

# Franchise Regulation in China: Law, Regulations, and Guidelines

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As reported in the summer 2005 issue of the *Franchise Law Journal*,<sup>1</sup> the Chinese Ministry of Commerce (MOFCOM) promulgated, without much advance notice or opportunity to comment, the controversial Franchise Measures (Measures), which became effective on February 1, 2005. Of particular concern for foreign franchisors was a requirement to have two company-owned units operating in China for one year before being able to obtain governmental approval to franchise (the so-called two-plus-one requirement), and this requirement was said to apply even to companies that had existing franchise systems in China. Prompted by China's commitment to the World Trade Organization (WTO) to lift restrictions on franchising by the end of 2004, the Measures were, in effect, a hastily put together temporary stopgap to give the government more time to complete its internal debate on exactly how to regulate franchising on a more permanent basis. Drafts of more permanent regulations had been circulating for some time prior to the promulgation of the Measures, and this effort at devising a more permanent regulatory framework was redoubled after the passage of the Measures.

After two years of internal discussion and a desire to "safeguard market order" due to rampant fraud in domestic franchising activities in China, the Chinese State Council<sup>2</sup> finally promulgated these permanent regulations, called the Regulations on Administration of Commercial Franchise (Regulations), on Jan. 31, 2007, with an effective date of May 1, 2007.<sup>3</sup> On May 1, 2007, MOFCOM, which has authority to interpret and implement these regulations, issued two implementation guidelines, namely, the Administration Rules on Commercial Franchise Filing (Filing Guidelines)<sup>4</sup> and the Administration Rules on Commercial Franchise Information Disclosure (Disclosure Guidelines).<sup>5</sup>

This article will explore the major requirements of the now more firmly established regulatory regime, provide some historical context, and highlight and suggest some possible solutions to the remaining areas of concern. We will discuss (1) the meaning



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and scope of the regulations in the context of general commercial principles in Chinese civil law jurisprudence; (2) the definitional and jurisdictional scope of the regulations and the qualifications one must have in order to franchise in China, including the two-plus-one requirement; (3) franchise agreement requirements and related issues; (4) the registration process, including the effect on existing franchise systems in China; (5) the disclosure requirements of the franchise regulations; and (6) enforcement mechanisms, including government sanctions.

## Civil Law Context

In considering the disclosure requirements of the new Regulations, one should bear in mind that the Regulations are just that—regulations, not laws. In China's civil law system, as in other civil law systems, laws set out general principles to be applied to specific cases by deduction. Regulations, ordinances, or decrees are used to provide guidance as to the specific applications. The adoption of the Regulations thus does not relieve franchisors of compliance with the general principles of Chinese contract law as set out in the Hetong Fa (Contract Law) that has been in force since October 1, 1999.<sup>6</sup>

In particular, Article 42 of the Hetong Fa has an obligation that is generally known in civil law as "pre-contractual good faith" or the doctrine of *culpa in contrahendo*.<sup>7</sup> The drafting of the Hetong Fa was heavily influenced by the provisions of German law, and Article 42 was based on the equivalent German doctrine. Article 42 provides as follows:

In the making of a contract, the party that falls under any of the following circumstances, causing thus loss to the other party, shall hold the liability for the loss: (1) engaging in consultation with malicious intention in the name of making a contract; (2) concealing intentionally key facts related to the making of a contract; or (3) taking any other act contrary to the principle of good faith.<sup>8</sup>

The phrase *zhongyao shishi* is translated as *key facts* in the government translation but is more commonly translated by Chinese lawyers as *material facts*.<sup>9</sup> Thus, the Regulations should be considered in the broader context of China's civil law system, particularly as subordinate to the Contract Law. Imbued within the civil law system and the Hetong Fa—much as in other civil law countries—are concepts of fairness and good faith that provide a backdrop for interpreting the meaning of the Regulations and the interpretive guides.

## Jurisdiction and Scope/Qualifications

The starting point to determine the applicability of the Regulations is, of course, to determine what kinds of relationships are subject to being regulated as franchises in China. Article 3 of the Regulations defines a commercial franchise as

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... the business activities whereby the Franchisor through executing contracts, allows the Franchisee the use of the operational resources, such as registered trademark, enterprise logo, patent, know how, etc., that the Franchisor owns, and the Franchisee undertakes business under the unified business format in accordance with the provisions of such contracts, and pays franchise fees to the Franchisor.

This definition may have a ring of familiarity to practitioners in the United States as it broadly parallels the definition of a franchise under U.S. law.<sup>10</sup> In essence, it consists of three elements: (1) the franchisor licenses to the franchisee “operational resources” such as trademarks, (2) the franchisee conducts its business under a unified business format, and (3) the franchisee pays the franchisor a franchise fee.

This definition is somewhat different in wording from the definition in the prior Measures, although it essentially covers the same types of relationships. However, like the Measures, the definition is broad and vague and therefore has the potential for covering a wide variety of arrangements beyond the business format franchise that is typically sought to be regulated in the United States and other jurisdictions.

What is meant by a *franchise fee* also remains undefined. Consequently, it is unclear whether it includes or excludes payment for goods supplied by the franchisor at bona fide wholesale prices, an exclusion commonly found in U.S. franchise regulations to exempt product distribution franchises.<sup>11</sup> The Chinese term for franchise, *texujingying*, has previously been used by the courts to apply to a wider variety of contractual arrangements, including what appear to be authorized dealers, and this may suggest that product distribution franchises also are covered.<sup>12</sup>

Unlike the Measures, the Regulations do not explicitly address master franchise relationships and the subfranchising activities conducted thereunder. However, from the breadth of the definition, it is hard to imagine that a master franchise relationship would not be covered, particularly as the forms attached to the Filing Guidelines (Schedule 2) recognize subfranchised units.

Also left unclear is under what circumstances branded management agreements (commonly used in the hotel industry) or the license components of branded joint ventures might be deemed franchises subject to the Regulations. Both of these type of structures may include provisions or agreements that resemble franchise agreements, but in a context where franchise regulation is not really warranted.

As with the Measures, the Regulations seek to regulate commercial franchising activities within the People’s Republic of China (PRC) but to exclude Hong Kong and Macau; from a PRC perspective, these special administrative regions are not subject to PRC law. Article 17 of the Filing Guidelines makes clear that the Regulations will apply to foreign franchisors engaging in transnational franchising in China. This implicitly resolves the debate fostered by an ambiguity under the Measures and other regulations about whether it was lawful to engage in cross-border franchising in China; such franchises were commonly interpreted by practitioners as requiring a foreign franchisor to set up a Chinese subsidiary in order to lawfully franchise in China.<sup>13</sup>

Article 7 establishes the qualifications to be able to franchise in China. The first part of the Article establishes general principles that a franchisor must own a well-developed business format and be capable of providing necessary support. It then refines these general principles by reiterating the controversial two-plus-one requirement of the Measures. Under the Measures, a franchisor was required to own two units for one year in China before it could obtain governmental approval to franchise, and this requirement was interpreted by MOFCOM to apply not only to new franchisors but also to existing franchisors. In effect, franchisors were required to establish company-owned operations in China before gaining governmental approval, even if they already had franchise systems established in China. Article 7 of the Regulations addresses this qualification requirement as follows: “[A] franchisor engaged in franchising activities should own at least two directly operated outlets for more than one year.” This change implicitly allows the requirement to be met with existing units outside China, and MOFCOM confirms this expansive interpretation by setting out in Article 5 of the Filing Guidelines the required documentation for outlets located outside China. Also, Article 33 of the Regulations specifically exempts existing franchise systems in China from having to meet this requirement.

Yet, neither the Regulations nor the Filing Guidelines clarify a number of other questions raised by the two-plus-one requirement, such as (1) whether the units must be owned by the same franchisor entity that is franchising in China or may be owned by an affiliate; (2) whether the franchisor’s management of an outlet owned by a third party (a common practice in the hospitality industry) meets this requirement; or (3) whether this requirement need only be met at the commencement of franchising in China, or whether it must continue to be met as long as franchises are being sold in China or so long as franchises remain operational in China.

MOFCOM has informally indicated some flexibility on the precise basis of meeting the two-plus-one requirement, but it will remain to be seen what will be accepted or rejected as franchise companies make their filings. Moreover, informal policies are always subject to change, with the attendant risk of falling out of compliance with little or no forewarning. Finally, neither the Regulations nor the Filing Guidelines provide any relief for the “pure” franchise company that franchises exclusively without operating any outlets. In essence, the two-plus-one requirement is a proxy for a franchisor demonstrating that it has a well-developed business format and is capable of providing the appropriate assistance to franchises, yet it does not provide any flexibility to allow a franchisor to demonstrate that it is a viable franchise company by any other means.

### **Franchise Agreement Requirements**

The requirements for franchise agreements in the Regulations supplement the requirements of the Hetong Fa or Contract Law, as mentioned earlier. Franchise agreements under Chinese law thus must comply with both the provisions of the Regulations and the Hetong Fa. There are 129 articles on general contracts in the Hetong Fa, including provisions regarding parties observing the principle of equity, offer, and accep-

tance, standard clauses allocating responsibility for gross negligence, choice of law, and bilingual contracts.

The franchise agreement requirements of the Regulations include Article 4, which states that “franchising activities shall be conducted in compliance with the principles of free will, fair dealing, honesty, and good faith.” This is a fairly common statutory acknowledgment of a good faith requirement in commercial transactions, which one typically would find in civil law jurisdictions. Although this Article does not mandate any particular contractual requirements, it leaves open the possibility that contractual provisions deemed harsh may be unenforceable or that a good faith requirement may be implied in connection with the negotiation of franchise agreements. In this respect, further interpretations of the general good faith provisions<sup>14</sup> of the *Hetong Fa* will be instructive.

Article 11 of the Regulations requires that franchise agreements be entered into in writing and mandates certain contractual provisions. The eleven enumerated categories are as follows:

- (1) basic information of the franchisor and the franchisee;
- (2) contents and duration of the franchise;
- (3) types, amounts, and payment methods of the franchise fees;
- (4) specific contents and provision methods of the operational guidance, technical support, business training, and other services;
- (5) quality and standards requirements, as well as guarantee measures, for the products or services offered by the franchised business;
- (6) promotion and advertisement of the products or services offered by the franchised business;
- (7) arrangements for protection of consumer rights/interests and undertaking of liability for compensation in the franchising activities;
- (8) amendments, rescission, and termination of the franchise contract;
- (9) liability for breach of contract;
- (10) methods of dispute resolution; and
- (11) other matters as agreed upon by the franchisor and the franchisee.

Most of these are not particularly controversial and typically are covered in comprehensive franchise agreements, although several raise some interesting questions. For example, subsection 5 references “guarantee measures” relating to quality and standards requirements. The exact meaning of this phrase remains to be seen, although hopefully it simply means that the agreement must address how quality control standards will be implemented. Likewise, subsection 7 requires arrangements for protection of consumer interests and “undertaking of liability for compensation in the franchising activities.” Again, hopefully, this requirement will be interpreted to mean that the franchise agreement must expressly state who has responsibility for customer liability issues, rather than mandating the franchisor to undertake some level of liability.<sup>15</sup>

Article 12 of the Regulations requires the franchise agreement to have a unilateral rescission right for the franchisee, in addition to a thirty-day delivery requirement with respect to the disclosure document and the franchise agreement (the disclosure and delivery requirements are discussed below). Neither the Regulations nor the Filing or Disclosure Guidelines suggest how long this rescission right should run, although presumably one or two weeks would suffice.

Articles 13 through 18 continue with a number of additional requirements imposed on the franchisor as follows:

**Article 13** The term of the franchise as stipulated in the franchise contract shall not be less than 3 years, unless otherwise agreed to by the franchisee.

The provision in the preceding paragraph shall not apply when franchisor and franchisee extend the term of the franchise contract.

**Article 14** The franchisor shall provide the franchise operation manual to the franchisee, and continuously provide operational guidance, technical support, business training, and other services to the franchisee according to the contents and methods as agreed upon.

**Article 15** The quality and standards of the products or services offered by the franchised business shall comply with the laws, administrative regulations and the provisions of the relevant requirements of the State.

**Article 16** Where the franchisor requires the franchisee to pay fees before the franchise contract is signed, it shall explain in writing to the franchisee the purpose of such fees and the conditions and manner for refund of the same.

**Article 17** The promotion and advertisement fees collected by the franchisor from the franchisee shall be used for the purposes as agreed upon in the contract. The status pertaining to the use of the promotion and advertisement fees shall be disclosed to the franchisee in a timely manner.

The franchisor shall not conduct the advertisement and promotions in a fraudulent or misleading manner, and the advertisement published by it shall not contain information publicizing the profits of the franchisees from their franchising activities.

**Article 18** Without the consent of the franchisor, the franchisee may not transfer its franchise to others.

The franchisee may not divulge or permit others to use the trade secrets of the franchisor of which it becomes aware.

For the most part, these requirements are self-explanatory. Article 15, however, requires that the products and services offered by the franchise business comply with all applicable laws yet fails to state who is responsible for assuring such compliance. It is unclear whether this is a requirement imposed on the franchisor, and it is not inconceivable that circumstances may lead MOFCOM to conclude that a franchisor should bear responsibility for noncompliant products or services offered by franchised locations.



Also, the second part of Article 17 contains a somewhat unusual requirement in that “. . . the advertisement published by [the franchisor] shall not contain information publicizing the profits of the franchisees from the franchising activities.” Although this might suggest that one cannot advertise what is commonly understood in the United States to be a financial performance statement (otherwise known as an earnings claim), the Disclosure Guidelines indicate that it is meant to prohibit disclosure of the profits of a particular franchisee while permitting franchisors to disclose general information about profits.

### Registration Process

Article 5 of the Regulations confers on various governmental agencies the authority to supervise and administer the franchise regulations, depending on where the franchisor is conducting its business. This authority is delegated to a provincial, autonomous region or municipal<sup>16</sup> level to the extent that a franchisor’s activities are limited to their jurisdictions. Franchisors whose activities cross jurisdictions or that engage in cross-border franchising are regulated by the competent commercial authority of the State Council, i.e., MOFCOM. This means that the authority to deal with the registration process and potential penalties for violating the regulations is diffused through various governmental agencies. However, for foreign franchisors, the appropriate agency is likely to be MOFCOM.

Article 8 requires the franchisor to register within fifteen days after the execution of the first franchise agreement. This registration process is to be Internet based and is intended to be a means for collecting statistical data on franchising, in addition to confirming qualification requirements. Certain information will be publicly available, enabling interested parties to contact franchisors. The Filing Guidelines specify that the application must include a number of items, including a sample franchise agreement, the table of contents of the operations manual, and a market plan, i.e., outlet growth plan in the various markets in China. (This is akin to the requirement in Item 20 of the UFOC relating to projected expansion of the franchise system.)

The franchisor will also need to demonstrate how it has complied with the two-plus-one requirement. In the event that the two-plus-one requirement is to be met in a foreign country, certificates from local authorities will be necessary to evidence the operations of those units, along with Chinese translations and Chinese embassy or consulate certification.

Article 7 requires material amendment filings, and Article 19 requires a franchisor to annually update certain information by March 31 of each year. The filing is effective indefinitely but subject to cancellation for violations of law or the provision of false information by the franchisor. The franchisor may also voluntarily cancel the filing. The Filing Guidelines also impose various penalties for failing to comply.

In contrast to the approach taken under the Measures, the second paragraph of Article 33 of the Regulations exempts existing franchisors from the two-plus-one requirement. Ironically, this exemption for franchisors that have existing franchise operations in China before May 1, 2007, appears to be applicable regardless of whether they complied with the prior two-plus-one requirement under the Measures. In any event, those existing franchisors need not comply with the two plus 1 requirement but have a one-year grace period in which to register their franchise programs.

Finally, Article 32 encourages franchise associations to formulate codes of conduct and to engage in self-policing activities. The Regulations essentially seek to encourage the China Chain Store Association, which had significant influence on the final version of these regulations, to take an active role in assuring that franchising activities in China are conducted responsibly.

### General Principles of Disclosure

Article 23 of the Regulations reflects the general principles regarding disclosure as set out in Article 42 of the *Hetong Fa*. It states that the information to be provided by the franchisor to the franchisee shall be true, accurate, and complete and shall not conceal any relevant information; and the franchisor may not provide any false information.

The relationship between the Regulations and the general laws was also made clear in the Questions and Answers released by the State Council and the Ministry of Commerce at

the same time that the Regulations were released. The answer to the second question states, “Second, a contractual relationship exists between a franchisor and a franchisee. Franchisors and franchisees are both independent third parties in the market and their respective rights and obligations are defined through signing the franchise agreement.” In addition, the third question starts thus: “Franchising is a kind of contractual activity by its nature, to which contract law and other relevant civil laws apply.”<sup>17</sup>

The importance of disclosure in connection with franchising in China is illustrated by *Huang Haiyan v. Beijing Hansen Cosmetology Co. Ltd.*, a case decided in Beijing on November 16, 2005, under the previous Franchise Measures.<sup>18</sup> In this case, the plaintiff entered into a cosmetics shop franchise agreement and soon thereafter discovered that the trademark was not registered; that it was not an international brand, as represented; and that there were undisclosed problems with the supply of products. The court noted that the Measures required written disclosure of basic information in advance and found the franchisor to have intentionally violated this regulation. The court described the purpose of the required disclosure as follows:

The essence of the duty to disclose is to enable the prospective franchisee to decide whether it understands the business objectives and its rights, and whether the franchise offer is

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fair. The goal of such disclosure is to prevent fraud and therefore to promote investment analysis and the general public welfare. Therefore in franchising if a franchisor violates the disclosure requirement, this also constitutes fraud.<sup>19</sup>

Citing Articles 54(2) and 58 of China's Hetong Fa, the court declared the franchise agreement to be lacking in fairness, rescinded the agreement, and ordered the return of the plaintiff's money.

Thus, the disclosure requirements of Chapter 3 of the Regulations must be considered in light of the rights and remedies under Article 42 of the Hetong Fa.

### Specific Disclosure Requirements

Article 20 of the Regulations requires that a franchisor establish a comprehensive or complete disclosure system, and Article 21 states that all information required pursuant to Article 22, together with a copy of the franchise agreement, be provided to a prospective franchisee not less than thirty days before the franchise agreement is signed.

Article 22 sets out a list of items that must be disclosed to the franchisee. They are as follows:

- (1) the franchisor's name, place of business, legal representative,<sup>20</sup> registered capital amount, the scope of its franchise business, and basic information about its franchising activities;
- (2) basic information about the franchisor's registered trademark(s), logo(s) or other commercial symbols, patent(s), proprietary technology, and operational or business format model;
- (3) the type, amount, and method of payment for franchise fees (including whether security deposits are required and the conditions and method of refunding a security deposit);
- (4) the costs and conditions for the products, services, and equipment provided by the franchisor;
- (5) detailed information regarding the continuous services to be provided by the franchisor, including operating advice, technical support, service training and the method of delivery, and the schedule for the provision of such services;
- (6) the method of guidance and supervision provided to the franchisees;
- (7) the investment budget for a franchise location;
- (8) the current number and location of existing franchise outlets within the boundaries of China, their distribution by region, and an evaluation of the level of their operations and condition;
- (9) summaries of financial statements and audit reports audited by an external accountant for the most recent two years;
- (10) franchise-related lawsuits and arbitrated matters for the last five years and their status;
- (11) information regarding whether the franchisor or its management legal representative has been convicted of significant illegal operations;
- (12) other information specified by the Commerce Department of the State Council (the Ministry of Commerce, known also as MOFCOM).

The list of required disclosures in Article 22 is not exhaustive of the disclosure obligations on the franchisor, as it is likely that the general disclosure obligation in Article 42 of the Hetong Fa would require disclosure of any other information that is material. Some common law jurisdictions have similar provisions.<sup>21</sup>

The specific requirements of Article 22 of the Regulations have a number of ambiguities in them. The Ministry of Commerce has since issued the Disclosure Guidelines to expand upon and clarify the provisions of Article 22. For example Article 22(8) requires an "an evaluation of the level of their operations and condition." Some have interpreted similar provisions found in the prior Measures as capable of being fulfilled by a table similar to the one usually provided as Item 20 in a UFOC. Article 5(VIII)(2) of the Disclosure Guidelines has clarified that this section of Article 22(8) means the following:

The franchisor shall disclose the franchisees' actual or estimated average sales volume, cost, gross profit, net profit, and simultaneously explain the source of the aforesaid information, time span, franchise stores/outlets concerned, etc. If such information is an estimate, the franchisor shall explain the basis of such estimate, and explicitly warn potential franchisees that the actual operating circumstances may be different from the estimate.

In civil law, the laws express the broad principle, and the regulations and decrees apply the broad principles in increasing detail to specific matters. Here, Article 42 of the Hetong Fa as adopted by the National People's Congress (the legislature) requires good faith in the making of a contract. The State Council (similar to a cabinet in a parliamentary system) prescribes in the Regulations that in franchising this means that prospective franchisees must be provided with an evaluation of the status of the franchisees. And, finally, the Ministry of Commerce clarifies that the evaluation requires what is known as a financial performance statement (otherwise known as an earnings claim) in the United States.<sup>22</sup>

For a foreign franchisor first embarking on expansion into China, Article 22(8) presumably means that financial projections must be provided and that there is no option for avoiding the disclosure. A major concern here is the difficulty of making any projections based on any reliable data in a new country, as well as the uncertainty of potential legal liability for not achieving the estimates. However, one obvious defense to a claim that the estimates were not achieved would be the text of the Disclosure Guidelines requiring a specific warning to franchisees that actual operating circumstances may be different from the estimates.

This form of analysis can be applied in the interpretation of other provisions regarding the required form of financial statements. The disclosure requirements in the Regulations do not specify a form for the financial statements that the franchisor is required to disclose. In general, accounting systems in economies that were formerly centrally planned are not very useful in a market economy. In this regard, China is working toward adopting International Financial Reporting Standards for public companies in 2007.<sup>23</sup> Financial statements prepared in accordance with U.S. GAAP are likely to provide informa-

tion to a prospective franchisee superior to any prepared in accordance with strictly Chinese standards. Accordingly, these may well fulfill the intent of Article 42, particularly if English text is translated into Chinese.

### **Liability for Noncompliance**

The fourth chapter of the Regulations sets out a series of penalties for noncompliance with the provisions of the Regulations, including the specified fines. When reading this chapter, one must remember that these are only the administrative penalties, and there are usually additional liabilities for breach of contract under the Hetong Fa or other laws. China has a mix of administrative penalties and liability under general laws in other areas as well, such as intellectual property.

For example, in the Huang Haiyan case mentioned earlier, the Beijing Chaoyang District People's Court used the previous Franchise Measures only to interpret the disclosure obligation as set out in the Hetong Fa. Article 39 of the Franchise Measures provided thus:

For failure to disclose information pursuant to these Measures, commerce regulatory agencies shall impose orders to comply, and/or fines of less than RMB30,000; and shall inform the Administration for Industry and Commerce to cancel the business license if the violations are serious.

However, the decision of the court did not refer to the penalty in the Measures but to the provisions of the Hetong Fa when it allocated liabilities based on the finding of a breach of the Hetong Fa. Specifically, it cited Articles 54(2) and 58 of the Hetong Fa. Article 54(2) generally provides that a contract made unfairly can be altered or rescinded. In this context, the unfairness was in the failure to disclose. Based on this, the court held the franchise agreement to be void. Article 58 provides generally that

After a contract becomes invalid or is rescinded, any property obtained under the contract shall be returned. If it is impossible or unnecessary to return the property, compensation shall be made at an estimated price. The party at fault shall compensate the other party for the loss caused by the fault.<sup>24</sup>

Based on these provisions, the court ordered the franchisee to return unsold products and equipment to the franchisor and ordered the franchisor to return the fees paid.

The liability provisions of the Regulations provide separately for failure to comply with provisions of the Regulations regarding a failure to have the qualifications required of a franchisor, such as having operated two locations for not less than one year (Article 24); failure to register (Article 25); failure to comply with the provisions regarding advance fees and to update the franchisor's registration information (Article 26); failure to comply with the provisions regarding misleading advertising (Article 27); and failure to disclose (Article 28). There is also an Article stating that fraud will be dealt with under the provisions of the Criminal Code and that any multilevel marketing activities will be dealt with in accordance with the State Council Regulations on Prohibition of Pyramid Sales (Article 29).<sup>25</sup>

Interestingly, there is also an Article imposing liability on any employee of the Ministry of Commerce who abuses

his power, is derelict in his duties, or engages in malpractice for personal gain (Article 30). The concept of abuse of regulatory power is gaining widespread recognition in China.

The fines to be imposed are prescribed in two categories in these Articles. There is a lower range for minor breaches and a higher range for breaches determined to be serious. There are no indications as to what would be considered serious, but such provisions are common in Chinese law; and the Supreme People's Court has issued interpretations of similar provisions under certain laws.

The fines specified range from about \$1,300 to \$65,000 in U.S. dollars at current conversion rates. Further, Articles 24 to 28 all prescribe that where the offense is serious, the name of the franchisor shall be published. This may include publication in the website information that will be maintained by the Ministry of Commerce on each franchisor. Such publication may represent the greatest hardship to any ongoing sales program in China.

In light of the earlier discussion regarding the interpretation of the disclosure obligations in the Regulations, it is important to note that Article 28 covers fines for violation of Articles 21 or 23 of the Regulations but does not directly mention Article 22, the Article that contains the list of prescribed disclosures. Article 21 requires that a franchisor provide a prospective franchisee with all the information required pursuant to Article 22. Article 23, on the other hand, requires that the information provided be true, accurate, and complete and not conceal any relevant information.

### **Conclusion**

In sum, the new Chinese franchise regulations, together with the Filing Guidelines and the Disclosure Guidelines, are an improvement over the hastily promulgated prior Franchise Measures and reflect contractual principles set out in Chinese laws. The qualifications of a franchisor, the application of the regulations, and the disclosure requirements have been clarified, although some uncertainties and ambiguities remain and still need to be sorted out. In the meantime, franchisors should consider the provisions of Article 42 when trying to resolve the ambiguities.

The new registration requirement is not as onerous as it might have been. However, some aspects may remain troublesome for some foreign franchisors, particularly compliance with the two-plus-one requirement and the mandatory financial performance statements. It remains to be seen how these regulations will be administered and how the Chinese courts will apply the new regulations. Both the administration and the courts are maturing rapidly and, to date, have not given foreign franchisors significant cause for concern.

Two things must be kept in mind when reading the Regulations and the Guidelines. One is that they were primarily adopted to deal with domestic concerns about abuses and fraud. The second is that franchisors must comply with the general provisions of the Hetong Fa; the Regulations, the Filing Guidelines, and the Disclosure Guidelines are subordinate to these provisions. These two points are important principles in interpreting the requirements imposed on franchisors entering China.



## Endnotes

1. Erik B. Wulff & Tao Xu, *Franchise Regulations in China: Dawn of a New Day*, FRANCHISE L.J., 19 (2005).

2. The State Council is the highest executive branch of the People's Republic of China's (PRC's) central government. It is chaired by the Premier. Its Standing Committee also includes four vice premiers, five state councillors, and the secretary-general (not to be confused with the Secretary-General of the Communist Party). The heads of each central government's ministries and agencies are members of the State Council. The State Council acts by the authority of the National People's Congress (NPC), which is the highest legislative branch of the government. The State Council can issue regulations and proposes legislation to the NPC.

3. Decree of the State Council of the People's Republic of China, No. 485, available in Chinese at [www.cafa.org.cn/end.jsp?id=36021](http://www.cafa.org.cn/end.jsp?id=36021). English translations available at [www.dlapiper.com](http://www.dlapiper.com) and [www.jonesco-law.ca](http://www.jonesco-law.ca) or in the March 2007 issue of *China Law & Practice*.

4. Administration Rules on Commercial Franchise Filing, Decree of the Ministry of Commerce 2007, No. 15, available in Chinese at [www.cafa.org.cn/end.jsp?id=38112](http://www.cafa.org.cn/end.jsp?id=38112). An English translation is available at [www.dlapiper.com/us/publications/detail.aspx?pub=2405](http://www.dlapiper.com/us/publications/detail.aspx?pub=2405).

5. Administration Rules on Commercial Franchise Information Disclosure, Decree of the Ministry of Commerce 2007, No. 16, available in Chinese at [www.cafa.org.cn/end.jsp?id=38111](http://www.cafa.org.cn/end.jsp?id=38111). An English translation is available at [www.dlapiper.com/us/publications/detail.aspx?pub=2405](http://www.dlapiper.com/us/publications/detail.aspx?pub=2405).

6. Adopted at the Second Session of the Ninth National People's Congress on March 15, 1999.

7. This was first expounded by Rudolf von Jhering, *Culpa in Contrahendo, oder Schadenersatz bei nichtigen oder nicht zur Perfektion gelangten Verträgen* [*Culpa in Contrahendo or Damages for Void or Unperfected Contracts*], 4 JAHRBÜCHER FÜR DIE DOGMATIK DES HEUTIGEN RÖMAISCHEN UND DEUTSCHEN PRIVATRECHETS [YEARBOOKS OF THE DOGMATICS OF THE MODERN ROMAN AND GERMAN PRIVATE LAW] 1 (1861); see also Friedrich Kessler & Edith Fine, *Culpa in Contrahendo, Bargaining in Good Faith, and Freedom to Contract: A Comparative Study*, 77 HARVARD L. REV. 401-09 (1964) (cited in E. ALLEN FARNSWORTH, DUTIES OF GOOD FAITH AND FAIR DEALING UNDER THE UNIDROIT PRINCIPLES, RELEVANT INTERNATIONAL CONVENTIONS, AND NATIONAL LAWS (Universität Köln), available at [http://tldb.unihoeln.de/php/pub\\_show\\_document.php?pubdocid=122100](http://tldb.unihoeln.de/php/pub_show_document.php?pubdocid=122100)). The civil law doctrine of *culpa in contrahendo* was developed by Rudolf von Jhering and added to Germany's *Bürgerliches Gesetzbuch* (BGB or Civil Code) in 2002 by amendments to Articles 241(2) and 311. German courts have applied this doctrine to impose on franchisors an obligation to disclose all material facts. An example of the imposition of such duties in a franchise case is in the decision of Landgericht Kaiserslauten Aktenzeichen 4 O 607/00, 26 Mai 2004, where the court said:

"The plaintiff has a claim against the defendant based on the doctrine of *culpa in contrahendo* because of its breach of its precontractual duty to provide education and information, a breach that gives rise to compensation. Before concluding a contract, the franchisor has an obligation to explain to the other party facts that would thwart the purpose of the contract and that are of substantial importance to the other party in the resolution of the negotiations (see Rostock 1996, ff. m.w.N.). Such circumstances particularly include, without further justification, information regarding expected profits and financial feasibility." (Translation by Paul Jones).

8. Translation from the bilingual edition of *The Contract Law of the People's Republic of China* (adopted at the Second Session of the Ninth National People's Congress on March 15, 1999) (Law Press, Beijing, China, 1999).

9. Translation by Paul Jones.

10. See, e.g., Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. pt. 436, § 436.1.

11. *Id.*

12. See, e.g., *Hu Aihe v. Salt City Pavilion Lake Thrifty Blind Co. Ltd.*, No. 63, (Jiangsu Province Higher People's Ct., June 2, 2006).

13. The Franchise Measures expressly provided that they apply if the franchise operations are conducted within the PRC. The Franchise Measures, however, did not speak to whether foreign franchisors may offer franchises directly to prospective franchisees without setting up a foreign-invested entity (FIE) in China, the so-called direct off-shore approach to franchising. However, under the Measure on the Management of Foreign Invested Commercial Enterprises (Commercial Sector Measures), a foreign franchisor was required to establish an FIE to offer franchises in China. Read together, the two regulations appeared to have thrown into doubt the legality of direct off-shore franchising in China.

14. See Articles 5, 6, & 60.

15. Under the Measures, a franchisor was required to guarantee the quality of products sold by designated suppliers. This requirement has been deleted in the Regulations, and hopefully the subsection 7 language will not be used to reintroduce this troublesome concept.

16. There are currently four municipalities treated as provinces and reporting directly to Beijing: Beijing, Shanghai, Tianjin, and Chongqing.

17. Members of the State Council Legislative Affairs Office & the Ministry of Commerce, Questions and Answers Regarding the "Commercial Franchise Administration Regulation," Feb. 16, 2007, available in Chinese at [www.cafa.org.cn/end.jsp?id=36040](http://www.cafa.org.cn/end.jsp?id=36040). An English translation is available at [www.jonesco-law.ca](http://www.jonesco-law.ca).

18. No. 486 (Beijing Chaoyang District People's Ct., 2005).

19. Translation by Paul Jones.

20. Each corporation in China must have a *fading daibiao ren*, a person with broad powers and unlimited liability as the agent for the corporation. The name of the person should appear on the business license (*yingye zhizhao*) of the corporation referred to in Article 8(1). This individual can sign for the corporation.

21. In this regard, it is similar to the disclosure obligations in the Province of Ontario, Canada. Section 5(4) of the Arthur Wishart Act (Franchise Disclosure), 2000 provides that a disclosure document shall contain "(a) all material facts, including material facts as prescribed [in the regulations]." The regulations to the Ontario legislation contain specific disclosure requirements that are similar to the specific requirements of China's Regulations. However, the requirements of the Ontario regulations are not exhaustive of the franchisor's disclosure requirements.

22. Such an approach differs from that used in the United States. Although the Federal Trade Commission has determined that earnings information is a "material fact" to prospective franchisees, it has, for other overriding policy reasons, specifically declined to require disclosure of such information by regulation.

23. James T. Areddy, *Adding Up Chinese Data*, WALL ST. J. ONLINE, Feb. 27, 2006.

24. Translation from the bilingual edition of *The Contract Law of the People's Republic of China*, *supra* note 8.

25. Regulations for the Administration of Direct Selling (Provisional) Order of the State Council, No. 443 (promulgated by the State Council on Aug. 23, 2005; effective as of Dec. 1, 2005).