

The Legal Framework on Commercial Franchise of In-home Care Business

Written by Michael Qu

Franchise offers a low cost and rapid growth model that provides easy access to the expanding consumer market and second and third-tier cities. Further, franchising enables faster brand recognition, drawing in consumers that see large brand name chains as being more reliable.....especially in the in-home care service sector, many investors see huge potential opportunities in applying the franchise model, while some have already moved on.

Franchise has a history of more than one hundred years in foreign countries. Now it has developed to be a mature business mode, and it is widely used in food and beverage, apparel and hospitality sectors. In China, franchise has rapidly developed since 21 century and has fostered the biggest market in the world. As senior care industry grows, especially in the in-home care service sector, many investors see huge potential opportunities in applying the franchise model, while some have already moved on.

Right at Home(R) International, Inc., a leading franchisor of in-home senior care and assistance, has since last year signed its first master franchise license agreement with an entrepreneurial group in Beijing, expanded into several cities. Seeing from the national strategy of helping majority elderly people to aging-in-place, we believe now it is just the very beginning.

Having advised investors in this sector since the industry's blooming, we found many are interested in franchise model—they all wish to

bring successful business from their home country to China. Of course, there are pros and cons, and profitability is to be tested given the scarcity of qualified caregivers in the market. However, enthusiasm never stops, thanks to not only the enduring charming of the franchise mechanism from itself, but a perfect match with senior care service as well.

To conclude a little bit on some of the most concerned questions from investors in the franchise regulatory environment, I will, in this article, introduce the legal system in China on commercial franchise, what are the solutions for in-home care service providers and what they should be aware of in the course of franchise business.

China's legal system on franchise

Generally speaking, commercial franchise is an arrangement whereby an enterprise (franchisor) through an agreement grants other operators (franchisees) the right to use its business operating resources, including registered trademarks, logos, patents, and proprietary

technologies; whereby the franchisee conducts business under a uniform mode of operation; and whereby the franchisee pay franchise fees according to the agreement. Franchise offers a low cost and rapid growth model that provides easy access to the expanding consumer market and second and third-tier cities. Further, franchising enables faster brand recognition, drawing in consumers that see large brand name chains as being more reliable.

The main legislative provisions governing the commercial franchising in the PRC are: (a) the Measures on Administration of Commercial Franchises 《商业特许经营管理条例》(the “Franchise Measures”), took effect on May 1, 2007; (b) the Measures on Administrative Rules on Commercial Franchise filing 《商业特许经营备案管理办法》(the “Filing Rules”), amended and took effect on February 1, 2012; and (c) the Measures for Administration of Disclosure of Commercial Franchise Information 《商业特许经营信息披露管理办法》(the “Disclosure

Rules”), amended and took effect on April 1, 2012.

Apart from the above three, several regulations from local or departmental authorities are also indicative. On February 24, 2011, Beijing Municipal People's Higher Court issued the Guiding Opinions on Some Issues Concerning the Application of Laws in Hearing Cases of Commercial Franchise Contractual Disputes 《北京市高级人民法院关于审理商业特许经营合同纠纷案件适用法律若干问题的指导意见》 (“the Guiding Opinions”), which represents the judicial attitude towards franchising in the city of Beijing. Moreover, Ministry of Commerce (“MOFCOM”) issued Guiding Opinions of the Ministry of Commerce on Further Promoting the Healthy Development of Franchises during the 12th Five-Year Plan 《商务部关于“十二五”期间促进商业特许经营健康发展的指导意见》 in January 2012 to further provide the policy trend in the regime.

Although the history of commercial franchise in China is short and unregulated market was found in early 90's, we have to admit right after the entry of WTO, a lot of progress was made and now these regulations are more catered to the international practice.

A, B, C steps and qualification for franchisors

Keeping one thing in mind is all franchising activities falls into the regulatory regime of MOFCOM, either MOFCOM itself or the local bureau of MOFCOM. To be qualified as a franchisor, the following requirements and conditions are to met:

Firstly, the franchisors shall be enterprises, excluding other economic organizations and individuals. The Franchise Measures clearly request that the franchisors shall operate at least 2 directly operated outlets, and the period of operation shall be more than 1 year (the “2+1” rule). If the outlets are outside China mainland and operated by foreign enterprises, franchisor shall provide proving documents, which have been notarized by local notary public and certified by Chinese embassy in the

country. However, a foreign franchisor does not meet the “2+1” rule if using the domestic outlets operated by its affiliates in China. It is worth mention that, according to Beijing’s Guiding Opinions, a franchise contract entered into failing to reach the “2+1” rule is not inevitably deemed invalid. That said, in a “Inter-company License” case where a foreign franchisor license trademarks or other resource to its China subsidiary will not be deemed as “franchising”, rather, it will be deemed as “inter-company licensing”, which will not trigger the application of the “2+1” rule.

Secondly, to engage in franchising a franchisor shall have a mature business model, and shall be able to provide franchisees with continuous operational guidance, technical support, training and other services. Enterprises which copy the manuals, websites and enlisting documents of others, and have no service abilities for providing business guidance, technology support and training shall be excluded. The trademarks to be licensed to franchisees shall be registered trademarks. And, the logos, patents and proprietary technology of enterprises are included in the business sources to be licensed to others. Franchising activities involving trademark licenses or patent licenses shall file with relevant Chinese authorities.

Thirdly, archival filing procedures with MOFCOM should be conducted. According to the Filing Rules, where a franchisor engages in commercial franchise operations within the territorial scope of a province, autonomous region or municipality directly under the central government, the franchisor shall register with the Commerce Department of the respective province, autonomous region or municipality directly under the central government where it is located. Where a franchisor engages in commercial franchise operations across the territorial boundaries of a province, autonomous region or municipality under the central government, the franchisor shall register with MOFCOM or MOFCOM’s delegated Commercial department. As a result, the general public may obtain the following information through the

government website of the Ministry of Commerce: (a) The registered trademark(s), enterprise mark(s), patent(s), know-how and other business resources of the franchisor; (b) The franchisor’s archival filing date; (c) The location of the legal business place, contact information and name of the legal representative of the franchisor; and (d) The location of the business place of the franchisee(s) within China. Moreover, foreign investment enterprises shall also submit <Approval Certificate of Establishment of Foreign Investment Enterprises>, which shall include “engage in business activities in the form of franchise” into its business scope.

What worth mentioning is that, the registration procedure with MOFCOM is only a filing procedure, not an approval one. Failure to file with the Chinese authority will be subject to penalties such as orders for rectification and fine, but not necessarily lead to the franchisor in question losing its legal capacity to sell franchise in China. And according to Beijing’s Guiding Opinions, a franchise contract is usually deemed valid even though franchisor fails to complete with the filing procedure.

And fourthly, franchisor should meet the information disclosure requirements. Information disclosure system is the core system of franchising. The Disclosure Rules provides that the franchisors shall establish and implement a perfect information disclosure system, and provide the relevant information and franchising contracts in written form, at least thirty days before execution of franchising contracts. It also sets out the specific provisions on the information which shall be provided by franchisors, including the basic conditions and commercial reputation records of the franchisors and their legal representatives, business sources owned by franchisors, abilities of franchisors to provide service to franchisees and management and supervision on business of franchisees, franchisee fees and the payments, and budgets for investment in franchising shops. To the franchisors that violate these

provisions, the authorities in charge of commerce will order them to rectify, charge penalties and make public statements. And if the franchisor fails to fully disclose the information accordingly, the franchisee is entitled to terminate franchise contract.

Common concerns from franchisors in senior care service providers

Choose between direct-ownership and franchise

Many international brands are struggling between the direct ownership (i.e. foreign direct investment with WOFE/JV) and franchise. Main reason to choose direct ownership over franchise might be the difficulty of finding good partners, lack of local management skills, local franchisees not following franchise standards (sacrificing brand image for short-term profits), lack of control over recruitment, intellectual property challenges or difficulties in acquiring locations. However, whilst direct-ownership gives investor control over business operations, it also constraints the business from rapid expansion. Franchise, on the other hand, provides investors with a simplest and cheapest way to get started and expand in China, but can result in a loss of control and supervision over the franchise. Therefore, a workable franchising mechanism is necessary to be established.

Protection of franchisor's intellectual property

Undoubtedly, core value of franchising is intellectual property. However, as a protective mechanism, franchisee is obliged to keep the franchisor's business

secret confidential. According to the Disclosure Rules, if a franchisee knows business secrets of a franchisor as a result of their contractual relationship, the franchisee is required to keep such business secrets confidential even if no specific agreement has been made to this effect. After the franchise agreement is terminated, even though the franchisor and franchisee have not signed a non-disclosure agreement that regulates the confidential obligations afterwards, the franchisee still has an obligation to keep the franchisor's business secrets confidential. Failure to abide by the confidentiality obligation and causes damages to the franchisor and others, franchisee shall be liable for relevant liquidated damage. However, the most common cases are franchisee gets to know how to do the business and make a fresh start all by its own after expiry of franchise contract, which is very hard to control. What franchisor can do in advance is to set provisions on trade secrets and non-competition in the franchise agreement on the scope, protection measures and liability of breach of contract, and protect its legitimate right via legal action whenever any infringement is conducted by the franchisee.

How to manage operational risk

The Franchise Measures have provided in details administrative punishment for franchisor's illegal activities, and also touch on some criminal liabilities under certain circumstance. However, provisions on civil liabilities are very few, where, on the other hand, lies the biggest operational risks for senior care business. Generally speaking, as franchisees are independent legal entities who have separate

capability to take their liabilities on their own, and therefore franchisor will not take responsibility to any third party that attributes to the franchisee. Only when the third party can prove franchisee is the deemed to have authorization from franchisor and franchisee is act on behalf of the franchisor, or in the event the business resources shared and licensed by the franchisor have some kind of defect and result in third party's damages, the franchisor is responsible to take liability to the third party.

In practice, accidents arising from negligence of caregivers occur very often in in-home senior care service industry, and therefore it is important to set provisions on liabilities that explicitly agreed on the liabilities between the franchisor and the franchisee if either of them breaches the contract or commits a tort against any third party. In addition, more important for the franchisor is put in place a supervision and control mechanism that explicitly agreed on supervision and control over the business location, business operation, quality of products and services and training for employees in order to prevent accidents from happening in daily operation.

Last but not the least important thing is to have the franchise contract well-drafted by your lawyers, and for foreign franchisors, whether they are already present in China or considering entering into the market, is advised to closely monitor the franchise regulatory developments and make sure that they are putting their best foot forward in terms of regulatory compliance. ■

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