News From Around the World – People's Republic of China

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2009 was a year of challenges. With the implementation of economic policies for encouraging the development of domestic consumer market, growth has been seen in the retailing sector. The latest figures from China Chain Stores and Franchise Association show that there are over 4,000 franchise systems in China by the end of 2009, and the growth was 15%. Regarding the number of stores opened, the growth was 10%. Both foreign and local franchisors are expanding at an amazing speed.

Regarding the administrative system, there has been no significant change so far. Many foreign franchisors have been granted approval for recordal in 2009 after requisitions and request for supplemental documentation. A common issue troubling franchisors is possibly the foreign exchange control, as foreign remittances under franchising contracts continue to be a complicated area. At the same time, there are some interesting developments in other aspects.

<u>Beijing Court Research Report on Franchising Law</u>

In early 2010, the Fifth Court of Beijing No.2 Intermediate People's Court released an interesting research report on franchising cases. The Fifth Court mentioned that 144 cases tried by different Beijing courts were studied, and comments from judges who presided some of the said 144 cases were sought and considered as well. This is probably the first organized studies by the People's Court on franchising law being published.

In theory, this research report does not have any formal judicial weight under the present system. However, it is expected that many local judges will find this research report a good reference. The major points discussed in the research report are below :

1. Basic features of franchise relationships :
   a. The franchisor owns certain rights, it can be intellectual property rights, or business secret;
   b. Franchising involves licensing of a bundle of rights (not some of the rights in the system), and management and control on use of such rights; and
   c. Royalties are charged by the franchisor.
2. Franchise agreements should be taken as the document reflecting the true intention of the parties, unless the contrary is proved.
3. Lack of provisions on franchise fee in the franchise agreement should not be a conclusive ground for rebutting the existence of a franchise relationship.

4. Regulatory default (e.g. the franchisor does not meet the “two shops, one year” requirements) should not be a conclusive ground for declaring the franchise agreement void for illegality. At the same time, a shop owned by a subsidiary of the franchisor should be considered as its direct store, if more than 50% of the share capital of such subsidiary is owned by the franchisor.
5. Ownership of trademark is not a pre-requisite for franchisors to enter into franchise agreements.
6. Regarding misrepresentation or non-disclosure, it is necessary to distinguish fraud against “exaggeration in normal course of business”. The Court believes that it is important to maintain certain degree of stability over the contractual relationships, and to avoid franchisees making use of technical breaches for unfairly shifting all responsibilities to the franchisors when there are business failures.
7. The general position of the Court is, if misrepresentation took place in the advertising campaign or the general materials provided to the franchisee before the conclusion of franchise agreement, the appropriate remedy should be discharge of contract. If the franchisee can show there were fraud elements (to include (a) intention to defraud, (b) existence of the fraudulent acts, and (c) the fraudulent acts caused the victim to take an act which was contrary to his/her true intention), the appropriate remedy should be declaring the franchise agreement void.

<u>Tax Notice No.(2009)507 – Definition of Royalties</u>

The Tax Bureau issued a Notice No.(2009)507 on license fees in September 2009, and subsequently the Tax Bureau further issued Notice No.(2010)46 on the same subject matter. In essence, the Notice drew a clearer line on what kinds of fees can be considered as royalties under avoidance of double taxation treaties.

1. Under a service contract, if the service provider uses proprietary technology during the course of services, but there is no licence for the recipient of the services to use such proprietary technology, the service fees received by the service provider should not be considered as royalties (Article 4 of (2009)507).
2. If the situation is that the fruit of the service provider’s services falls within the coverage of royalties under an avoidance of double taxation treaty, and service provider retains the ownership of such fruit, while the recipient of services is allowed to implement or use such fruit, the incomes arising therefrom should be considered as royalties (Article 4 of (2009)507).
3. Fees arising from technical supports provided after the transfer or license of proprietary technology should be considered as royalties, subject to the definition of “permanent establishment” (in which case Business Tax applies instead) (Article 5 of (2009)507 and Article 1 of (2010)46).

New Restaurant Licensing and Supervision System

The key features of the new licensing and supervision system are all food safety incidents should be reported within 2 days, and the hygiene requirements are tightened (each restaurant should have its own food safety modus and policies).