited judicial guidance, it has become the norm, as recognized by the Chinese courts, that the post-term non-compete covenant between the franchisors and the franchisees should not be more than two years. The Anti-Monopoly Law imposes restrictions on geographical exclusivity as well as price fixing and product tying.⁴¹

1. Geographical Exclusivity

Operators with a dominant market position are prohibited from establishing exclusive geographical areas without justifiable cause.⁴² An operator is considered having a dominant market position if it has the power either to control the price or quantity of commodities or other trading conditions in the relevant market or to block or affect the entry of other business operators into the relevant market.⁴³

Under the Anti-Monopoly Law, “justifiable causes” refer to those that have positive impact on economic efficiency, social and public interests, and economic development.⁴⁴ In China, most franchise systems provide exclusive territories. Such exclusivity is often justified in the context of international franchising for the purposes of protecting the franchise system as a whole.

2. Product-Tying

Product-tying without justifiable cause is expressly prohibited by the Anti-Monopoly Law if the operators are considered having a dominant market position.⁴⁵ The catchphrase in the analysis of product-tying is therefore “dominant market position.”⁴⁶ The issue of monopoly by way of product-tying is rather significant when the operator is considered having a dominant market position, as product-tying will likely extinguish the vertical competition of the relevant business. Particular attention must also be paid when the bundled sales involve the sale of intellectual property rights.⁴⁷

In determining whether a franchisor has a dominant market position, franchisors should take into account the various factors which contribute to the market share, such as possible choices of alternative products or services, and the difficulty for outsiders to join the competition.⁴⁸ When structuring the franchise to be introduced into China, franchisors should consider

41. Anti-Monopoly Law art. 17 (China).

42. Interim Provisions on Prohibiting Abuse of Dominant Market Positions art. 18(3) (issued by the State Administration for Market Regulation on June 26, 2019; effective on Sept. 1, 2019) (China).

43. *Id.* art. 18.

44. *Id.* art. 15.

45. Anti-Monopoly Law art. 17(5) (China).

46. *Id.* art. 17.

47. Prohibition of Abuse of Intellectual Property Rights to Eliminate or Restrict Competition art. 9 (issued by the State Administration of Industry of Commerce on Apr. 7 2015; effective on Aug. 1, 2015) (China).

48. Interim Provisions on Prohibiting Abuse of Dominant Market Positions art. 5.

their share of the relevant market based on existing data and the anticipated expansion rate of the franchise business in China before imposing product-tying or purchasing restrictions on franchisees. Meanwhile, under the general contract law, there are also restrictions if product-tying takes place in licensing of patents and proprietary technologies.⁴⁹

3. Price Fixing

Franchisors should also observe the price fixing restrictions under the Anti-Monopoly Law. The Anti-Monopoly Law prohibits traders from forming agreements that seek to undermine the market competition by, among other things, fixing the resale price of the products or restricting the minimum resale price.⁵⁰

The current law is unclear as to whether franchises are exempt from the price-fixing and minimum resale price prohibitions under the Anti-Monopoly Law. Minimum advertised price policy, which is a relatively mature practice in the United States, is practiced, but its legality remains a controversial topic. Academic discussions have shed light on the need for an express exemption for franchising under this umbrella of restrictions due to the inherent need in franchise systems to fix prices in order to safeguard the sustainability and other inherent qualities of a franchise system.⁵¹ However, neither the legislature nor any governmental authorities have taken any action so far.

E. Intellectual Property

In practice, franchisees are usually granted licences to use the intellectual property rights in the trademarks, operations manual, and confidential know-how of the franchisor so that they may operate their franchised business. Franchisors often expressly reserve the right to develop or require new intellectual property and improvements created in the course of the franchise business under the Patent Law and Copyrights Law of the PRC. The parties also commonly agree that new intellectual property and improvements created in the course of the franchise business are otherwise deemed to be the property of the franchisor.

Chinese franchise agreements also usually expressly provide that the franchisee will assign any new intellectual property and improvements to the franchisor where they are not deemed to be the property of the franchisor. However, the franchisor must pay particular attention to the Regulations on Technology Import and Export Administration of the PRC and the relevant

49. Contract Law art. 329 (China); *see also* Circular concerning Summary on Certain Issues on the Determination of Disputes over Technical Contracts, issued by Supreme People's Court of PRC ¶ 1.1 (issued June 19, 2001).

50. Anti-Monopoly Law art. 14 (China).

51. Xiang Jing, *Issues of Anti-Monopoly in the Context of Franchising*, 37, J. Sw. UNIV. (Social Sciences ed.) (Jan. 2011).

circular.⁵² Together, they provide that, if a Chinese licensee makes improvements to the licensed technology (including know-how), the improvements belong to the Chinese licensee, and the assignment or the grant of an exclusive licence of them to a foreign transferor must be given consideration (i.e., they must be paid for).

II. Entrance Strategies

As mentioned earlier, the franchising laws do not restrict the type of franchise model that can be used in China. Local or foreign franchisors can adopt several franchise models in China.

A. Master Franchising, Area Development, and Hybrid Arrangement

In the context of international franchising, master franchising and area development are probably the most widely used models in China due to the massive geographical size of China, which calls for an enormous supply of a wide variety of products and services. As opposed to single-unit franchising, master franchising, area development agreements, and hybrid arrangements (i.e., the mix of master franchising and area development with conditions for exercising certain franchising) are far more likely to grow successfully given market demands.

Master franchising and area development are not only useful in that they help the franchise business to grow exponentially, but they also allow the franchisors to delegate functions to an entity of their choice to deal with the complicated tax issues and compliance with the local rules imposed by the local administrative and regulatory units, which foreign franchisors usually do not have the necessary administrative power or knowledge to address. Indeed, master franchisors are often highly versatile and experienced franchisees themselves, as they are typically required to assume the primary functions of the franchisor, such as provision of operational support to the franchisees, recruitment and selection of franchisees, and handling payments of franchise fees from the franchisees to the franchisor.

Chinese master franchisees and area developers often request exclusivity for the whole country, or at least in certain regions of China, particularly the major cities such as Guangzhou, Shenzhen, Shanghai, and Beijing. Franchisors should carefully consider any decision regarding the geographical scope of a proposed master franchise by evaluating the franchisee's financial strength, commitment, and managerial capability. Due to the scale of franchised operations, some franchisees may expect financing or introducing new investors at a certain point in time, and it is better to ascertain their intention and plan in advance.

52. Circular Concerning Summary on Certain Issues on the Determination of Disputes over Technical Contracts, issued by Supreme People's Court on June 19, 2001.

Like in many other jurisdictions, one major concern of the franchisor in a master franchising and area development arrangement is inevitably the degree of control over the franchisees and sub-franchisees. In this context, some franchisors have local subsidiaries housing teams of experienced franchise managers, and they will need to take these costs into account when planning their development in China.

Finally, in any master franchise or area development arrangement, foreign franchisors should be aware of the “2+1” requirement mentioned above. Master franchisees and area developers are required to comply with the “2+1” requirement when sub-franchising to a third party.⁵³

B. *Direct Franchising to Single-Unit/Several-Units Chinese Franchisees*

Direct franchising to single-unit/several-units Chinese franchisees has been very common in educational franchise systems. While single-unit/several-units franchisees are less common, this kind of structure is relatively simple and easier to manage than master franchise and area development arrangements. But due to the size of the Chinese market, few foreign franchisors use this model.

C. *Joint Venture*

Joint venture franchising is another feasible option for entering the Chinese market and has been receiving more attention in recent years. The fundamental framework involves the establishment of a joint-venture vehicle between a foreign franchisor and a China-based franchisee. The foreign franchisor grants certain rights, especially the key intellectual property rights, to the joint venture vehicle so that the joint venture may carry on the business as a franchisor or master franchisee as the case may be. Use of offshore entities as joint venture vehicles, such as Hong Kong-based companies, is common due to corporate governance, and more importantly, for tax reasons.⁵⁴

III. Protection of Franchisors' Intellectual Property in China

A. *Trademarks*

Under the Trademark Law of the People's Republic of China, franchisors must register their trademarks with the Trademark Office of the China National Intellectual Property Administration (Trademark Office) to secure their rights over the registered trademarks. The reasons are twofold. First, for obvious reasons, franchisors cannot licence their products bearing the trademarks to franchisees without licensing the trademarks, which require

53. 2007 Regulations, *supra* note 2, art. 7.

54. Hong Kong SAR adopted a low-tax regime. The profit tax rate (i.e., the corporate income tax) is currently 16.5%, and the enterprise income tax rate in Mainland China is generally 25%. There are also various preferential withholding tax rates for monies moving from Mainland China to Hong Kong.

registration in China. Second, China is a “first-to-file” country, which means that the franchisor who registers the trademark first gets all the exclusive rights to deal with the trademark.⁵⁵ Most franchisees will use a Chinese transliteration of the brand to market the business, and it is necessary to secure protection of such Chinese transliteration through filing trademark applications.

In a franchisor-franchisee relationship, it is equally important for franchisors to register the relevant trademark licence with the Trademark Office. Failure to register a trademark and the trademark license may not be fatal to the franchise business, but franchisors may risk losing their proprietary rights in the trademarks. Trademark squatters or third parties may apply to the Trademark Office to cancel the franchisor’s trademark for non-use in the preceding three years. In such case, the franchisor will have to produce evidence of the use of the trademarks in China in the preceding three years⁵⁶ and, in most cases, show that the trademarks were used by the franchise through licensing to the franchisee. Where the trademark licence agreement was not properly registered, the franchisor will not be able to prove valid use of the trademark by the franchisee.

The State Administration of Market Regulation (SAMR or AMR for local Administration of Market Regulation) (formerly known as the State Administration of Industry and Commerce (AIC))⁵⁷ is the governmental authority that can offer assistance to the brand owners in case of infringement, and indeed SAMR anti-counterfeiting actions are generally considered as a low-cost and quick option. Of course, SAMR can only deal with relatively straightforward situations where the acts of infringement can be easily proved beyond reasonable doubt. When controversies arise, such as an outstanding contractual dispute, courts are a better venue to handle the situation.

B. Trade Secrets

Trade secret is defined under the Anti-Unfair Competition Law of the People’s Republic of China (Anti-Unfair Competition Law) as technology or business information unknown to the public and of a commercial value for which the owner (i.e., the franchisor) has taken corresponding confidentiality measures.⁵⁸ Trade secrets may include—as the parties may define them in the franchise agreement—for example, recipes, prices, and customer lists.

Franchisors should include restrictive clauses to prohibit the franchisees from disclosing or otherwise dealing with the franchisor’s trade secrets for any purpose other than the franchised business. Franchisors may also

55. Trademark Law of the People’s Republic of China art. 31.

56. *Id.* art. 49.

57. Since 2018, the State Administration for Industry and Commerce (SAIC) was restructured as State Administration for Market Regulation. That said, many relevant regulations still refer to the SAIC instead.

58. Anti-Unfair Competition Law art. 9 (China).

consider expanding the definition of trade secrets in the franchise agreement by listing out particular items constituting trade secrets. As a matter of formality, all trade secrets and confidential information should be expressly marked “confidential.”

Although the SAMR can theoretically handle trade secret situations, courts are usually the preferred venue for handling disputes arising from alleged misuse of trade secrets.⁵⁹

C. Copyrights

Under the Copyright Law of the PRC, copyright is defined as works of literature, art, natural science, social science, or engineering technology that can be reproduced in a tangible form.⁶⁰ A copyright entitles the franchisor to copy, reproduce, and license its work in whatever manner may be used by the franchisee or third party.⁶¹ In China, although copyright protection arises automatically with its creation, proof of ownership of copyrights in practice would become less cumbersome upon voluntary registration. Franchisors can accomplish registration by filing with the National Copyright Administration. Registration provides a public record which serves as prima facie evidence of ownership in case of dispute.⁶² There are local authorities designated to deal with copyright infringement,⁶³ but most of the time courts are the preferred venues of dealing with copyright infringement due to the complex legal issues usually involved in copyright disputes and the conclusiveness of court judgments.

D. Patents

Similar to trademarks, patents are granted and thus protected on “first-to-file” basis.⁶⁴ Under the Patent Law of the People’s Republic of China (Patent Law), patents include inventions, utility models, and designs.⁶⁵ Franchisors must register patents with the State Intellectual Property Office (SIPO), and franchisors may enforce their patent rights in the Chinese court where interim injunctions are available.⁶⁶

Franchisors should also be aware of the relevant regulation on “service invention.”⁶⁷ Service invention refers to an invention created by employees⁶⁸

59. Nothing in law restricts the authority of SMAR in this respect; but in actual practice the officers may be reluctant to resolve cases with complex legal issues that may be better resolved by the courts.

60. Copyright Law art. 3 (China).

61. *Id.* art. 10.

62. See *Creative Power Entertaining v. Lin Po*, Hunan Province Intermediate People’s Ct. (2015) (China) (2015).

63. Now the local authorities are grouped under the State Administration for Market Regulation.

64. Patent Law art. 9 (China).

65. *Id.* art. 2.

66. *Id.* art. 66.

67. *Id.* art. 6; Rules for Implementation of the Patent Law of PRC art. 10 (China).

68. In this context the reference to “employees” refers to the employees of the franchisee.

in the course of performing their own duties.⁶⁹ The patent rights in the service invention will belong to the employer,⁷⁰ but the employer must reward the relevant employees for inventions they create in accordance with the Rules for Implementation of the Patent Law of PRC.⁷¹ Where the franchisee fails to reward its employees for any such invention, the franchisor may pay on behalf of the franchisee. In this sense, the franchisor's interests will extend to such service invention where the franchise agreement provides for the ownership of or entitlement to the invention of the franchisee.

Local authorities are designated to deal with patent infringement,⁷² but the majority of patent disputes are handled by courts due to complex legal issues usually involved in patent disputes and the conclusiveness of court judgments.

E. Domain Names and Social Media

Under the Measures for the Administration of Internet Domain Names, China Internet Network Information Centre (CNNIC), the Ministry of Industry and Information Technology of the People's Republic of China is responsible for registration of domain names in China.⁷³ The domain name is protected on "first come, first served" basis.⁷⁴ The CNNIC will, upon approval, issue a domain name registration certificate to a franchisor. Similar to trademark squatting, domain-name squatting is an issue that franchisors come across often.

When fighting domain-name squatters, franchisors have to establish that (1) they have legitimate and effective rights in the use of domain name, (2) the franchisee or third party has no such right over the domain name in issue, and (3) the squatters acted in bad faith.⁷⁵

If franchisors wish to set up a China-based website, they must apply for the Internet Content Provider (ICP) License.⁷⁶ However, foreign companies without a local presence in China cannot apply for an ICP License.⁷⁷ One of

69. Patent Law art. 6.

70. Employer refers to the franchisee.

71. *Id.* art. 16; Rules for Implementation of the Patent Law of PRC arts. 71 & 72 (China).

72. There are two kinds of ICP licenses. One is more of a recordal, which is required where the China-based website is purely informational. Another one is more of a permit, which is required where the China-based website generates profits. For the purpose of this discussion, we collectively refer to them as "ICP License."

73. Measures for the Administration of Internet Domain Names art. 3 (issued by Ministry of Industry and Information Technology on Nov. 1, 2017; effective on Aug. 24, 2017) (China).

74. *Id.* art. 26.

75. Interpretation of the Supreme People's Court on Application of Laws in the Trial of Civil Disputes over Domain Names of Computer Network art. 4 (issued by the Supreme People's Court on Jan. 17, 2001; effective on July 24, 2001) (China).

76. There are two kinds of ICP licenses. One is more of a recordal, which is required where the China-based website is purely informational. Another one is more of a permit, which is required where the China-based website generates profits. For the purpose of this discussion, we collectively refer to them as "ICP License."

77. Measures for the Administration of Telecommunications Business Licensing (2017 Revision) art. 9 (issued by Ministry of Industry and Information Technology on Mar. 7, 2017; effective on Sept. 1, 2017) (China).

the prevailing practices is that the franchisor will set up a local subsidiary or representative office in China to hold the ICP License.

Major social media platforms, such as Wechat and Weibo, are also widely utilized by local franchisees in China. In the absence of an express arrangement, there is a likelihood that the local franchisees will register such major social media platforms for the purpose of the franchise. Thus, the use of social media should be regulated by the franchise agreement.

IV. The Franchisor-Franchisee Relationship in China

A. *The Franchise Agreement—Contract Law Aspect*

The relationship between the franchisor and the franchisee is primarily contractual due to the “practice” that all franchise agreements concerning a franchise in China must be filed with the authority for either registration or verification purposes.⁷⁸ Accordingly, the formation of the franchisor-franchisee relationship in China is constructed on the principle of good faith imposed by the Contract Law,⁷⁹ as opposed to the common law doctrine of *caveat emptor* (buyer beware). As a result, the franchise agreement inevitably must comply with the formality requirements under the Contract Law.

The franchise agreement governs the respective rights and obligations of the franchisor and the franchisee in a franchisor-franchisee relationship. However, the agreement must observe the 2007 Regulations, which impose certain duties on franchisors towards franchisees, such as disclosure and ongoing assistance. Typically, franchisors reserve the right, to a certain degree, to monitor or otherwise control the franchisees under the franchise agreement, such as the right of inspection and the right to access the franchisees’ computer systems and point-of-sale data.

Nonetheless, any failure to comply with the 2007 Regulations will only attract penalties on the administrative level and will not invalidate the franchise agreement *per se*. Accordingly, with respect to the enforceability of the franchise agreement, it is advisable to consider using PRC law as the governing law of the agreement.

In most cases, the foreign franchisors favor the laws of their respective home country as the governing law of the franchise agreement. Under the Contract Law, an agreement can be governed by foreign law if the contracting parties so agreed.⁸⁰ However, in practice, if the agreement will be, actively or passively, brought before the Chinese courts for determination of issues arising from the franchise, foreign law as the governing law of the agreement will bring about practical difficulties in enforcing the contract. In some instances, the Chinese court may simply apply the laws of the PRC.

78. While the very first franchise agreement must be registered, additional franchise stores after the very first franchise agreement has to be “verified” by the Bureau of Commerce in practice.

79. Contract Law art. 6 (China).

80. *Id.* art. 126.

Further, the languages of the franchise agreement should also be treated with care, especially the Chinese version or translation. Although under the Contract Law any foreign language can be the governing language of the agreement, the Chinese court will not determine an issue on the agreement without the Chinese translation of the same.⁸¹ In any event, bilingual agreements with prevailing governing language provisions should be incorporated; however, practically speaking, the Chinese version or translation will be considered primarily.

B. Employment Versus Independent Contractor?

A big question as to the existence of employer-employee relationship is seen in franchisor-franchisee context, especially from the U.S. law perspective. The position of the franchisee in such a contractual relationship has a great impact on the extent of liability of the franchisor—that is, whether the franchisor will be vicariously liable for the franchisee's acts and, more specifically, whether the franchisor will be vicariously liable for the acts of the franchisee's personnel.

Typically, and as most franchise agreements will expressly state, a franchisee is an independent contractor of the franchisor. Indeed, insofar as courts are concerned, the Chinese courts are inclined to view that franchisors and franchisees are independent contractors in the sense that the franchisors and the franchisees are independent entities who should be accountable for their own human resources and finance.⁸²

C. Multi-level Selling

China has general prohibitions against multi-level selling, which involves a network of independent representatives who sell and market products to family, friends, and acquaintances, or otherwise take the form of a pyramid scheme where the compensation is primarily based on the collection of member's fee directly or indirectly by recruiting persons to participate in the sales network.⁸³ In practice, a genuine franchise will not be seen as a form of multi-level selling. For reference, MOFCOM identified three major areas of difference between franchise and multi-level selling as follows:⁸⁴

- a. The organizational structure. The level of structure of a multi-level selling network is generally unrestricted, whereas the level of structure of a franchise is strictly organized. Typically, a franchise adopts a two-tier, or maximum of a three-tier, structure.

81. Civil Procedure Law art. 262 (China).

82. For example, see *Challenge Petrochemical and Kunming Dongqiao Petrochemical Co., Ltd*, Yunan Supreme's People Ct., Yun Min Zhong No. 149 (2016).

83. See Regulation on the Prohibition of Pyramid Selling arts. 2, 7 (issued by the State Council on Aug. 23, 2005; effective on Nov., 1 2005) (China).

84. Commercial Reform and Development Division of the Ministry of Commerce of the People's Republic of China, *Questions & Answers Regarding Franchise* (2007) (<http://www.mofcom.gov.cn/article/zhengcejd/bp/200706/20070604820258.shtml>)

- b. The legal capacity of the new members. The chain of multi-level selling networks is comprised of natural persons in their individual capacity, while a franchise in China is generally operated through a corporation.
- c. Profit distribution mechanisms. In multi-level selling networks, persons on the upper level of the chain earn commissions from persons on the lower level, whether on the basis of their performance or their procurement of new members. In a franchise, profits are yielded from lawful operation of a business.

In short, the determination of the existence of multi-level selling lies on the substance of operations. As one may infer from the above, a self-proclaimed franchise arrangement by which the so-called franchisors and sub-franchisors can sustain profitability merely through admission fees from new franchisees without having to worry about loss and expenses incurred from the operation of the business may as well be regarded as multi-level selling.

V. Practical Issues

A. Foreign Exchange Control

China has implemented a foreign exchange control regime. Under the foreign exchange control regime, the purchase of foreign currency with Chinese currency is subject to an annual quota, beyond which the approval from State Administration of Foreign Exchange (SAFE) is required.⁸⁵

The local administration of foreign exchange and the banks is vested with powers to approve different kinds of foreign exchange remittance.⁸⁶ Supporting documents, such as the tax records (in certain situations), underlying contracts (i.e., the franchise agreement) and invoices, must be provided to the remitting banks.⁸⁷

Therefore, the first practical implication of such system is that no payment can be paid before the conclusion of any contract, and it usually takes several weeks to secure such approval. Many franchise agreements will stipulate the timeframe, having such process taken into account. In the meantime, if the principal or certain group entities of the franchisee will provide a

85. See Regulations of the People's Republic of China on Foreign Exchange Control (as revised by the Decision of the State Council on Amending the Regulation of the People's Republic of China on Foreign Exchange Control issued by the State Council on Aug.1, 2008; effective Aug. 5, 2008).

86. *Id.* art. 12.

87. Detailed Rules for the Implementation of the Guidelines for the Foreign Exchange Administration of Trade in Services art. 6(4) (as revised by the Notice of the State Administration of Foreign Exchange on Repeating and Amending Relevant Regulatory Documents Involving the Reform of the Registration System for Registered Capital (issued on May 4, 2015; effective May 4, 2015) (China); see also Guide to Administration of Common Foreign Exchange Items (published by local branch of State Administration of Foreign Exchange).

guarantee, there is a need to register such guarantee. Otherwise, remittance will not be allowed in the future.

B. *Leasing of Premises*

When investing in China to purchase any not-for-self-use real estate, an overseas institution or individual must abide by the principles of commercial presence and establish a foreign investment enterprise according to the relevant provisions on foreign investment in real estate.⁸⁸ Further, a foreign franchisor must establish a PRC legal entity before entering into a leasing or sub-leasing agreement in China.⁸⁹

The common customary terms of the lease arrangement vary from city to city. If the lease is a retail business lease that has multiple outlets in shopping centers, the landlord will typically dictate the material terms of the leasing agreement as it has greater bargaining power. Generally, the lease term is much shorter in major cities, and there are extreme situations where the landlord will only grant a “probationary” period to observe the business performance of the tenant before a longer lease is granted. This will sometimes affect the drafting of the certain documents.

C. *Insurance*

It is common for franchisors to require franchisees to secure insurance policies to cover losses or damages arising from the franchisees’ development and operation of the franchise stores, and at the same time the franchisors are named as additional insureds to the extent that they have insurable interest.

In China, there is limited choice of insurance products, and, more importantly, naming the foreign franchisor as an additional insured is rare in practice. Therefore, it is not unusual to see franchisees procuring supplemental insurance coverage adding the name of the franchisors as co-insured from elsewhere, notwithstanding that the Insurance Law requires all insurance policies be taken out locally.

VI. Franchise Litigation

A. *Litigation and Remedies*

1. Franchise Litigation in General

The law with respect to civil procedure is relatively straightforward compared to many common-law jurisdictions. In China, the stages of franchise litigation include the following: (1) filing of pleading, (2) submission of

88. Opinions of the Ministry of Construction, the Ministry of Commerce, National Development and Reform Commission, the People’s Bank of China, the State Administration for Industry of Commerce and the State Administration of Foreign Exchange on Regulating the Access to and Administration of Foreign Investment in the Real Estate Market art. 1 (China).

89. *Id.*

evidence, (3) court investigation,⁹⁰ and (4) court debate.⁹¹ In the midst of the litigation, the judge may conduct mediation upon the consent of the parties.⁹² The usual advice is to take part in voluntary mediation.

Franchisors should be aware that there is no automatic discovery of documents in franchise litigation. Therefore, franchisors are encouraged to collect and seek ways to secure the evidence on their own for the purpose of franchise litigation. More importantly, documentary evidence must be presented in its original form.⁹³ If the document is not in Chinese, it must be translated by an authorized translation agency for the purpose of submission of evidence to the court.⁹⁴ A notary public must be instructed to authenticate evidence.⁹⁵ In sino-foreign franchise disputes, the foreign franchisor must also be aware that documentary evidence formed outside China must be properly notarized and legalized at the relevant Chinese consulate in the jurisdiction from its origin country.⁹⁶

Strategically, the franchisor should obtain the requisite evidence before commencement of franchise litigation because there may be the risk of alerting franchisees or other alleged infringers for which they will destroy or remove the evidence. Where it is likely that the evidence may be destroyed or hard to obtain at a later time, the Civil Procedure Law empowers the court to enter a preservation order.⁹⁷ However, franchisors who wish to seek quick injunctive relief are advised to resort to administrative proceedings at the same time, if such administrative proceedings are available. For example, in case of trademark infringement or anti-counterfeiting, the claimant may resort to local Administration for Market Regulation (AMR) for quick administrative relief and investigation.

One must also bear in mind that the Chinese courts rarely grant preliminary injunctive relief in non-intellectual-property related claims, though some local courts are willing to grant orders to a similar effect. In general, injunctive relief is not as widely used in China as in many common-law jurisdictions. As a result, the remedies in civil litigation are mostly monetary compensation.

2. Administrative Actions

Where the franchisees are found to be infringing on the franchisor's intellectual property rights, administrative proceedings enable the franchisor to suppress the infringement in a relatively expeditious manner. The procedure of administrative proceedings is not as onerous as litigation.

90. Civil Procedure Law art. 138 (China).

91. *Id.* art. 141.

92. *Id.* art. 9.

93. *Id.* art. 70.

94. Certain Provisions of the Supreme People's Court on Evidence in Civil Procedure art. 17 (issued by the Supreme People's Court on Dec. 21, 2001; effective on Apr. 1, 2002) (China).

95. *Id.* art. 16

96. *Id.*

97. *Id.* art. 81.

The AMR is the key administrative body that is empowered to take actions against the infringers in trademark infringement cases.⁹⁸ It offers a relatively fast and cost-effective way to deal with infringements of the franchisor's intellectual property rights. The relief includes orders to (1) seize or destroy the infringing goods, (2) raid the infringer's premises, (3) force the infringer to desist, and (4) impose fines on the infringer. Other authorities may offer assistance in intellectual property infringement situations in local cities, but AMR is generally considered to be more effective.

B. *Alternative Dispute Resolution*

For international franchising, the parties usually opt for arbitration in the event of a dispute due to the conclusiveness of arbitral awards in China. That is to say, assuming that the losing party has the necessary financial resources to pursue an appeal in litigation, arbitration can put an end to the dispute sooner than litigation. Apart from the benefit of conclusiveness, if the franchisee has assets outside China, arbitral awards can be enforced more "conveniently" in foreign countries who are party to the New York Convention⁹⁹ than Chinese court judgments.

Further, arbitration in China enjoys the Chinese court-ordered interim measures, albeit limited, in aid of the arbitral proceedings.¹⁰⁰ Since 2014, PRC commercial arbitral institutions—including but not limited to Shanghai International Economic and Trade Arbitration Commission, China International Economic and Trade Arbitration Commission, and Beijing Arbitration Commission—have adopted the mechanism for emergency arbitrator proceedings in which urgent interim relief such as preservation orders and prohibitory injunctions may be granted.¹⁰¹ The emergency arbitrator proceedings provide a procedurally less cumbersome choice for the parties to acquire the interim relief with the aim to preserve the status quo in aid of the arbitral proceedings.

Multi-tiered dispute resolution has also been widely adopted by China-related franchise parties. However, parties who wish to adopt multi-tiered dispute resolution should use definitive terms and set out how the dispute resolution will be conducted when drafting a multi-tiered dispute resolution clause to increase enforceability.

The position of the PRC law on the enforceability of a multi-tiered dispute resolution clause is not entirely clear. However, precedents state that

98. Trademark Law art. 2 (China).

99. Convention on the Recognition and Enforcement of Foreign Arbitral Awards (June 10, 1958).

100. This will soon extend to Hong Kong arbitrations. On April 2, 2019, the Hong Kong Special Administrative Regional government (HKSAR) and the Supreme People's Court entered into an arrangement that extends the court-ordered interim measures by the PRC courts to Hong Kong arbitration. Such arrangement will come into effect in the near future upon the promulgation of a judicial interpretation by the Supreme People's Court and completion of relevant procedures in the HKSAR.

101. Arbitration Law of the People's Republic of China art. 28 (China); Civil Procedure Law art. 101 (China).

the Chinese courts will only enforce such clauses where the details of each level of dispute resolution intended by the parties are clearly set out and defined.¹⁰²

Mediation is not a prerequisite requirement for litigation or arbitration, although it remains a viable option in lieu of informal negotiation.

VII. Conclusion

All in all, the world has witnessed the rapid growth of franchising in China. As mature as the existing framework seems, legal principles continue to develop to cope with the commercial needs of the importation of international franchising into China. Along with economic reform, the sector will continue to flourish.

102. *See* Mawan Elec. (Shenzhen) Co., Ltd. V. Runhe Dev. Co., Ltd., Reply of the Supreme People's Court to the Hunan High People's Court's Judicial Review on Runhe Company's Application of Non-enforcement of Arbitral Award, [2008] MIN SI TA ZI No.1.