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Franchising in China

The following graph says it all in terms of the potential opportunity for businesses in the U.S. and other developed countries to expand their sales by franchising in China.

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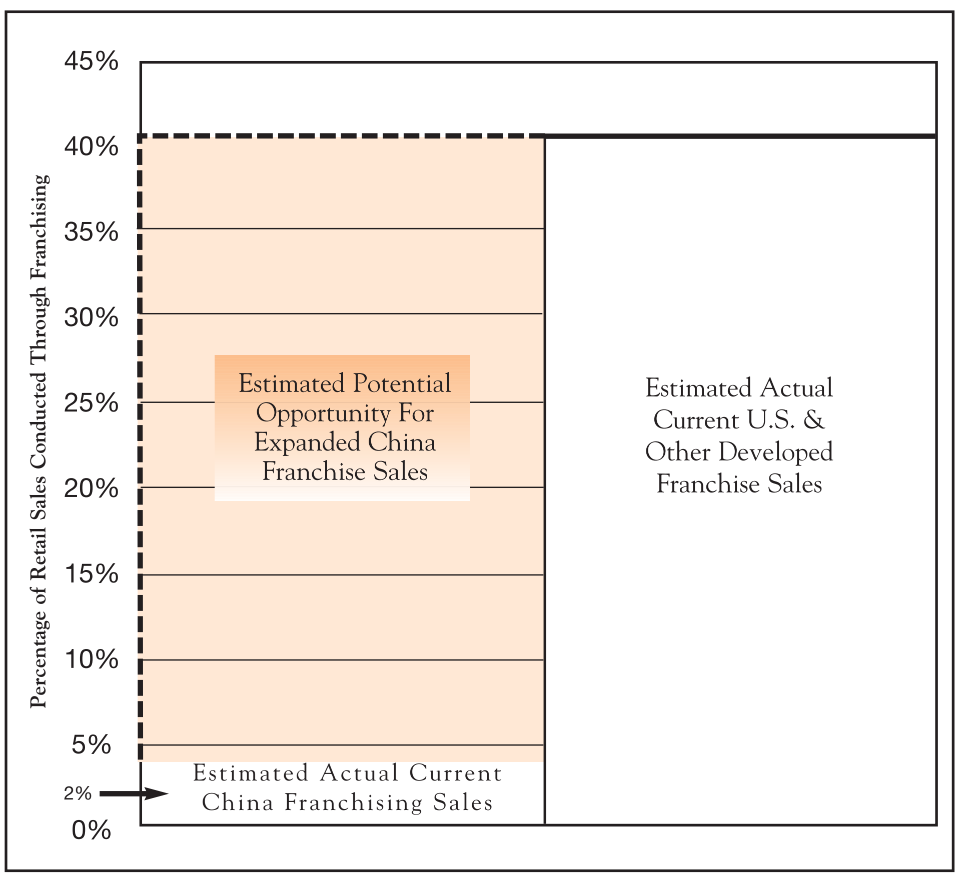
Benesch and Allbright regularly work together on behalf of U.S. clients. In this issue of China Insights, we are presenting selected information and perspectives about franchising in China.

--Allan Goldner, Chair of Benesch's China Group

The China Franchising Opportunity



China Franchising – The New Frontier

The vitality of the Chinese economy and its effect on the rest of the world is staggering. China's economy is growing exponentially. China has rapidly transformed its economy and mind-set by changing its business laws to better conform to world business practices.

The strong growth of international franchising, and its overwhelming popularity as a way to do business, is just as spectacular. Franchising has been embraced by a large number of countries.

Not surprisingly, the explosion of China's business growth and franchising's worldwide popularity have merged to create a big bang of opportunity in China today. This article will briefly explore franchising in China and some of the best strategies for achieving your goal of company growth.

Why Franchising?

For good reason, many foreign countries and their residents want to enjoy western-style prosperity and services, and like the U.S., Chinese consumers want better choices, convenience, products and services. Franchising delivers on this promise.

Chinese consumers have been enjoying a remarkable increase in disposable income. In fact, there has been a spike in spending by the populace on items such as clothing, health and beauty related products and services, household goods, as well as education. Of eighteen thousand teenage respondents who participated in a recent survey, 40% said that they have had western fast food at least once a month.

Disposable income increased 13.4% over last year. Franchising is poised to surge in an economy that is just starting to rev up.

Chinese Connection.

During my tenure as franchise counsel for KFC-USA in the late 1980s, my international counterpart was in the process of completing the first deal in Beijing, notably within sight of Chairman Mao's mausoleum in Tiananmen Square. This was the beginning of the evolutionary change in China. The juxtaposition of the Colonel with Mao has helped feed China's surge into the 21st century.

There is little doubt that China is still an intriguing market. With over 1.3 billion mainland customers, China offers some of the best growth opportunity for any company with the resources and skills to explore and grow with it. However, like with all matters, it is critical to do business in foreign markets methodically in order to increase your chances of success. Even KFC stumbled with its trademark "Finger Lickin' Good", which translates in Chinese to "Eat Your Fingers Off".

> **"[T]he explosion of China's business growth and franchising's worldwide popularity have merged..."**

How-To Guide.

Certainly one of the best methodologies to enter China is by having the necessary resources to open the first store as a corporate store. By using a "corporate" store, you are able to secure better protections and work out the vagaries of local tastes and needs prior to franchising. As with all development, it is best to lay a solid foundation prior to expanding.

China, as a foreign country, has its own unique ways of doing business. The long accepted Chinese term "guanxi" is an ancient and well-accepted manner of establishing personal relationships in China.

Regional Preferences – Local Familiarity.

A major consideration in franchising in China is not to view China as a single market. Just as there are nuances in the market between Atlanta and Seattle, so there are differences in the markets of Shanghai and Beijing which must be taken into account. In fact, due to customs and languages, the differences are far greater.

It is interesting to note that according to a recent A.C. Nielsen survey, KFC is the most widely-recognizable franchise in China, placing well above McDonalds. This was attributable to KFC having a menu which was more compatible to the Chinese diet. McDonalds has now altered their menu, including spicy chicken-type dishes to compete better in the market.

Intellectual Property is Key.

All companies must strive to maximize their intellectual property. Whether it be a patent, trademark or a trade secret, knowledge that is controlled by a company is critical to its continued success in the marketplace.

China has unique challenges in this regard. China, like many countries, often follows the "first to file" rule in trademarks. This rule often allows companies to trade on internationally-known brands in an unfair manner.

For example, in 1996, TGI Saturday's opened within sight of the TGI Friday's flagship store. While such blatancy is finally ebbing from the Chinese market, the local competition can still be fierce, and should not be underestimated. However, since brand registration is still on a first come - first served basis, with limited exceptions for some "sufficiently well-known" brand names, it is best to move early.

Another concern is protecting your company's trade secrets. One of China's leading reasons for encouraging foreign company investment was to learn certain information or "technology transfer" of foreign companies' business practices.

If your company has certain trade secrets, they are entitled to protection in today's China by contract. In the past, contracts had little value, since China did not follow the rule of law. It is critical for any entry into China that your company's intellectual property needs are reviewed and protected.

Partner or Solo?

One of the first key considerations many companies have in China is how to proceed. There are three main forms that companies consider in this market.

Joint Ventures - The oldest form of establishing a presence in China. Joint ventures have the advantage of working with a local partner in order to establish the franchise business. However, joint ventures, by nature, may be limited in duration and scope.

Master Development - The next choice is the master development agreement. It affords a way to identify a company or individual in which you would like to use as the "franchisor" for China. The master developer is in charge of all the human resource and capital requirements for development. While there can be some exceptions to this, as in facilitating lending facilities, it is still the master developer's job to navigate and work through the local laws and customs to do business in China. The master development agreement is a popular approach to those companies that want to minimize their investment capital and still establish their toehold in China and for future growth.

WFOE - An increasingly popular form of doing business in China is the wholly foreign-owned enterprise ("WFOE"). A U.S. Franchisor may find that 100% ownership of a WFOE is the best way to control franchise operations in China.

Conclusion.

A number of challenges remain to doing business in China, including language, legal, governmental, human resources, materials, marketing and local customs and tastes. China is, however, a market that cannot be ignored, and any U.S. company that wants to grow should consider looking to China for part of that growth. While franchising in China is still in its infancy, it presents an attractive and viable alternative for participating in the Chinese market – an alternative, however, that requires experienced and knowledgeable guidance.

For additional information on this topic, please contact Thomas Brule at 216.363.4417 or tbrule@bfca.com.

Chinese Regulation of Franchising

China's franchising regulatory framework includes both international and domestic aspects. International regulations mainly refer to the accords of the WTO which require that legal restrictions on foreign investment in Chinese franchising businesses be eliminated no later than December 12, 2004, according to Annex 9 of the Schedule of Specific Commitments on Service of Legal Instruments on China's Accession to WTO. The domestic aspects include the following regulations and rules:

> **"Franchising... has become one of the fastest growing business areas in China."**

I. The Legal Framework of Franchising Business

A. General Regulations and Rules

China has promulgated several regulations and rules governing franchising in general. Some specific regulations that are noteworthy include:

- Normative Opinion of the Management of Chain Stores (Promulgated on March 27, 1997 by the former Ministry of Domestic Trade)
- Measures for Commercial Franchising Business (Promulgated on November 14, 1997 by the former Ministry of Domestic Trade)
- Circular on Further Regulating on Joining in Franchising League (Promulgated in 1999 by the former Ministry of Domestic Trade)
- Trial Measures on Foreign Invested Commercial Enterprises (Promulgated on June 25, 1999 by the Former State Economic and Trade Commission and Ministry of Foreign Trade and Economic Cooperation)

B. Rules on Franchise's Registration and Recording

According to the Circular on Registration Management of Chain Stores, all chain stores are required to register with the local Administration of Industry and Commerce.

According to the Administration Measures on Franchising Business Enterprises, all franchising enterprises are encouraged to register with the China Chain Store & Franchise Association on a voluntary basis.

C. Regulations Governing the Operations of the Franchise

- Circular on Regulating Price Administration of Catering Chain Stores;
- Circular of Fortifying the Administration of Commodity Quality of Chain Stores and Promote the Development of Franchising Business;
- Rules on the Industrial Administration of Agency Ration and Delivering of Commodity.

II. The Business Model of the Franchise Arrangement

Franchised stores may be based on three different models:

- Direct Operation Chain: All of the chain stores are owned by one headquarters company and operate uniformly under the direction of their headquarters.
- Voluntary Chain: All of the stores of the chain are independent legal entities. They operate together under a contractual arrangement with a single headquarters company.
- Franchise Chain (or League Chain): All of the stores of the chain sign contracts with a headquarters

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company to obtain chartered rights to the trademark, trade name, operational management, and the purchase of products established by the headquarters company.

Regarding chain stores trading in commodities under exclusive rights, both the head store and subsidiary stores must obtain franchise permits. Businesses engaged in certain commodities, such as tobacco, pharmaceuticals, books, newspapers and periodicals, and other media products, require special approval permits. For the convenience of consumers and customers, chain stores engaged in one particular main business may, upon receiving the necessary approvals or permits, engage in the additional sale of books, newspapers and periodicals, media products, postage stamps, envelopes, post cards, and public telephones.

III. Taxation on the Franchise Business

A. Payment Location for Value Added Taxes

For cross-region Direct Operation Chain businesses, where all subsidiary stores are located in different regions, value added taxes must be paid in the region where the headquarters store is located.

For Voluntary Chain businesses and Franchise Chains (or League Chains), each independent store must pay value-added taxes individually.

B. Business Taxes

Generally, within the franchise industry, a foreign licensor may be exempt from business taxes for the revenue generated from transfers of its know-how to a Chinese domestic licensee. The foreign licensor is required, however, to pay a 5% business tax on the franchise trademark licensing fees or trade name licensing fees.

C. Income Taxes

Generally, for a foreign franchisor without its own established business in China, licensing fees received from a Chinese franchisee are subject to a 10% income tax. For a foreign franchisor with its own established business in China, licensing fees received from Chinese franchisees are subject to a 20% income tax. A domestic licensee must withhold the amount of such income tax before remitting the royalties outside of China. The franchisor is responsible for paying its income tax.

IV. Recent Development and Growing Opportunity for Franchising in China

Franchising was a totally new concept in China a few years ago, but today it has become one of the fastest growing business areas in China. At the end of June 2002, there were over 1000 franchises engaged in more than 50 business categories in China. The most common categories are fast food/restaurant, convenience stores/supermarkets, specialty stores and printing/photocopying services.

This development has been inspired by the huge success of giant foreign franchisors such as McDonalds, KFC and Pizza Hut in China, and encouraged by the Chinese government, which has made a significant commitment as a consequence of its WTO accession.

For additional information on this topic, please contact Steve Zhu or Ke Chen of Allbright Law at 86(21)5385-069 or stevezhu@allbrightlaw.com or chenke@allbrightlaw.com.

How We Work With Clients

We help U.S. companies: (1) develop U.S.-based solutions to competition from China; (2) source components and products from China, and deal with related logistics issues; (3) establish China-related strategic alliances and joint ventures for assembly, R&D, manufacturing and distribution; and (4) establish wholly owned manufacturing and other business operations in China.

We help clients structure, negotiate and document China-related transactions, and provide counsel with respect to capital structure, operating control, governance and other issues.

In the area of intellectual property, we are experienced in working with our China-based colleagues and governmental officials to maximize the protection of our clients' valuable patents, trademarks, know-how, trade secrets and other intellectual property rights.

Our established network of highly competent, experienced and reliable U.S. and China-based service providers enable us to help produce complete China business/legal solutions. Together we provide U.S., China and other international legal, tax, governmental relations, import/export, construction, operational and other solutions for our clients in a cost effective manner.

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