

# Legal Developments in Chinese Franchising

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Although China is developing a civil law legal system, unlike some European civil law jurisdictions it encourages the courts to post cases on-line to improve the transparency of the legal system.<sup>1</sup> As a result an increasing number of court decisions involving franchising may now be found on-line and used as guidance by those who read Chinese.<sup>2</sup>

As a civil law system China is also developing doctrinal sources for the interpretation of its law. One of the more significant sources are the "Interpretations" issued by the Supreme People's Court.<sup>3</sup> These are now being posted on-line as they are released allowing equally prompt access from Toronto, Paris or Beijing.

This brief article will review legal developments in the cases and in the interpretations of laws primarily from 2006. Previously published articles have reviewed some of the older cases.<sup>4</sup> The protection of trade-marks is a significant issue for franchisors in China, and an update on franchise legal developments must necessarily include a discussion of trade-mark cases involving franchisors.

## **Trade-mark Cases**

The year 2006 began with the news that Starbucks had won its case against a Shanghai company that had registered its corporate name as "Shanghai Xingbake Coffee Co." ("Xing Ba Ke" are the sounds of the three characters that comprise Starbucks' Chinese character name) in Shanghai No. 2 Intermediate People's Court.

As the decision was under appeal it was not made available to the public, in accordance with Chinese civil procedure. However this did not inhibit

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<sup>1</sup> Supreme People's Court, Measures on the Management of Publication of Judgment Documents, June 15, 2000.

<sup>2</sup> For a list of Chinese Courts that now have web sites see <http://www.chinacourt.org/fyzx/>.

<sup>3</sup> For a list of Interpretations see <http://www.court.gov.cn/lawdata/explain/>.

<sup>4</sup> Paul Jones, "Franchising in China: Judicial and Legislative Update 2005-2006" forthcoming in the *International Journal of Franchising Law*, 2007; Paul Jones, "China's Franchise Laws: Initial Cases and Commentaries," in CCH, *Business Franchise Guide*, (Chicago; CCH, Loose-leaf) Newsletter October 20, 2006 and Permanent Edition ¶7068; and Paul Jones, "The Regulation of Franchising in China and the Development of a Civil Law Legal System" paper and presentation to the 2006 China Franchise International Summit, Beijing Normal University, Zhuhai College Campus, People's Republic of China, November 11, 2006, now forthcoming in *Chinese Law and Policy Review*, 2007, University of Pennsylvania.

considerable commentary on the case in the Western media, some of which was decidedly inaccurate. On December 29, 2006 it was announced in the Chinese press that the Shanghai Higher People's Court had rejected the appeal.<sup>5</sup>

Although widely hailed in the Western press as a sign of improvement in the protection of intellectual property rights in China, the case was actually a straightforward contest between a registered trade-mark<sup>6</sup> and the name of a registered business.

There are problems with trade-mark infringement in China, but the courts and the laws are not the source of the problem. For example with the expiry of the patent protection around the world for the well-known LEGO brick, the famed toy-maker has gone to court in a number of countries seeking to stop competitors from copying the shape of the brick through the application of copyright or trade-mark laws.<sup>7</sup> Generally they were unsuccessful.<sup>8</sup> But in China Interlego AG was successful both at trial and on appeal in obtaining protection under copyright and design laws.<sup>9</sup>

A more challenging decision is the one made by the Tianjin City Higher People's Court in the action brought by the chocolate maker Ferrero against its Chinese competitor<sup>10</sup> under China's Anti-Unfair Competition Law.<sup>11</sup> Ferrero had neglected to register its Chinese character name and had delayed bringing an action against the infringing competitor for almost 15 years.

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<sup>5</sup> "Coffee Chain Told to Drop Name," CRIenglish.com, December 29, 2006. The decision of the Shanghai Higher People's Court in this case, dated Decemebr 20, 2006, is available at [http://ipr.chinacourt.org/public/detail\\_sfws.php?id=5919](http://ipr.chinacourt.org/public/detail_sfws.php?id=5919).

<sup>6</sup> Contrary to some reports Starbucks had registered the Chinese version of its name in China well before the infringer registered its corporation.

<sup>7</sup> For a discussion of these actions see Jenny Lundahl, "The Lego Brick: In the Borderzone Between Forms of Protection," Master Thesis, Department of Law, Göteborg School of Economics and Commercial Law, Göteborg University, Sweden, Spring 2005.

<sup>8</sup> For example in Canada the Supreme Court said "Under the modern law of passing off, a passing-off action by the appellant was bound to fail. It would not have been able to meet the first condition of the action, namely that there be goodwill in respect of the distinctiveness of the product. The alleged distinctiveness of the product consisted precisely of the process and techniques which were now common to the trade. Again, Kirkbi could not overcome another form of the functionality problem. Granting such a claim in these circumstances would amount to recreating a monopoly contrary to basic policies of the laws and legal principles which inform the various forms of intellectual property in our legal system. The appellant is no longer entitled to protection against competition in respect of its product. It must now face the rigours of a free market and its process of creative destruction." *Kirkbi AG v. Ritvik Holdings Inc.*, [2005] 3 S.C.R (released November 17, 2005).

<sup>9</sup> *InterLego AG v. Tianjin Coko Toy Co., Ltd.*, Beijing Higher People's Court, Case No. 279, decided December 18, 2002.

<sup>10</sup> *Italian Fei Lie Luo Company (Ferrero S.p.A.) v. Mengtesha (Zhangjiagang) Food Company Limited*, Tianjin City Higher People's Court, Case No. 36, released January 9, 2006.

<sup>11</sup> Fan Bu Zheng Dang Jingzheng Fa, adopted at the 3rd Meeting of the Standing Committee of the National People's Congress on September 2, 1993; Promulgated by Order No. 10 of the President of the PRC, and effective as of December 1, 1993.

The Court ruled in Ferrero's favour for four reasons. Citing the adherence of both China and Italy to the Paris Convention<sup>12</sup> the court ruled that in order to determine what is "well-known," reference cannot only be had to the domestic market. Secondly the Court noted that in another action the Chinese company had been unable to prove that it had independently created its packing design, and held that the packaging had been copied from Ferrero's product.

Thirdly the court said:

Based on the principles of good faith and recognized business ethics, "well-known" status for a product must be achieved through management's own efforts. Therefore unfair competition as specified in law cannot be used as a method for management to achieve "well-known" status for a product.<sup>13</sup>

Accordingly because the Chinese company copied Ferrero's packaging it cannot use its resulting status in China against Ferrero. Finally it cited Article 10bis (2) of the Paris Convention in support of the proposition that Article 5(2) of China's Unfair Competition Law should be read liberally.<sup>14</sup>

This decision has been appealed to the Supreme People's Court.<sup>15</sup> On January 18, 2007 the Supreme People's Court released an Interpretation<sup>16</sup> that clarifies the protection to be afforded to well-known marks, among other things, and provides for the protection of distinctive packaging. It will be interesting to see how these principles are applied to the decision in the appeal.

Finally a restaurant franchisor that had achieved success in its hometown in Sichuan Province sought to expand by franchising in Shanghai. Unfortunately the Shanghai Higher People's Court held that its use of the Chinese character "Tan" in its logo was insufficient to prevent another restaurant in Shanghai with a similar menu from using the mark because the character "Tan" is a common surname in China.<sup>17</sup> Franchisors adopting Chinese character names for entry into China should consider avoiding characters that are also surnames.

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<sup>12</sup> *Paris Convention for the Protection of Industrial Property*, made March 20, 1883, as revised at Brussels on December 14, 1900, at Washington on June 2, 1911, at The Hague on November 6, 1925, at London on June 2, 1934, at Lisbon on October 31, 1958, and at Stockholm on July 14, 1967, and as amended on September 28, 1979.

<sup>13</sup> Translation by the author.

<sup>14</sup> Article 10bis (2) reads: "Any act of competition contrary to honest practices in industrial or commercial matters constitutes an act of unfair competition."

<sup>15</sup> IP Dragon Blog, ([www.ipdragon.blogspot.com](http://www.ipdragon.blogspot.com)) "Anticipated Supreme People's Court Decision in Counterfeit Case Between Montresor and Ferrero," December 26, 2006.

<sup>16</sup> Supreme People's Court Interpretation regarding Certain Questions in the Trial of Anti-Unfair Competition Law Matters, adopted December 30, 2006 by the Supreme People's Court Judicial Commission at its 1412th meeting, in effect from February 1, 2007.

<sup>17</sup> *Sichuan Deyang Tan Dining Chain Ltd. v. Shanghai Tan Shiguan Fucai Dining Development Ltd.*, Shanghai Higher People's Court Case No. 10, decided March 16, 2006.

## **Franchise Cases**

Franchising has developed far enough in China that termination cases are becoming more common in the courts. In December 2006 there were reports in the Chinese press about a Beijing gas station franchisee being terminated for selling unapproved product<sup>18</sup> and a Ford Mazda dealer in Shanxi Province was terminated because of either poor sales performance or Ford's restrictive sales policies and low-quality products, depending on who is telling the story.<sup>19</sup>

Two decisions from 2006 on the sales of unapproved product and terminations will be discussed in this article, as well as a termination decision from 2005 that has received some commentary in China, but has not been previously discussed in English.

In a relatively short decision released in December of 2006 the Changsha City Intermediate People's Court awarded damages of 50,000 Yuan<sup>20</sup> against a former franchisee who continued to use the franchisor's trade-mark.<sup>21</sup> The parties entered into a franchise agreement on March 17, 2003 for a term of two years. Before the contract expired the franchisee applied for arbitration to nullify the agreement and to obtain a refund or royalties paid and compensation for losses incurred. The dispute was settled on terms that included an undertaking by the franchisee to change its registered name and discontinue using the franchisor's trade-mark.

When this did not occur the franchisor sued and requested 300,000 Yuan in damages.<sup>22</sup> But the court held that the franchisor had not shown any evidence of special losses to justify such an amount.

In June 2006 Jiangsu Province Higher People's Court upheld a judgment enforcing the exclusivity provisions of a franchise agreement against a third party.<sup>23</sup> On April 1, 2001 Salt City Pavilion Lake Thrifty Blind Co. Ltd. (the "Franchisee") entered into a franchise agreement with the manufacturer to open a shop selling window treatments under the trade-mark "MUO LI KE". Later Hu Aihe also opened a shop selling "MUO LI KE" blinds and window treatments in the same area.

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<sup>18</sup> John Hao, "Poorly Performing Franchisees Lose their Sinopec Credentials," *Xinhua* (as reported in CCFA Brief), December 12, 2006.

<sup>19</sup> Jin Jing, "Ford waves legal stick as dealer feud revs up," *Shanghai Daily.com*, December 18, 2006.

<sup>20</sup> About \$6,500.00 USD.

<sup>21</sup> *Beijing Kyoto Wei Wei Beautification Technical Development Co. Ltd. v. Changsha Kyoto Wei Wei Beautification Service Co. Ltd.*, Hunan Province Changsha City Intermediate People's Court, File No. 284, October 17, 2006. Mao Zedong began his political career in Changsha, where he also studied to become a teacher.

<sup>22</sup> About \$38,500.00 USD.

<sup>23</sup> *Hu Aihe v. Salt City Pavilion Lake Thrifty Blind Co.Ltd.*, Jiangsu Province Higher People's Court, Court File No. 63, June 2, 2006.

On March 27 2003 the Franchisee was named as the primary store in the area. Finally on August 22, 2005 the Franchisee obtained the rights to be the exclusive agent for the “MUO LI KE” products in the Yancheng area of Jiangsu Province. It then brought an action against Hu Aihe for violating the exclusivity arrangement with the manufacturer by selling the “MUO LI KE” products. The franchisee entered photographs and copies of the order forms as evidence.

The Intermediate Court (the trial court) considered Hu Aihe’s activities to be a breach of the general “good faith” obligations under Chinese law, a breach of business ethics, and a violation of the Anti-Unfair Competition Law.<sup>24</sup> It ordered a halt to such sales and compensation of 20,000 Yuan.<sup>25</sup>

Hu Aihe, the competing dealer, appealed on the grounds that he had been improperly served with the Statement of Claim, and that a contract between two parties is only enforceable between those parties. The Franchisee replied that the service was sufficient and that the unfair competition had occurred in the form of misleading advertising when Hu Aihe used the “MUO LI KE “ mark on his signs and forms. If the Franchisee has an exclusive agency it is misleading to consumers for Hu Aihe to use the “MUO LI KE” trade-mark.

The Jiangsu Higher People’s Court dismissed the claims regarding improper service because Hu Aihe had not been prejudiced in defending against the claim by the error. Although he had not attended the first trial because of the improper service, the Higher People’s Court felt that he had fully defended himself in the second hearing before it. With respect to the second ground of appeal the court focused on the fact that HuAihe had been caught using a card declaring himself as the exclusive agent for “MUO LI KE” products in the Yancheng area in 2005. This was not in accordance with his “good faith” obligations under the Anti-Unfair Competition Law.

Finally in an older decision that has been the subject of commentary in China the Shanghai No. 2 Intermediate People’s Court considered a request by a terminated franchisee for a return of a portion of the initial franchise fee and a security deposit. The franchisor claimed unpaid royalties and advertising contributions, and liquidated damages.<sup>26</sup>

On September 2, 2003 the parties entered into a franchise agreement with a term of five years to operate a teahouse in Shanghai’s new Pudong area. The franchisor is from Hong Kong and the franchise is quite popular in China. The initial franchise fee was 150,000 Yuan<sup>27</sup> and the franchise agreement specified

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<sup>24</sup> *Supra* note 11.

<sup>25</sup> About \$2,600.00 USD.

<sup>26</sup> *Shanghai Wind Shelter By the Pond Teahouse Co. Ltd. v. Tang Kouping*, Shanghai No. 2 Intermediate People’s Court, File No. 394, February 8, 2005.

<sup>27</sup> About \$19,250.00 USD.

that it was non-refundable. By January 2004 the franchisee was behind on the November and December royalties and advertising contributions and a warning letter was sent. In February it sent the franchisee a couriered notice of default. Finally it terminated the franchise agreement and brought an action in the Shanghai Jinan District Court.

The District Court found that the franchisor was authorized to terminate the franchisee for his failure to pay amounts owed because it was authorized by the provisions of the franchise agreement and such terms were permitted by China's Contract Law,<sup>28</sup> and because it had given notice of the default and an opportunity for the franchisee to cure the default.

However Tang Kouping claimed that because the Franchisor terminated the agreement he should receive a proportionate refund of the initial franchise fee, that the unpaid security deposit cannot be claimed as damages, and that liquidated damages provision was a penalty and was also contrary to law. Tang Kouping also claimed that the franchisor had not fulfilled its obligations regarding training and equipment.

The District Court also held that the franchisee must pay the penalty as stipulated, but that the franchisor must give a proportionate refund of the initial franchise fee.

On appeal the franchisor cited Article 14 of the Measures for the Regulation of Commercial Franchising<sup>29</sup> to support the notion that the initial franchise fee may be non-refundable. The Intermediate Court agreed, provided that the termination was not done in bad faith. Thus the decision of the District Court on this issue was reversed.

However with respect to the liquidated damages provision the Intermediate Court agreed with Tang Kouping because the contract was not allowed to run its course, and because the franchisor had not proved the quantum of its damages. It also agreed with Tang Kouping with respect to the deposit money.

Commentary on franchise cases in China is increasing. A Beijing lawyer, Xiao Chaoyang, published a guide to the Franchise Measures in January 2006.<sup>30</sup> The commentaries are also useful guides to the interpretation of the laws governing franchising in China. The cases discussed in this article, such as the Lego case, the Ferrero case and the Salt City case, suggest that China's courts will enforce intellectual property rights and contractual rights.

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<sup>28</sup> He Tong Fa, adopted at the Second Session of the Ninth National People's Congress on March 15, 1999 and came into force on October 1, 1999.

<sup>29</sup> Shangye Texujingying Guanli Ban Fa, Ministry of Commerce Order No. 25 of 2004, in effect February 1, 2005. On January 31, 2007 the State Council approved in principle a new regulation (Tiaoli) that will replace these Measures. It is expected to be proclaimed in the Spring, after some minor amendments.

<sup>30</sup> Xiao Chaoyang, *Commercial Franchise Measures: A Guide to Application* (Beijing: Machine Industry Press, 2006).