



PRC Retail Law Newsflash

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OUTSTANDING ISSUES CONCERNING CHINA'S NEW FRANCHISE REGULATIONS

Our March 13th issue discussed the promulgation of the *Administrative Regulations for Commercial Franchises (New Regulations)*. This newsletter follows up by discussing key issues which have yet to be clarified pursuant to the implementation of the New Regulations on 1 May 2007.

Background

The New Regulations introduce several significant changes to the legal framework for franchises that were originally set forth in the 2004 *Administrative Regulations on Foreign Investments in the Commercial Sector (FICE Measures)*, issued by the State Council, and the 2004 *Administrative Measures for Commercial Franchises (Franchise Measures)*, subsequently issued by the Ministry of Commerce (MOFCOM).

Importantly, the New Regulations will take precedence over both sets of legislations in the event of any conflict with them. However, the practical implications of this remain to be seen.

Key Issues

- *Ambiguous Rules on Foreign-Invested Franchises*

The FICE Measures provide general guidance as to the operation of franchises by foreign investors. They allowed, for the first time, the establishment of foreign-invested commercial enterprises (FICEs) to operate franchise businesses in China.

The Franchise Measures subsequently imposed the requirement that both potential domestic and foreign franchisers must have operated at least 2 directly-operated stores for 1 year or more *within the territory of China* before qualifying to establish Chinese franchise operations (emphasis added).

Under Article 7 of the New Regulations, "A franchiser engaged in franchising activities shall own at least 2 directly-operated stores (in operation for more than 1 year)". By specifically not stipulating that the 2 stores must both be within the territory of China, the New Regulations appear to imply that such stores may be operated anywhere in the world, and without the need to first establish a FICE in the PRC. However, the wording of Article 7 is unclear, and does not specifically permit direct franchises in China by overseas entities.

Taken in the original Chinese language, the New Regulations are also vague as to whether the 2 directly-operated stores must have been in operation for at least 1 year, or whether the franchiser itself must have been established for at least that long.

- ***Special Requirements for Franchise Enterprises Uncertain***

The Franchise Measures contain a separate chapter imposing various additional requirements for FICEs intending to enter the Chinese franchise market. Moreover, a foreign franchiser is required to either establish a new FICE to carry out its local franchising operations or apply for an expansion of an existing FICE's business scope to include commercial franchising.

The New Regulations have eliminated what had previously been a separate chapter containing the abovementioned requirements in respect of FICEs. However, based on discussions with MOFCOM officials, we understand that the requirement for special approval still apply, pending formal policy or notice otherwise.

Commentary

- The New Regulations have established a new registration system for franchise contracts. Under this new system, new franchisers are required to, within 15 days of selling their first franchise (existing franchisers are allowed 1 year following the promulgation of the New Regulations), register their sample franchise agreement with the Commission of Foreign Economics Relations and Trade (**COFERT**) for local franchises or the MOFCOM for franchises in multiple provinces.
- Notwithstanding the above requirements, some provincial COFERTs will not accept registration of direct off-shore franchise agreements between a foreign franchiser and a local franchisee for the operation of franchises within its jurisdiction. Based on our discussions with the Shanghai COFERT, such stance is a reaction to the questionable legitimacy of direct off-shore franchising arrangements. However, according to the relevant foreign exchange regulations, registration with the MOFCOM or COFERT is a prerequisite for the outward remittance of franchise fees to foreign franchises; as such, lack of cooperation on the part of the COFERT may present an insurmountable hurdle to foreign franchisers looking to establish direct cross-border franchise operations in China.
- Whether the 1-year operating history requirement under the New Regulations applies to the foreign franchiser itself or its 2 direct stores is also causing much confusion to foreign franchisers seeking to enter China. The MOFCOM has been unable to provide us with a definitive interpretation, advising that this issue is still subject to discussions with the State Council and will be clarified after the New Regulations are implemented.

Conclusion

- Viewed as a whole, despite the fact that certain provisions of the New Regulations remain unclear, they finally provide franchisers with a more solid legal framework (see our previous newsletter on this topic for detailed discussion of significant improvements), on which to build their China operations.

- One notable example is that the New Regulations have expressly defined the relationship between a franchiser and its supplier as one of independent contractors, and stating that a franchiser will no longer be liable for the products and services provided by its designated suppliers (as opposed to the previous joint liabilities between a franchiser and its suppliers, as set forth under the Franchise Measures).
- Such a stipulation provides franchisers with a certain level of security that their operations will not be jeopardized as a result of any potential sub-standard performance of their various suppliers.

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Full English translation of any aforementioned PRC legislation as well as other rules and regulations are available for purchase upon request.

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