

## Commercial Franchising in China

### 1. Overview

China remains an increasingly important market for Australian companies considering international business expansion, whether through franchising, licensing, setting up foreign investment enterprises (" **FIEs** ") or other business structures. Amongst these market entry options, franchising enables rapid market expansion and penetration using a combination of the intellectual property of the franchisor, and the capital and enthusiasm of a network of franchisees.

In recent years in China, corresponding to a shift in consumption pattern from household basics to greater expenditure on quality of life, new franchising opportunities arise in the sectors of education, real estate, housing services, automotive care, body fitness, beauty and hair-dressing, communications and family services. [\[1\]](#) Although the franchising prospect in China is promising, Australian companies aiming at franchising into China need to be aware of the legal framework for commercial franchise in China as this will have direct impact on their business expansion.

This legal update provides a summary of information on the new Chinese franchise regulations and intellectual property protection to Australian companies aiming at entering China's marketplace through franchising.

### 2. Legal framework

Commercial franchising only emerged in China since the early 1990s. At the time, due to the government restrictions on foreign investment and the lack of governing law on franchising, many global franchisors did not enter the China's market by franchising but through forming limited liability joint ventures with local Chinese partners, followed by establishing branches in various cities in China, such as the McDonald's in China.

Since late 1990s, the Chinese government has been developing the franchise laws in order to promote an orderly regulated commercial franchise market. With China's accession to the WTO in 2001, China agreed to permit foreign investment in franchising from 11 December 2004. [\[2\]](#) China has also revised the laws on direct foreign investment and the intellectual property laws including the Trademark Law, the Patent Law and the Copyright Law.

On 6 February 2007, the State Council promulgated the new franchise laws known as the *Regulations on Administration of Commercial Franchise* (" **the Franchise Regulations** "), which is effective from 1 May 2007 and replaces the current *Measures for the Administration of Commercial Franchises* that has been in operation since 1 February 2005 (" **the 2005 Measures** "). [\[3\]](#) The Franchise Regulations apply equally to foreign and domestic franchisors who engage in commercial franchising within the territory of the People's Republic of China (" **PRC** ").

### 3. What you need to know about the Franchise Regulations

#### 3.1 General Provisions

The Franchise Regulations define "commercial franchise" as the business activities whereby a franchisor, who owns business operational resources (including registered trade marks, enterprise logo, patent, know-how, etc),

allows a franchisee through contracting to use its business operational resources, and the franchisee conducts business under the unified business format in accordance with the terms of the contract and pays franchise fees to the franchisor.

### 3.2 Requirements of a Franchisor

The Franchise Regulations specifically provides that only "enterprises" (and not individuals or other entities) may engage in franchising as franchisors. [4] A franchisor must own a well-developed business format and is capable to provide franchisees with long-term business guidance, technology support, business training and other services.

The 2005 Measures requires that a franchisor must have owned and operated two direct outlets in China for at least one year before they are entitled to franchise. This is known as the *two stores one year rule* (or the "*local outlet rule*") which constitutes an obstacle for foreign franchisors who have not already established their presence in China.

The new Franchise Regulations have partially retained the *two stores one year rule* by removing the requirement that the outlets be in China. [5] It therefore seems that from 1 May 2007 foreign franchisors may be able to franchise in China if they have owned and operated two direct outlets for at least one year outside the territory of PRC. However, more clarification is required from the Ministry of Commerce to confirm that this is the intention of the new Franchise Regulations.

Further, although the *local outlet rule* has been modified to the benefit of foreign franchisors, the new Franchise Regulations do not specify whether foreign franchisors are permitted to offer direct franchising from outside China to local Chinese franchisees without having to establish a presence in China.

Under Article 3 of the *Regulations on Foreign Investment in Commercial Industry*, foreign companies which engage in commission agency, wholesale, retail and franchising in China must do so through foreign-invested enterprises (FIE) established within China. When this requirement is read together with the new Franchise Regulations, it suggests that a direct offshore franchising is not available to foreign franchisors. To date, there has been no formal clarification by the PRC Ministry of Commerce to the effect that direct franchising from outside China is legally permitted.

Accordingly, in order to grant a franchise in China, foreign franchisors must satisfy the general requirements under the new Franchise Regulations and must:

- (a) have owned and operated two direct outlets for at least one year either within or outside China; and
- (b) establish an FIE in China.

### 3.3 The Franchise Agreement

The Franchise Regulations provide for the main contents which must be included in a franchise agreement. These include:

- (a) basic information of franchisor and franchisee;
- (b) contents and term of the franchise;

- (c) type, amount and payment method of franchise fees;
- (d) provisions of operational guidance, technical support and training;
- (e) quality and standards requirement for product or services and guarantee provisions;
- (f) promotion and advertising of products or services;
- (g) protection of consumer interest;
- (h) amendment, rescission and termination of franchise contract;
- (i) liability for breach of contract;
- (j) dispute resolution mechanism; and
- (k) any other matters agreed between the parties. [\[6\]](#)

The franchise agreement should stipulate that unless otherwise agreed by the franchisee, the term of a franchise agreement is no less than 3 years and that the franchisee is entitled to unilaterally rescind the franchise agreement within a certain period after the agreement is signed. [\[7\]](#) A franchisee may also rescind the agreement if the franchisor has concealed relevant information from or provided false information to the franchisee. [\[8\]](#)

### 3.4 Information Disclosure

The Franchise Regulations require a franchisor to provide genuine, accurate and complete information in writing in relation to the franchisor and the franchise business operations (" **the disclosed information** "). The disclosed information and the franchise contract must be provided to the franchisee at least 30 days before the formal contract is signed.

The basic information that must be disclosed by a franchisor includes registered capital, franchising activities, business scope and format, intellectual property rights, investment budget for franchise business, summary of its financial reports and audit reports for the last 2 years, involvement in litigation for the last 5 years. [\[9\]](#)

### 3.5 Franchise registration system

The Franchise Regulations introduce a registration system for franchise operations in China. Nationwide franchise businesses are under the administration of the Ministry of Commerce. The commerce department of each provincial and municipal government will be the supervisory body of franchising activities which only occur within their jurisdictions.

The new Regulations require a franchisor to submit and file for record with the abovementioned supervisory body, within 15 days after executing its very *first* franchise contract, the following documents: [\[10\]](#)

- (c) business licence or enterprise registration certificate;
- (d) sample franchise contract;

- (e) franchise operation manuals;
- (f) a marketing plan;
- (g) written undertaking and evidence that the franchisor's qualification requirements have been met; and
- (h) other documents and materials as required by the commerce department under the State Council.

### 3.6 Strict legal liabilities

The Franchise Regulations also impose penalties for contravention of the requirements in relation to registration, reporting, advertising and information disclosure. For example, conducting a franchise business without meeting the qualification requirement of a franchisor may result in a pecuniary penalty of up to RMB500,000 and public announcement of the breach. Misleading or fraudulent advertising will be subject to the relevant provisions of the advertisement laws. Criminal liability may arise if money or property is defrauded in the name of franchising.

## 4. Establish an FIE in China

Foreign companies can only do business in China through one of the four types of foreign investment enterprises (FIEs), namely, sino-foreign equity joint venture, sino-foreign cooperative joint venture, wholly foreign-owned enterprise ("WFOE") or foreign companies limited by shares ("FCLSs"). Each type of FIE has its distinctive features and All types of FIEs are limited liability companies with limited authorised business scopes and terms of existence. Registration of an FIE in China is subject to the enterprise registration system as well as the company registration system. [\[11\]](#)

In choosing the suitable type of FIE, foreign investors should take into account their long-term business need and the commercial goal, finance feasibility and tax implications involved in various business structures.

The type of FIE to be chosen also depends on the industry sector which the foreign investors will engage in. In China, foreign investment projects are classified by industry sector in the *Catalogue for the Guidance of Industries for Foreign Investment* ("the Catalogue"). [\[12\]](#) The Catalogue lists specific industries where foreign investors are encouraged, restricted or prohibited to invest. For example, certain industries and economic activities are restricted to FIEs in which the Chinese investor has the majority equity holding, which means WFOE are prohibited to invest in these industries or economic activities.

## 5. Protection of Franchisor's Intellectual Property Rights

As intellectual property rights are valuable assets of a business investors intending to expand their business into China should ensure that their intellectual property rights, including the trade marks, trade names, logos, company names, company images, patentable formats and digital copyright, are well protected in China.

### Registration of Trade mark and Domain name

Unlike the Australian trade mark system which gives ownership of a trade mark to the first user of the mark (subject to exceptions such as honest concurrent use), China (and many Asian countries) adopts a *first to file* system which allows the first person who files a trade mark application to be entitled to registration and exclusive use of the mark within the territory of PRC, provided that all other registration requirements are met. [\[13\]](#)

The *first to file* rule is however subject to some important exceptions. For example, the *first to file* rule will not apply if two or more applicants apply for registration of identical or similar trade marks simultaneously on the same day in respect of identical or similar goods, in which case evidence of prior use of a trade mark would be relevant. [14] In addition, a trade mark applicant can claim right of priority if its application in China is made within six months from the date of filing its first trade mark application in another Convention Country.

Well known trade mark is another important exception to the *first to file* rule. The Chinese Trademark Law prohibits unfair registration and use of a mark which is identical or similar to a well-known foreign trade mark not yet registered in China, if the proposed registration and use of the mark is in respect of the same or similar goods for which the well-known mark is used. Obtaining recognition of the well-known status for a foreign registered trade mark is necessary as it entitles the holder to claim for protection of its trade mark in China or enforce its rights against unfair competition on the basis that its marks are well-known.

Registration of domain name also operates on a *first to file* system in China. [15] It is therefore possible for well known brand names to be subject to cyber-squatting, which is the pre-emptive registration of famous global brand names or trade marks as domain names. If this is the case, the domain name holder may be held liable if it can be established that the registration or using of the domain names has infringed other person's existing legal rights. [16] If a claim arises from the registration or use by a third party of a domain name which is identical or similar to a registered trade mark, there is no need for the court to determine whether the claimant's trade mark is famous or not. [17]

Given the above, foreign investors are recommended to consider having their trade marks/logos registered with the Chinese Trademark Office before they enter the China market. If they intend to have a Chinese domain name for their website in China, they should also file a domain name application with the domain name registrar.

## **Registration of trade mark/patent licensing agreement**

Where franchising activities involve trade mark licence or patent licence, the new Franchise Regulations require such trade mark/patent licence agreement to be regulated in accordance with the relevant provisions of the Chinese Trademark Law or the Patent Law. [18] For example, under the *Regulations for the Implementation of Trademark law*, a licensor of a trade mark must submit a copy of the licence agreement to the Chinese Trademark Office for record within three months from the date of licence agreement. [19]

## **6. Adapting the franchising system in China**

Foreign franchisors will need to allow for local adaptation of their franchising systems in China where the tastes and preferences of local consumers are important to the success of their business expansion. In doing so, foreign franchisors need to conduct the necessary research of the regional and cultural differences in consumer taste.

An important aspect of local adaptation involves proper translation of trade marks and trade names. A good Chinese version of the registered trade mark is one that represents the meaning of the English version, has a similar sound and is appealing to local consumers. For example, the US Starbucks Corp registered its trade mark *Starbucks* in China as "Xing Ba Ke", which is a transliteration of *Starbucks* in Chinese. "Xing" means "star" in Chinese and "Ba Ke" has a similar sound to "Bucks".

To protect their registered trade mark in China, foreign franchisors are advised to develop a Chinese version for their trade mark and have it registered in China in both its English and Chinese version.

## 7. Conclusion

There are many specific issues that need to be considered by foreign franchisors aiming to franchise in China. In addition to compliance with the laws and regulation, foreign franchisors need to work out a strategy that addresses the issues of tax implications, system adaptation, foreign investment restrictions and foreign exchange regulations in China. Franchisors should also test the viability of the franchise expansion before granting franchising right to a franchisee as a franchise expansion in China may endanger the group brand if the franchisees do not meet the brand's strict standards.

Legal advice should be sought regarding these issues in order to ensure that the risks involved in franchise expansion are carefully considered and minimized.

**Stephens Lawyers & Consultants works with and have assisted clients in entering into the Chinese market including advising in relation to the business structures and protection of intellectual property.**

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[1] See US & Foreign Commercial Service and US Department of State, "Doing Business in China: China Country Commercial Guide" Chapter 4, (2006) ( [http://www.buyusainfo.net/docs/x\\_4694155.pdf](http://www.buyusainfo.net/docs/x_4694155.pdf) )"More Overseas franchisers to access China", *China Daily* , 21 April 2006, ( [http://english.people.com.cn/200604/21/eng20060421\\_260076.html](http://english.people.com.cn/200604/21/eng20060421_260076.html) )

[2] *Regulations on Foreign Investment in Commercial Industry* (Ministry of Commerce of PRC, 16 April 2004)

[3] The 2005 Measures replaced the *1997 Interim Measures on Administration of Commercial Franchising Operations*.

[4] *Regulations on Administration of Commercial Franchise*, Article 3

[5] *Regulations on Administration of Commercial Franchise*, Article 7

[6] *Regulations on Administration of Commercial Franchise* , Article 11

[7] *Regulations on Administration of Commercial Franchise* , Articles 12 & 13

[8] *Regulations on Administration of Commercial Franchise* , Article 23

[9] *Regulations on Administration of Commercial Franchise* , Article 22

[10] *Regulations on Administration of Commercial Franchise* (State Council of PRC, 6 February 2007) Articles 5 & 8

[11] See Administrative Regulation Governing Registration of Legal Corporations (PRC Ministry of Commerce, 1988) ( <http://english.mofcom.gov.cn/aarticle/topic/lawsdata/chineselaw/200307/20030700112448.html> ) Law on Sino-foreign Equity Joint Ventures (PRC Ministry of Commerce, adopted 1 July 1979) ( <http://english.mofcom.gov.cn/aarticle/topic/lawsdata/chineselaw/200301/20030100062855.html> ) Law on Sino-foreign Cooperative Joint Ventures (PRC Ministry of Commerce, adopted 13 April 1988) ( <http://english.mofcom.gov.cn/aarticle/topic/lawsdata/chineselaw/200301/20030100065891.html> ) Law on Wholly Foreign Owned Enterprises (PRC Ministry of Commerce, adopted 12 April 1986) ( <http://english.mofcom.gov.cn/column/print.shtml?/topic/lawsdata/chineselaw/200301/20030100062858> ); and the PRC Company Law 1994

[12] *Catalogue for the Guidance of Industries for Foreign Investment* (PRC Ministry of Commerce/National Development and Reform Commission, 1 January 2005)

[13] *Trademark Law of PRC* (adopted on 27 October 2001), Article 29

[14] *Regulations for the Implementation of Trademark Law* (RPC State Council, effective from 15 September 2002), Article 19

[\[15\]](#) *ChinaInternet Domain Name Regulations* (Ministry of Information Industry of the PRC, 20 December 2004), Article 24

[\[16\]](#) *ChinaInternet Domain Name Regulations* (Ministry of Information Industry of the PRC, 5 November 2004), Article 29

[\[17\]](#) *Interpretation on the Application of the Law Concerning Several Issues Regarding the Trials of Civil Disputes Relating to the Protection of Famous Trademarks* ", promulgated by The Supreme People's Court the on April 23, 2009 and came into force on 1 May 2009

[\[18\]](#) *Regulations on Administration of Commercial Franchise* , Article 31

[\[19\]](#) *Regulations for Implementation of Trademark law* (State Council of PRC, effective 15 September 2002), Article 43