

To: Our Clients and Friends

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## Revised Measures Require More Disclosure and Confidentiality in China Franchising

On February 23, 2012, the Ministry of Commerce of the People's Republic of China promulgated the revised Measures for the Administration of Information Disclosure of Commercial Franchises ("Revised Measures"). When the Revised Measures became effective on April 1, 2012, they replaced the currently effective Measures for the Administration of Information Disclosure of Commercial Franchises ("Old Measures"), promulgated on April 30, 2007. The Revised Measures expand the scope of information franchisors must disclose to potential franchisees, increase the confidentiality obligations of franchisees, and add criminal liability as a punishment for franchisors that violate the Revised Measures. These substantive revisions are further explained below, along with a comparison of how they differ from the Old Measures.

### I. Affiliates Include Shareholders

Article 3 of the Revised Measures expands the Old Measures' definition of 'affiliates' to include shareholders. Affiliates are now defined as:

[T]he parent company or the natural person shareholder of the franchisor, a subsidiary company which the franchisors directly or indirectly owns all or the controlling interest thereof, and a company which the same owner directly or indirectly owns all or the controlling interest with the franchisor.

The expanded definition broadens the amount of information the franchisor will be required to disclose, as several disclosure requirements listed in the Revised Measures include disclosing affiliate information.

### II. Expanded Scope of Information Disclosure

Article 5 of the Revised Measures describes the information franchisors must disclose prior to the execution of a franchise contract. Specific revisions to the Old Measures include:

- i. Article 5.1.5, Bankruptcy – Franchisors must now disclose information on bankruptcy or application for bankruptcy by the franchisor or franchisor's affiliate within the last two years. The time period specified in the Old Measures was five years.
- ii. Article 5.6.1, Content of Guidance – The content of the operational guidance, method of provision and implementation plan the franchisor is required to provide to the franchisee is now specified to include "site selection, fitting out and decoration, store management, advertising promotions and product configuration, etc." The content for such guidance, method, and implementation was not specified in the Old Measures.

iii. Article 5.8.2, Financial Disclosure – The Revised Measures require franchisors to disclose financial information, and the source of such information, on the actual amount of investment, average gross sales, costs, gross and net profits for existing franchisee(s) within the territory of China. Under the Old Measures, franchisors could choose between disclosing the actual and estimated amount.

iv. Article 5.10, Litigation and Arbitration – Franchisors must now disclose information on all major litigation and arbitration concerning their franchises in the latest five years. Under the Old Measures, ‘major litigation and arbitration’ was more narrowly defined as those involving a dispute of more than RMB 500,000.

v. Article 5.11.1, Illegal Operations – The Revised Measures require franchisors to disclose information on records of any major illegal operations involving the franchisor or its legal representative where the fine imposed by the relevant law enforcement authorities exceeded RMB 300,000. Under the Old Measures, the fine was limited to a range between RMB 300,000 and RMB 500,000.

vi. Article 5.11.2, Illegal Operations – Franchisors must also disclose information if the franchisor and its legal representative have been investigated for any illegal operation. Under the Old Measures, franchisors were only required to disclose such information if the franchisor and its legal representative had been sentenced with criminal liability.

vii. Article 5.6.3, Consumer Complaints – Franchisors must now disclose the respective liabilities of the franchisor and the franchisee arising out of or in connection with the complaints filed by consumers as well as compensation made to consumers.

### **III. More Confidentiality Obligations**

The Revised Measures increase the confidentiality obligations for franchisees both during the execution of the franchise contract and after the termination of such contract, whereas the Old Measures only provided for the franchisor’s right to require the franchisee to sign a confidentiality agreement.

According to Article 7 of the Revised Measures, franchisees may not disclose or improperly use trade secrets known to them in the course of executing the franchise contract, no matter whether the contract is executed or not. Furthermore, upon the termination of the franchise contract, if the franchisee becomes aware of the franchisor’s trade secrets through the contractual relations, the franchisee must assume the confidentiality obligation even if the franchisee has not executed a confidentiality agreement after the termination of the contract.

Article 7 in the Revised Measures also states that franchisees that breach these provisions on confidentiality or disclose or improperly use the trade secrets and cause losses to the franchisor or others shall be liable for the corresponding damages and compensation.

### **IV. Criminal Liability**

Article 10 specifies the punishments for franchisors that violate the relevant provisions of the Revised Measures, making criminal liability enforceable. Article 10 of the Old Measures stipulated that franchisors breaching the provisions could incur certain fines depending on the severity of the breach.

According to the Revised Measures the relevant commercial administrative authorities may now punish such franchisors according to Articles 26, 27, and 28 of the Administrative Regulations on Commercial Franchising (“Regulations”). Article 27 of the Regulations states that criminal liability may be lawfully investigated for certain actions that constitute a crime. Therefore, franchisors that

breach the provisions of the Revised Measures could receive a fine or be charged with criminal liability.

## V. Conclusion

On April 16, 2012 the Ministry of Commerce issued a notice urging local government agencies to increase management of the registration process and urge unregistered franchisors to register as soon as possible. It also extended the annual March 31 annual report deadline to April 30 due to the large number of franchisors who have failed to timely submit the required annual report this year. Franchisors need to be aware of the increased attention and requirements for disclosing information before the execution of a franchise contract as well as the specified punishments for those franchisors that violate provisions of the Revised Measures. Franchisors should also be aware of the confidentiality obligations that franchisees now bear before execution and after termination of the franchise contract.

The Revised Measures represent what is hopefully a positive step towards increased transparency and predictability in China's relatively young franchising market.

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