1-1-1989

Franchising in Mainland China

Anna M. Han
Santa Clara University School of Law, ahan@scu.edu

Christopher Oechsli

APPENDIX

FRANCHISING IN MAINLAND CHINA*

ANNA M. HAN AND CHRISTOPHER OECHSLI
Shanghai, People's Republic of China

I. INTRODUCTION

Since mainland China adopted an "Open Door" policy, many well-known international trademarks and trade names have appeared in China. However, insofar as the authors are aware, none of these businesses take the form of franchise. Although some of the best known companies usually operate through franchising, this has not been possible in mainland China for a very simple reason: In the traditional sense of franchising, the franchisee is usually a private individual or entity who will operate the business with assistance from the franchisor and follow standards and practices established by the franchisor. In mainland China, private entrepreneurs are still difficult to find. Almost all companies doing business in the People's Republic of China (PRC) must deal with the government or some agency thereof.

Despite the obstacles to direct franchising in mainland China, companies interested in promoting their names and products in China have found alterative methods of doing business there which closely resemble franchising.

A. JOINT VENTURES

A number of foreign companies have entered into cooperative or equity joint ventures with Chinese entities in the PRC in order to market their products in mainland China. As part of its contribution to the joint venture, the foreign company often contributes methods of management, trademark, trade name, and product specifications. Unlike the traditional concept of franchise, however, such joint ventures involve not only investment by the supplier of the trade name and trademark

---

* *Editor's Note:* This article is included as an Appendix to Robert P. Parker's article, *Franchising in Taiwan.*

(traditionally the franchisor), but also active participation in the management as well as sharing in the profits and losses of the joint venture. While the foreign company may provide franchisor-related services such as the furnishing of management, marketing or personnel data, establishing product standards, and personnel policies, the joint venture business format affords the Chinese joint venture party greater latitude than a franchisee. All joint ventures in mainland China are governed by the Chinese Joint Venture Law and Regulations.

Because the management of the joint venture in mainland China is legislated by the Joint Venture Law and Regulations, a potential investor is restricted in the amount of management input. For example, the site of the joint venture is often jointly determined by the partners and, in most cases, restricted to a site easily accessible to the Chinese partners. The foreign partner is usually not at liberty to shop for the best site.

B. Technology Licensing

One form of international business contact with China is the licensing of technology to Chinese entities. Often, licensing of the technology is coupled with the licensing of the licensor's trademark and trade name. This is different from a joint venture in that the foreign licensor does not make a capital contribution and is not involved in the day-to-day management of the local operations. The licensee, in most cases a Chinese factory, has day-to-day control over the management of its factory and the use of the technology it has licensed. The application of the technology, the manufacturing process, and the quantity of products manufactured or sold, are also decided by the local licensee, not the licensor.

The PRC imposes several restrictions on the licensing of technology. For example, the licensor cannot require that the raw materials used can only be purchased from the licensor. The licensor also cannot restrict the use of the license after the expiration of the license. The licensor also cannot require the licensee to pay for patents which are not used or are no longer in effect.

C. Management Contracts

A number of hotel management companies have entered into management agreements with hotels (often joint ventures), providing their name, management know-how, and international marketing abilities to the hotels. Occasionally, the hotel management company has an equity interest in the hotel. However, this is not a prerequisite to a management contract in mainland China.

Such hotel management companies typically license the hotels in China to use their trade names and trademarks. Management services are provided by the management company's international headquarters and local staff are hired and trained to meet the chain's standards. Reservations and advertising of the hotel are on a world-wide basis. The management contract may call for a fixed fee or percentage of gross revenues plus a percentage of profits. To the extent that the hotel management companies have significant control over the methods of operation, accounting, personnel, and marketing practices, this particular form of business resembles franchising. However, the difference is that the actual management is being performed by the international hotel management company. The traditional notion of franchising calls for local personnel to be initially trained by the international management company but actual management is performed by the franchisee.

D. DISTRIBUTORSHIPS

Some companies have attempted to market their products in mainland China by designating specific Chinese organizations as distributors for their products. The difference between this type of relationship in China from the traditional concept of franchising is the status of the franchisee. In mainland China, the appointed distributor is generally a government organization authorized to deal in the particular product. That same organization is often also the designated distributor for competitors of the manufacturer. Because the PRC has a planned economy and state-controlled trading organizations, the import and export of all goods are monitored and controlled by state-owned trading corporations. All products of the same category would necessarily be handled by the same trading corporation. A local "private" distributor is difficult, if not impossible, to locate. Marketing efforts are often made by the manufacturer's sales representatives from the home office and the distributor acts only as a clearing house or liaison center.

E. COMPENSATION TRADE CONTRACTS

Due to a shortage of foreign exchange, compensation trade is widely used in the PRC. Basically, the licensor of technology supplies equipment and know-how to the local manufacturer. As payment for the technology and equipment, the licensor buys back (is compensated by) products produced by the licensee. The licensor thus has a strong interest in monitoring the quality and the quantity of the products produced, since the licensor is ultimately responsible for the marketing of the product. This differs from franchising in that the licensor, at least initially, must make a substantial capital contribution by way of equipment and technology before it will be compensated. This form of business is also limited to companies that have a sourcing need from sales outside of mainland China and/or are not interested in direct sales in mainland China.

F. FRANCHISE FEES AND ROYALTIES

The question of whether a franchisor can receive franchise fees and royalties from operations in the PRC raises issues related to foreign exchange earnings of any foreign investor, including foreign franchisors, in the PRC. These issues are not different for franchisors than they are for foreign investors in the PRC generally. That is, there are no foreign exchange laws that are specific to franchising operations per se.

Generally, there are no restrictions in PRC law that prevent a franchisor or licensor from requiring payment from its franchisee or licensee in foreign exchange. The terms of the contract will control. However, all contracts between PRC and foreign entities require government approval. If the PRC end-user (licensee or franchisee) does not have sufficient foreign exchange of its own to cover its projected foreign exchange expenditures under the proposed project contract, the relevant government approval authorities will have to determine whether, within the planned budget for the relevant sector (and relevant region or municipality) the project merits an allocation of foreign exchange from government sources. Franchising operations that do little to upgrade technology in a targeted sector or that have little prospect of earning foreign exchange (e.g., through exports) are highly unlikely to receive government source appropriations of foreign exchange. These "non-productive" agreements, in fact, may be refused government approval even if the PRC licensee or franchisee has sufficient foreign exchange of its own, because such projects are generally not encouraged by government authorities.

A common approach to licensing or franchising is to couple such a transaction with equity investment, e.g., creation of a Sino-foreign joint venture (JV) that manufactures products or provides services that are covered by a licensing or franchising agreement between the foreign party and the JV. JVs are required by law to balance their own foreign exchange earnings and expenditures. Limited exemptions are made in the early stages of JV operations for JVs that introduce advanced technology, are likely to export a majority of their product value, or produce government certified import substitutes.

Regulations that address the balance of foreign exchange by JVs state that there are five ways of balancing a JV's foreign exchange receipts and expenditures:

(1) *Exports.* PRC authorities want very much to follow the example of Taiwan, Korea, Hong Kong, and other similar export-led economies by promoting export industries. Consequently, in the early stages of equity project negotiations, when a requisite feasibility study is prepared, PRC parties will press for an export commitment. If the JV is committed to an export schedule in its feasibility study—and, subsequently, in the JV contract—and then fails to meet this schedule, Chinese authorities will not assume responsibility for securing foreign exchange for the JV. The primary condition for such assistance is the JV's adherence to its export commitments, unless a specific alternative obligation or arrangement is specified. The feasibility study export projections in this regard, then, are of major significance.

(2) *Domestic Sales.* A JV may make domestic sales in foreign exchange under one of three general conditions:

(a) The JV's products are deemed to be urgently needed, are made with advanced technology, or are of superior quality based on international standards; or

(b) The products qualify as import substitutes and are available at international competitive prices; or

(c) Domestic consumers located outside of the special economic zones (like Shenzhen) or open coastal cities (of which there are fourteen, including Shanghai) who can pay foreign exchange have approval from government authorities to so pay for the JV's products.

To exercise the domestic sales option to earn foreign exchange, the JV must obtain advance government approvals, some of which are required at the feasibility study stage (e.g., import substitution). As a result, in order for a JV to plan on foreign exchange earnings from domestic sales, it must address projected foreign exchange needs and earning options in the feasibility study.

(3) *Countertrade.* Upon obtaining prior approval from the Ministry of Foreign Economic Relations and Trade (MOFERT), a JV can purchase non-joint venture products with its RMB earnings and resell them abroad for foreign exchange. This option is attractive if the JV or the foreign party has marketing channels for Chinese products or if the foreign party's other non-PRC operations can use products that can be sourced in China with non-convertible RMB earnings of the JV. (One wholly foreign-owned venture in Shanghai uses this approach, but it is not an easy one to realize, since most Chinese organizations with exportable products would prefer to export them themselves.)

(4) *Transfer of Foreign Exchange Between Joint Ventures.* JVs with excess foreign exchange earnings (typically JV hotels) were previously able to swap those earnings directly with other JVs for RMB at negotiated rates. This procedure has now been largely supplanted by stricter exchange procedures at state-controlled "swap centers." In Shanghai, for example, the current procedure for swapping foreign exchange for RMB is as follows: Once weekly, applicants can submit requests for currency exchange to the center. A minimum of U.S. $10,000 is required. The center decides the total amount of currency that it will exchange in a session and fixes the rate to balance the stated demands of the applicants. The swap rates in Shanghai in recent months have been in the range of U.S. $1 = RMB6.7–7.0 (versus the official recent rate of U.S. $1 = RMB3.71). This procedure has helped to alleviate the foreign exchange expenditure needs of JVs, but has not been a highly desirable method of obtaining foreign exchange for profit repatriation, as the swap center rates reflect a hefty premium for obtaining foreign exchange.

(5) *Reinvestment of RMB Earnings.* The foreign party to a JV can reinvest its RMB earnings into other mainland China ventures that have a greater potential for earning foreign exchange.

1. *Taxes*

Royalty payments to a foreign company are subject to a twenty percent withholding tax on the gross income from the project. ("Royalties" include income from the provision of patent rights, proprietary technology, know-how, copyrights, and trademarks.) The U.S.-PRC Income Tax Agreement reduces this tax to ten percent. A number of PRC regulations also offer reductions or exemptions from this tax either for certain components of "technology transfer" (e.g., fees for blueprints, technical services, and personnel training) or for "advanced" technology that is offered at "preferential" terms. In addition, and aside from the general PRC tax scheme that is applicable to earnings (of whatever currency denomination) which are sourced from within the PRC, the PRC joint venture tax law imposes a ten percent withholding tax on repatriated profits (i.e., repatriated foreign exchange). "Export-oriented," "technologically advanced" enterprises, or enterprises located in designated areas can qualify for an exemption from this tax.

II. LEGAL CONSIDERATIONS

While China does not have any laws or regulations that directly regulate franchising, a potential franchisor or any company choosing to do business in mainland China using one of the above methods will need to consider some of mainland China's existing laws.

A. TRADEMARK/TRADE NAME

To any franchisor, the protection of its trademark and trade name is paramount. China does have a national trademark law and registration will protect the trademark nationwide. However, trademark registration can be tricky in China since protection is usually necessary in both Chinese and English (or any non-Chinese language). Protection of just the foreign trademark is insufficient if Chinese consumers begin to identify the product by its Chinese name. Registration of a trademark must also be in each class of goods on which the trademark will be used. Currently, China does not recognize service marks with the exception of service marks on paper goods.

B. PATENT LAW

Any licensor of technology should also consider registering its patents under China's Patent Law. Whether an invention is patentable or not will need to be carefully considered in light of China's Patent Law. Patent applications must be submitted in Chinese through recognized Chinese Patent Agents.

C. TECHNOLOGY LICENSING CONTRACT LAW

If a contract in mainland China includes the transfer of technology, then PRC's law on Technology Contracts will govern. In this law, transfer of technology is broadly defined to include management know-how, quality control, and product design.

The Regulations on Administration of Technology Import Contracts of the PRC also contain various prohibitions against clauses which are often found in traditional franchise agreements. For example, as cited above, the licensor cannot require the licensee to purchase equipment or components only from the licensor. The licensor cannot have unilateral control over quality and sales price of the product. The licensor cannot restrict the use of the license after termination of the contract.

D. JOINT VENTURE LAW

If a joint venture is chosen as a method of operation in mainland China, then there are laws and regulations that will govern the formation, administration, and termination of the joint venture. There are also specific tax laws and regulations that will tax the profits of the joint venture as well as the remittance of the foreign partner's share of profits.

E. TAXES

Under a licensing arrangement, the licensor is taxed on royalty payments received. If the licensor's only business in China is the license contract, then the licensor is treated as an entity not having an "establishment" in China. Therefore, the licensor is taxed at a withholding rate of twenty percent for royalties received under the PRC's Foreign Enterprise Income Tax Law. This tax law is also applicable to those entities engaged in compensation trade arrangements or having a wholly owned subsidiary in China.