THE REGULATION OF FRANCHISING IN CHINA AND THE DEVELOPMENT OF A CIVIL LAW LEGAL SYSTEM

中国特许经营法规及其民法体系的发展

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A. Introduction[1]

The structure of China's legal system must be kept in mind when translating and interpreting China's laws. This has proven to be particularly true for the 商业特许经营管理办法 (Shangye Texujingying Guanli Ban Fa - Measures for the Regulation of Commercial Franchising)[2] (the "Franchise Measures") which have proven to be of great interest to lawyers in common law jurisdictions, and in particular in the United States. A lack of understanding of the principles of civil law systems in general will lead, and has led, to serious errors in the understanding of China's laws governing franchising.

This paper will briefly describe the origins of civil law in China and the differences between civil law and common law in general and with respect to franchising. It will then review the more significant features of China's laws governing franchising both discussing issues of interpretation and illustrating how an understanding of civil law jurisprudence is effective in interpretation, and some errors made by common law lawyers in interpreting the laws.

1. Origins of Civil Law in China

At the end of the 清朝 or Qing Dynasty legal reformers were translating Western ideas about law into Chinese and had prepared a draft civil code modeled on the German

[1] This article is based largely upon a 'Country Update' written for the International Franchising Committee of the International Bar Association by the author and research conducted for a forthcoming article in the *International Journal of Franchising Law* entitled "特许经营在中国:审判上和立法的报告 2005-2006 (Franchising in China: Judicial and Legislative Update 2005-2006) and an article entitled "China's Franchise Laws: Initial Cases and Commentaries," published in CCH, *Business Franchise Guide,* (Chicago; CCH, Loose-leaf) Newsletter October 20, 2006 and the Permanent Edition at ¶7068. Paul Jones is a member of the Law Society of Upper Canada (Ontario).

[2] Ministry of Commerce Order No. 25 of 2004, in effect February 1, 2005.

Bürgerliches Gesetzbuch ("BGB" or Civil Code) of 1900.[3] At the time Japan had adopted the German civil law system as its model. Other possible reasons for this choice are the political prominence of Germany after its victory in the Franco- Prussian war, the better match of civil law jurisprudence as compared to common law models with China's previous administrative form of law codes, and the fact that the BGB was then the most recent of the European civil codes.

The drafts prepared under Qing rule were never formally adopted and the dynasty ended in 1911. The civil code was eventually adopted in 1930 by the Republic of China that was governed by the 国民党 (Guomindang) but wide spread civil strife during the warlord years meant that it was not truly implemented.[4] To the extent that the then government was influenced in its choices by its Russian advisors, the Soviet Union also had a civil law system similar to that of Germany that it was modifying to become a socialist law system. China's current government has continued to build the legal system as a civil law system and in particular to follow the German model.

2. Civil Law vs. Common Law

In civil law broad principles are set out in laws of general application and the decisions of courts do not have precedential value. Commonly these laws are aggregated in "civil codes" but it is possible to have a civil law system of jurisprudence without adopting a civil code. Because civil law may be said to move from the general to the particular the drafting of statutes in a civil law system is generally somewhat vaguer or less precise than in a common law system. If the drafts person leaves a gap in the more particular clauses, the general principle that is set out broadly in a code or general can be used to infer what has been omitted.

Common law systems in contrast develop law from the decisions made in individual cases, supplemented by statutes adopted by the legislature. Common law originated in England and all common law systems are derived from the English system. Another way of describing it is to say that common law builds legal principles from the particular to the general, or from the bottom up rather than the top down. In contrast to civil law statutes, statutes in common law jurisdictions are draft to be as precise as possible. Vagueness in the drafting of a common law statue is an anathema.

Historically common law has taken a different approach to the rules for contracts than civil law. The English courts still resist the notion of a doctrine of good faith in the performance of a contract,[5] although such a doctrine is now considered part of the

[3] Yin-Ching Chen, "Civil Law Development: China and Taiwan," 2 *Stanford J. of East Asian Affairs* 8 (2002) at p. 9.
[4] *Ibid.*
[5] Alberto M. Musy, "The Good Faith Principle in Contract law and the Precontractual Duty to Disclose: Comparative Analysis of New Differences in Legal Cultures," 1 *Global Jurist Advances* 1 (2001) available on line at: http://www.bepress.com/gj/advances/vol1/iss1/art1/ .

common law of Canada,[6] and a doctrine of implied good faith is written into the Uniform Commercial Code in the United States[7].

Specifically relevant to the regulation of franchising, the formation of contracts in common law is governed by the doctrine of *caveat emptor* or buyer beware. There is no duty to disclose material facts when negotiating a contract. The onus is on the purchaser to conduct his or her own investigations, otherwise known as "due diligence."

In contrast various civil law systems have developed the notion that contracts must be negotiated in good faith (known as "pre-contractual good faith"). This means that a vendor must disclose certain information accurately during negotiations. Remaining silent and failing to inform the proposed purchaser about material facts regarding the business may be considered to constitute an absence of good faith in the conduct of the negotiations. This in turn invalidates the consent that is necessary for the formation of a contract. In German law this was developed into a doctrine known as *culpa in contrahendo* (or "fault in negotiating") as early as 1861 by von Jhering [8] and in most civil law systems have used the doctrine of good faith to develop this doctrine.[9]

3. Development of Franchise Regulation

In a simple contract for the sale of goods the common law principle of buyer beware is an effective rule. The proposed purchaser could inspect the goods or negotiate with the seller for warranties as to the quality of the goods. But with the development of more complex market economies problems began to arise, particularly in relationship contracts.

After the stock market crash of 1929 the Federal Government in the United States took one of the first major steps to modify the principle of buyer beware with respect to the purchase of securities by adopting the *Securities Act of 1933*. This legislation had two basic objectives:

- to require that investors receive financial and other significant information concerning securities being offered for public sale; and

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[6] See *Shelanu Inc. v. Print Three Franchising Corp.*, 2003 CanLII 52151 (ON C.A.) 64 O.R. (3d) 533; (2003), 226 D.L.R. (4th) 577; (2003), 38 B.L.R. (3d) 42; (2003), 172 O.A.C. 78.

[7] UCC §1-203, "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."

[8] 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), in 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). Friedrich Kessler and Edith Fine, Culpa in Contrahendo, Bargaining in Good Faith, and Freedom to Contract: A Comparative Study , 77 *Harvard Law Review* 401, at pp. 401-9 (1964) as 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 online at http://tldb.uni-koeln.de/php/pub_show_document.php?pubdocid=122100 .

[9] Ibid.

- to prohibit deceit, misrepresentations, and other fraud in the sale of securities.

After the end of World War II franchising became a new type of long term investment contract, but without the regulatory burden imposed on the sale of securities. Under the doctrine of buyer beware purchasers of franchises were left to do their own investigations as to the background and reliability of the people and companies selling the franchises, and the economic viability of the franchise concepts that they were selling. This was not always easy or possible. And some perceived the doctrine as being unfair. Why should each individual purchaser have to conduct their own due diligence when the facts are obviously known and available to the seller?

As the reports of fraud and abuse in franchise sales grew California adopted the first franchise disclosure law in 1970[10] with the intent of prohibiting fraud and providing "each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered."[11]

At the national level the U.S. Federal Trade Commission ("FTC") commenced hearings on the possibility of a law regulating franchise sales disclosure on February 14, 1972. But the FTC did not issue what is now known as the Franchise Disclosure Rule until 1978 and in it did not come into effect until 1979.[12] A significant number of states have also adopted their own franchise laws.

Under these disclosure laws a franchisor must provide a prospective franchisee with basic information about the franchisor, the franchised business, and the franchise agreement as specified in the laws. Misleading disclosure, or a failure to disclose when there is a duty to do so, may also give rise to actions under the common law for fraudulent misrepresentation or concealment.[13]

But there is no explicit duty to disclose all material facts. The *Securities Act of 1933* has a similar structure. American franchise lawyers examine the wording of the list of required disclosures carefully and items that are clearly not required to be disclosed may be left out of a disclosure document. . This is appropriate in a common law jurisdiction.

The most common example of such a material fact is information about the average sales per location for the most recently completed financial year (also known as an "earnings claim"). In the United States there is no duty to disclose this information and only about 20% of franchisors actually disclose an earnings claim.

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[10] *Franchise Investment Law*, California Corporations Code, Division 5, Parts 1 through 6, Sections 31000 through 31516, added by California Laws of 1970, Chapter 1400, approved September 18, 1970, effective January 1, 1971, as amended.

[11] CCH, *Business Franchise Guide* ¶105.

[12] Code of Federal Regulations, Title 16, Chapter I, Subchapter D, Part 436 (16 CFR 436), promulgated December 21, 1978, effective October 21, 1979 (effective date extended from July 21, 1979, 44 *Federal Register* 31170, May 31, 1979).

[13] Judith M. Bailey and Dennis E. Wieczorek, "Franchise Disclosure Issues" in Rupert M. Barkoff and Andrew Selden, eds., *Fundamentals of Franchising – Second Edition* (Chicago: American Bar Association Forum on Franchising, 2004) at p. 95.

In the Canadian Province of Ontario the franchise disclosure law[14] requires the disclosure of all material facts as well as items prescribed in the regulations,[15] as do the securities laws. The concept of "material fact" is defined in the law as information that would reasonably be expected to have a significant effect on the value of the franchise being offered or the decision to purchase the franchise.[16]

Still many lawyers in Ontario advise their clients to simply disclose the items listed in the regulations, and do not enquire as other material facts that must be disclosed. Specifically they do not disclose historical sales information for the system as a whole or an average per location.

As will be seen next in the discussion of the disclosure requirements of China's laws and Franchise Measures, and in their comparison to some other civil law systems in Québec and Germany, and the regulation of franchising is quite different from the model found in these common law jurisdictions. The requirement that the buyer beware is not the overriding rule of contract law.

B. Disclosure

1. General Disclosure Requirements

Both China's general 合同法 (Hetong Fa - Contract Law)[17] and the current Franchise Measures require pre-contractual disclosure of all material facts.

China has not yet completed the drafting of its civil code. The Contract Law is however the equivalent of the book (or chapter) on obligations in other civil law systems and the 物权法 (Wu Quan Fa or Property Rights Law) that in all likelihood will be presented to next National People's Congress in March of 2007 is the equivalent of the book on property.

Drafting a civil code is always a long process and accordingly in 1986 China adopted as an interim measure to guide the development of a civil law legal system the 中华人民共和国民法通则 (Zhonghua Renmin Gongheguo Minfa Tongze – General Principles of the Civil Law of the People's Republic of China).[18] Article 4 of this Law requires that:

> 第四条 民事活动应当遵循自愿、公平、等价有偿、诚实信用的原则.
> (Article 4 - In civil activities, the principles of voluntariness, fairness,

[14] *Arthur Wishart Act (Franchise Disclosure), 2000*, S.O. 2000, c.3.
[15] *Ibid.,* Section 5(4)(a).
[16] *Ibid.,* Section 1(1).
[17] Adopted at the Second Session of the Ninth National People's Congress on March 15, 1999 and came into force on October 1, 1999.
[18] Adopted at the Fourth Session of the Sixth National People's Congress on April 12, 1986.

making compensation for equal value, honesty and credibility shall be observed.)[19]

It should be noted that despite this translation, the term used for "honesty" is 诚实 (chengshi). This term is used in the Contract Law and the Franchise Measures to mean "good faith."[20]

The Contract Law, which is modeled on the provisions regarding obligations in the BGB or German Civil Code, in Article 42 provides as follows:

> 第四十二条　当事人在订立合同过程中有下列情形之一，给对方造成损失的，应当承担损害赔偿责任：　　（一）假借订立合同，恶意进行磋商；　　（二）故意隐瞒与订立合同有关的重要事实或者提供虚假情况；　　（三）有其他违背诚实信用原则的行为. (Article 42 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 name of making a contract; (2) concealing intentionally key facts related to the making of a contract;(3) taking any other act contrary to the principle of good faith.)[21]

This provision essentially requires that parties negotiating a contract conduct themselves in good faith and according to principles of fair dealing.

Article 17 of the Measures provides that both before signing a franchisee agreement and during the course of the operation of a franchise both the franchisor and the franchisee shall disclose relevant information in a timely manner:

> 第十七条 特许人和被特许人在签订特许经营合同之前和特许经营过程中应当及时披露相关信息.

Article 42 of the Contract Law is similar to provisions requiring good faith during negotiations found in other civil codes. For example, the Civil Code[22] of the Province of Québec contains the following provisions:

> 6. Toute personne est tenue d'exercer ses droits civils selon les exigences de la bonne foi.

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[19] Translation form the bilingual edition of 中华人民共和国民法通则 – *General Principles of the Civil Law of the People's Republic of China* / 中华人民共和国民事诉讼法 – *Civil Procedure Law of the People's Republic of China*, published by Law Press, Beijing, China, 1999.

[20] See Article 60 of the translation from the bilingual edition of *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)* published by Law Press, Beijing, China, 1999 and Article 5 of the Franchise Measures.

[21] Translation from the bilingual edition of Contract Law, supra note 20.

[22] *Code civil du Québec*, L.Q., 1991, c. 64.

7. Aucun droit ne peut être exercé en vue de nuire à autrui ou d'une manière excessive et déraisonnable, allant ainsi à l'encontre des exigences de la bonne foi.

1375. La bonne foi doit gouverner la conduite des parties, tant au moment de la naissance de l'obligation qu'à celui de son exécution ou de son extinction.

(6. Every person is bound to exercise his civil rights in good faith.

7. No right may be exercised with the intent of injuring another or in an excessive and unreasonable manner which is contrary to the requirements of good faith.

1375. The parties shall conduct themselves in good faith both at the time the obligation is created and at the time it is performed or extinguished.)[23]

It should be noted that in 1991 Quebec updated and revised the original *Code civil du Bas Canada* that was originally adopted in 1865. These provisions were added at this time. The new Civil Code came into effect in 1994.

Germany updated portions of the BGB in 2002 and at that time incorporated the doctrine of *culpa in contrahendo* as enunciated by von Jhering almost 150 years earlier. The relevant provisions are:

§ 241(2) Das Schuldverhältnis kann nach seinem Inhalt jeden Teil zur Rücksicht auf der Rechte, Rechtsgüter und Interessen des anderen Teils verpflicten.

(An obligation may require each party to have regard to the other party's rights, legally protected interests and other interests) …

§ 311 Ein Schuldverhältnis mit Pflichten nach § 241(2) ensteht auch durch… (2) die Anbahnung eines Vertrags, bei welcher der eine Teil im Hinblick auf eine etwaige rechtsgeschäftliche Beziehung dem anderen Teil die Möglichkeit zur Einwirkung auf seine Rechte, Rechtsgüter und Interessen gewährt oder ihm diese anvertraut, …

(An obligation with duties in accordance with § 241(2) also arises as a result of…

(2)preparations undertaken with a view to creating a contractual relationship if one party permits the other party to affect his rights, legally protected interest or other interest or entrusts them to that party, …)[24]

[23] Translation from the bilingual version of the Civil Code.
[24] Translations by the author.

Neither Québec nor Germany have adopted franchise disclosure legislation, yet courts in both countries have found that a franchisor has an obligation to disclose material facts during negotiations based on these provisions.

In *Cadieux c. St-A. PhotoCorporation*,[25] in the Québec Superior Court stated:

> La bonne foi est le fondement de toute relation contractuelle. Elle doit gouverner la conduite des parties…La réticence ou l'omission de lui révéler la réalité entournant le studio a vicié le consentement donné: ce motif justifie l'annulation du contract de franchise et le remboursement des sommes versées.
>
> (Good faith is the basis of all contractual relations. It should govern the conduct of the parties…The hesitation or omission of the defendant [franchisor] to reveal the reality regarding the studio vitiated the consent given: this justifies the annulment of the franchise agreement and the reimbursement of payments made.)[26]

But not everything must be disclosed. In *Les Investissements Stanislas et Patricia Bricka Inc. c. Groupe CDREM Inc.* [27] a franchisee brought an action for failing to disclose certain aspects with respect to the financial statements of a corporately-owned location that was being sold to the franchisee. However the evidence was clear that the franchisee had chosen not to ask for the information. He had asked for other information, and it had been properly provided to him. The court said:

> La lecture des témoignages me confirme cependant que l'absence de divulgation ne reléve pas du dol mais du choix qu'ont fait appelants. Ils n'ont posé la question, estimant que les informations qu'ils avaient en main luer suffisaient. De fait, toutes les données étaient disponibles dès avant a conclusion des contracts.
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> (Reading the testimony confirmed to me however that the absence of disclosure does not arise out of willful misrepresentation but from the choice made by the appellants. They did not ask the question, thinking that the information that they had in hand was sufficient for them. In effect, they had all the data available before the conclusion of the agreement.)[28]

In Germany there have been a number of cases requiring a franchisor to disclose all material facts. In a recent case the Landgericht (State Court) Kaiserslautern said:

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[25] Cour supérieure, 9 avril 1997.
[26] Translation by the author.
[27] Cour d'appel du Québec, 23 juillet 2001.
[28] Translation by the author.

> Die Klägerin hat aus dem Gesichtspunkt der *culpa in contrahendo* wegen Verletzung vorvertraglicher Aufklärungs- und Informations- pflichten einen Anspruch gegen die Beklagte auf Schadensersatz. Der Franchisegeber hat bei Verhandlungen über den Abschluss eines Vertrages die Verpflichtung, den anderen Teil über Umstände aufzuklären, die zur Vereitelung des Vertrages zweckgeeignet sind und für die Entschließung des anderen Teils von wesentlicher Bedeutung sind (vgl. OLG Rostock 1996, 13 ff. m. w. N.). Zu solchen Umständen gehören, ohne dass es weiterer Begründung bedarf, insbesondere Angaben über die Gewinnerwartung und Rentabilitätsberechnung.[29]
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> (The Plaintiff has a claim against the Defendant based on the doctrine of *culpa in contrahendo* because of its breach of its pre-contractual duty to provide education and information, which breach 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 include particularly, without further justification, information regarding expected profits and financial feasibility.)[30]

In summary, China's Franchise Measures are quite unlike the FTC Franchise Disclosure Rule or other franchise laws used in the United States. The FTC Franchise Disclosure Rule is considered to be the complete law on the matter. Although The Franchise Disclosure Rule was enacted under the authority of the *Federal Trade Commission Act*[31] which prohibits "unfair or deceptive acts in or affecting commerce," the general principle of this law is not usually applied to assist in interpreting the Franchise Disclosure Rule.

In contrast China is a civil law jurisdiction and the requirements in the Franchise Measures regarding disclosure are simply a clarification of the general principle regarding pre-contractual negotiations as set out in Article 42 of the Contract Law. In this regard it is very similar to modern civil code contractual principles in Western jurisdictions. This will be seen more clearly when the actual list of types of information to be disclosed is examined.

2. Information to be Disclosed

There is no specified disclosure format, but Article 19 of the Measures sets out basic information that must be disclosed, as follows:

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[29] Aktenzeichen 4 O 607/00, 26 Mai 2004. In Germany the names of the parties are not disclosed, even when it may be obvious from the text who the parties are.
[30] Translation by the author.
[31] 15 U.S.C. § 45 (a)(1). Section 5 of which provides "Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful."

第十九条 特许人披露的基本信息资料应当包括以下内容：

（一）特许人的名称、住所、注册资本、经营范围、从事特许经营的年限等主要事项，以及经会计师事务所审计的财务报告内容和纳税等基本情况；

（二）被特许人的数量、分布地点、经营情况以及特许经营网点投资预算表等，解除特许经营合同的被特许人占被特许人总数比例；

（三）商标的注册、许可使用和诉讼情况；商号、经营模式等其他经营资源的有关情况；

（四）特许经营费的种类、金额、收取方法及保证金返还方式；

（五）最近五年内所有涉及诉讼的情况；

（六）可以为被特许人提供的各种货物供应或者服务，以及附加的条件和限制等；

（七）能够给被特许人提供培训、指导的能力证明和提供培训或指导的实际情况；

（八）法定代表人及其他主要负责人的基本情况及是否受过刑事处罚，是否曾对企业的破产负有个人责任等；

（九）特许人应被特许人要求披露的其他信息资料。

（Article 19 The basic information to be disclosed by a franchisor shall include the following:

(1) The franchisor's name, address, registered capital, scope of business, number of years engaged in franchising **and similar operating information**, audited financial statements, and information regarding tax payments and **similar financial information;**

(2) The number, location and operational results of its franchisees; initial investment for a franchised unit **and similar information**; and the proportion of the former franchisees whose franchise agreements have been terminated as against the total number of franchisees;

(3) The registration and use of its trade-marks and any litigation regarding its trade-marks; information regarding business operating resources such as trade names and operational models;

(4) The type, amount and payment method with respect to franchise fees, as well as the collection and refund of any deposit;

(5) Any litigation in which the franchisor was or is involved in the past five years;

(6) The services or goods that the franchisor can supply to the franchisee, and accompanying restrictions and conditions;

(7) The capability of the franchisor to provide training and guidance to the franchisee, and information regarding the training and guidance actually provided;

(8) Basic information regarding the legal representative and principal managerial personnel, including whether they were subject to any

criminal penalties and whether they were personally liable as the result of the insolvency of any enterprise **and similar information**;

(9) **Other disclosures requested by the franchisee**.)[32]

It should be noted that the list is not intended to be exhaustive. The list often requires the disclosure of what is best translated as "similar information." All franchise agreements are still subject to the general provisions of Article 42 of the Contract Law that require all 重要事实 (zhongyao shishi) or "key facts" to be disclosed. Franchisors should also be wary about relying on any particular English translation of the requirements, including the ones provided here. In a Chinese court the general intent of Article 42 will be more important than a nuance in the wording of a "Guanli Ban Fa" (a subordinate form of regulation).

However the current translation of the Franchise Measures that is available to most American attorneys and franchisors[33] does not translate the words "similar information." For example Article 19(2) is translated:

> number, locations, and operational results of its franchisees; initial investments of a franchised unit; and the proportion of the former franchisees whose franchises are terminated to the total number of franchisees.

An American franchise lawyer is thus likely to provide the limited disclosure based on the requirements of the FTC Franchise Disclosure Rule and to consider the meaning of these words narrowly, in a common law manner.[34]

Article 19(9) of the Franchise Measures has also not been well understood by common law franchise lawyers. A recent article has stated that "the China Regulations require franchisors to provide other information that the 'franchisee should know.' This requirement is so open ended as to be unreasonable."[35]

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[32] Translation by author. Emphasis added. In preparing this and other translations of portions of the Measures in this article the author reviewed translations by other persons, including the unofficial translation of the "Measures for the Regulation of Commercial Franchise" provided to CCH by Philip F. Zeidman, Lee J. Plave and Tao Xu of DLA Piper Rudnick Gray Cary of Washington, D.C.

[33] "Measures for the Regulation of Commercial Franchises" in CCH, *Business Franchise Guide* ¶7065, also *supra* note 32.

[34] See for example Gary R. Duvall, Paul Jones, Amy Sommers and Guanxi Zheng, "Rising Affluence and Post-WTO Reforms: Converging Trends Boost Franchising in China," paper presented at the American Bar Association Annual Meeting , Chicago, Illinois, August 7, 2005 and in particular Section D by Gary R. Duvall and Guanxi Zheng entitled "China's New Measures for the Regulation of Commercial Franchises."

[35] Christopher A. Nowak, John Pratt and Carl E. Zwisler, "International Franchising in an Unclear and Uncertain Legal Environment," in *The Fine Art of Franchise Law-29th Annual Forum on Franchising* (Chicago: ABA Forum on Franchising, October 11-13, 2006) at p. 26.

Yet this provision is simply a codification of the approach taken by the Québec Court of Appeal in *Investissements Stanislas et Patricia Bricka Inc. c. Groupe CDREM Inc.*[36] as quoted earlier in this paper. And this provision is simply an extension or clarification of the civil law requirement of pre-contractual good faith that exists in numerous civil law jurisdictions. Indeed the authors of this comment go on to discuss the requirements for disclosure in Germany and to come to the conclusion that:

> It is clear from these three franchise decisions that, even in the absence of specific franchise disclosure legislation, franchisors in Germany are required to disclose information to franchisees. The extent of such disclosure requirement is unclear but certainly relates to likely profitability based on the performance of existing franchisees and a specific analysis of the likely performance of the proposed franchised outlets.[37]

Article 18 of the Measures require that a written disclosure document and a copy of the franchise agreement shall be provided to a prospective franchisee at least twenty (20) days prior to the signing of the agreement.

3. **Remedies for Failure to Disclose**

A franchisor that fails to make the required disclosure may be subject to both an action for damages by the franchisee and an administrative fine and/or an order to comply.

Article 19 of the Measures provides that a franchisor shall compensate the franchisee for losses caused by the inadequate disclosure or misrepresentation by the franchisor.

> 由于信息披露不充分、提供虚假信息致使被特许人遭受经济损失的，特许人应当承担赔偿责任。

Article 39 of the Measures provides that for a failure to disclose the authorities that regulate commerce may make a compliance order and impose a fine of less than 30,000 Renminbi (about $3,780.00 USD). If the circumstances are serious enough to warrant it, the case shall be referred to the Administration for Industry and Commerce for revocation of the business license of the franchisor.

> 第三十九条 未按本办法规定进行信息披露的，由商务主管部门责令改正，并处以 3 万元以下罚款；情节严重的，提请工商行政管理机关吊销营业执照。

One of the first cases regarding a failure to disclose illustrates the liability of a franchisor in a Chinese court. In 黄海燕 (Huang Haiyan) v. 北京汉森 美容有限公司 (Beijing

[36] *Supra* note 27.
[37] *Supra* note 35 at p.15.

Hansen Cosmetology Limited Co.) decided in Beijing on November 16, 2005[38] the plaintiff, a thirty-two year old woman, entered into the franchise agreement on January 2, 2005. She paid a deposit of 30,000.00 Yuan (Renminbi) and a franchise fee of 150,000.00 Yuan (about $3,750.00 USD and $18,700.00 USD respectively) to set up a cosmetics service for men in Chengdu, a large city in Sichuan Province in southwest China. Soon after the franchisee discovered that the trademark to be used was not actually registered, that it was not an international brand as represented and that there were problems with the supply of product that had not been disclosed.

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:

> 该信息披露义务的要旨在于使加盟商能够在掌握了各种信息的程度上作出正确的判断，是决定加盟商能否客观认 识特许经营权及能否公平交易的基础。信息披露的目的在于防止欺诈、促进公众的整体利益和促进投资分析。因此，在特许经营中，特许人违反信息披露义务，也构 成欺诈。(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 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.)[39]

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

Article 54 provides as follows:

> 第五十四条　下列合同，当事人一方有权请求人民法院或者仲裁机构变更或者撤销：
>
> （一）因重大误解订立的；
>
> （二）在订立合同时显失公平的。
>
> 一方以欺诈、胁迫的手段或者乘人之危，使对方在违背真实意思的情况下订立的合同，受损害方有权请求人民法院或者仲裁机构变更或者撤销。当事人请求变更的，人民法院或者仲裁机构不得撤销。

[38] 北京朝阳 区人民法院 (Beijing Chaoyang District People's Court) （2005）朝民初字第 24486 号 (File No.).
[39] Translation by author.

(Article 54 Either party has the right to request a people's court or an arbitration institution to alter or rescind any of the following contracts:

(1) any contract which is made under substantial misunderstanding; or
(2) any contract the making of which lacks fairness.

Where a party makes a the other party enter into a contract against its true will by means of deceit, coercion or taking advantage of its difficulties, the injured party has the right to request a people's court or arbitration institution to alter or rescind the contract. Where the request of the party is an alteration of the contract, the people's court of arbitration institution shall not rescind it.)[40]

Article 58 provides among other things that when a contract becomes invalid or is rescinded any property obtained under the contract shall be returned.

4. **Financial Information Regarding Performance**

There is a debate amongst foreign lawyers[41] as to whether a franchisor in China is required to disclose financial information about the performance of the franchisees, or what in the U.S. is known as 'earnings claim information.' There are no restrictions on the provision of such information.

The debate centers on the interpretation of Article 19(2) of the Measures, as described above. Franchisors are required to disclose "被特许人的数量、分布地点、经营情况 … (franchisees' number, location and operational results …). The phrase "经营情况" (jingying qingkuang) may be translated in a number of ways, including "operational circumstances," "operational situation," or "operational status." A Google search of the four character phrase will reveal that it is used to refer to both financial and non-financial information, but it usually refers to more than simply whether the unit is operating or not.

In such a case a Chinese court may therefore look to the general intent of the Measures and Article 42 of the Contract Law. The question would then be whether in all the circumstances of the proposed sale of the franchise was the financial information about the performance of the franchisees a "重要事实" (zhongyao shishi – translated in Art, 42(2) of the Contract Law as 'key fact') that cannot be concealed. Another common translation for this phrase is "material fact."

C. Relationship Laws

The Measures contain a number of provisions intended to govern the relationship between the parties after the purchase by the franchisee.

[40] Translation from the bilingual edition, *supra* note 2.
[41] See Duvall *et al., supra* note 34.

In keeping with the provisions of Article 4 of the General Principles of the Civil Law of the People's Republic of China[42] and Articles 6 and 60 of the Contract Law, Article 5 of the Measures provides that:

> 第五条 开展特许经营应当遵守中华人民共和国的法律、法规，遵循自愿、公平、诚实、信用的原则，不得损害消费者合法权益。特许人不得假借特许经营的名义，非法从事传销活动。特许人以特许经营方式从事商业活动不得导致市场垄断、妨碍公平竞争。 (Article 5 Franchise operations shall be conducted in accordance with the laws and regulations of the People's Republic of China and in accordance with the principles of free will, fair dealing, good faith. Consumers' legitimate interests shall not be harmed. A franchisor shall not engage in illegal direct marketing activities [pyramid selling] under the pretense of franchising. A franchisor engaging in commercial activities through franchising shall not cause market monopoly or impede fair competition.)[43]

With respect to the franchise agreement, Article 15 of the Measures provides for minimum term of three years. It then goes on to state that upon the expiration of the agreement the franchisor and franchisee can negotiate the terms for renewal of the franchise agreement based on the principles of fair dealing and reasonableness.

Articles 9 - 10, and 11 – 12, set out the rights and obligations of the franchisor and franchisee respectively. Article 9(2) specifically provides that the franchisor has the right to terminate the franchise in accordance with the franchise agreement for breach of contract, infringing legitimate rights and interests of the franchisor, or damages the caused by the franchisee to the franchise system. Article 16 specifically provides that upon termination the franchisee must cease using the franchisor's trade-marks and similar indicia.

Among the other rights and obligations of the parties are the obligation of the franchisor to be liable for the goods supplied by its designated suppliers and to provide promotional, advertising and to provide guidance and training. The franchisor can only require a franchisee to purchase proprietary goods and such goods as are necessary to ensure the quality of the franchise operations from itself or a designated supplier.

D. Qualifications Required of a Franchisor

In addition to the above requirements foreign franchisors considering entry into the Chinese market should pay particular attention to Article 7 of the Measures which sets out the qualifications required to be a franchisor, as follows:

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[42] 中华人民共和国民法通则（Zhonghua Renmin Gongheguo Minfa Tongze）, adopted at the Fourth session of the Sixth National People's Congress on April 12, 1986.
[43] Translation by author.

第七条 特许人应当具备下列条件：

（一）依法设立的企业或者其他经济组织；

（二）拥有有权许可他人使用的商标、商号和经营模式等经营资源；

（三）具备向被特许人提供长期经营指导和培训服务的能力；

（四）在中国境内拥有至少两家经营一年以上的直营店或者由其子公司、控股公司建立的直营店；

（五）需特许人提供货物供应的特许经营，特许人应当具有稳定的、能够保证品质的货物供应系统，并能提供相关的服务。

（六）具有良好信誉，无以特许经营方式从事欺诈活动的记录。

(Article 7 A franchisor shall have the following qualifications:

(1) be an enterprise or other economic entity duly organized under the laws and regulations;
(2) have the rights to a trade-mark, trade-name, business format and other business resources and have the right to license others to use them;
(3) be capable of providing long-term business guidance and training services to franchisees;
(4) have had at least two units owned by itself or its subsidiary or holding companies in operation in China for more than one year.
(5) if the franchisor is required to supply goods to the franchisee, have a supply system that is stable and can guarantee quality, as well be capable of providing related services; and
(6) have a good reputation, without any record of using franchising to commit fraud.)[44]

Cases where the franchise agreement is held to be invalid because of the franchisor lacked the necessary qualifications are currently more common than cases ordering rescission for failure to disclose. While foreign commentators have focused on the barrier to entry posed by the requirement to have operated two locations in China for at least a year, Chinese commentators have focused on whether the foreign franchisor is duly organized under China's laws and regulations to offer franchises.

In China there are restrictions on foreign investors as to the types of industries that they can enter. Previously the distribution sector was restricted and foreign invested enterprises were not allowed to enter a sector where China considered its domestic players to be weak. Until December 11, 2004 franchising was restricted to domestic enterprises.

[44] Translation by author.

This restriction was key to the decision in 韩美艳 (Han Mei Yan) v. 北京印气巴谊印气健美有限公司 (Beijing Yinqi Bayi Yinqi Jianmei Limited).[45] The plaintiff franchisee entered into a franchise agreement with the defendant on July 2, 2004 to operate a cosmetics store under their brand and paid the initial fee of 100,000 Yuan (about $12, 485.00 USD), and agreed to pay a further 641,250 Yuan (about $80,063.00 USD) for equipment later in two installments. When the further payments were not made, the lawyer for the franchisor defendant sent the plaintiff a letter terminating the contract for non-payment and advising that the initial payment already made would be retained.

The franchisor defendant was incorporated on February 18, 2003 as a wholly foreign-owned enterprise[46] ("WFOE") to operate a business in the health sector providing cosmetology services, and to provide skill training and management services. The trade-mark was not registered until March 28, 2005. But at the time of the decision it still did not have the approval of the authorities to be engaged in franchising. As was mentioned earlier franchising was not even opened to WFOEs until December 11, 2004.[47]

As the Court in this case stated:

> 根据国务院《指导外商投资方向规定》及其批准的《外商投资产业指导目录》，特许经营属于中国逐步开放的产业，列为限制类外 商投资项目，并明确于 2004 年 12 月 11 日后允许外商投资。也就是说，在 2004 年 12 月 11 日之前，国家不允许外商投资企业以特许经营方式从事商业活 动。(According to the "Regulations regarding Foreign Entity Investment in Industry" of the State Council and the "Catalogue Guiding Foreign Investment in Industry," franchising is one of the industries that China gradually opens up, and it was listed as 'restricted.' It is clear that foreign investment is permitted after December 11, 2004. In other words, before December 11, 2004 China did not permit foreign invested entities to be engaged in franchising.)[48]

Accordingly the Court found that the franchisor had violated these requirements. Based on Article 52(5) of the Contract Law[49] and Article 10 of the Interpretations of the Supreme People's Court of Certain Issues concerning the Application of the Contract

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[45] 北京市朝阳区人民法院 (Beijing Chaoyang District People's Court) No. 5967, August 16, 2005, available at: http://www.lawyer3721.net/index.php3?file=detail.php3&kdir=1657 .

[46] The decision describes the enterprise as a 外商独资经营 or "foreign sole-ownership management" enterprise rather than "外资企业" or "wholly foreign-owned Enterprise."

[47] See 外商投资商业领域管理办法 (Waishang Touzi Lingyu Guanli Ban Fa – Administrative Measures on Foreign Investment in Commercial Sectors), approved April 16, 2004, Ministry of Commerce Regulation No. 8, 2004. This was to fulfill part of China's commitment to remove restrictions on entry to markets within three years of entry into the WTO. The third anniversary of such entry was December 11, 2004.

[48] Translation by author

[49] *Supra* note 21. 第五十二条　有下列情形之一的，合同无效：….（五）违反法律、行政法规的强制性规定。(Article 52 A contract is invalid under any of the following circumstances: … (5) mandatory provisions of laws and administrative regulations are violated).

Law[50] the franchise agreement was held invalid and the money was ordered returned to the plaintiff franchisee.

A lawyer in Beijing[51] had predicted in 2005 that the courts would find that WFOEs could not legally be engaged in franchising in China until after December 11, 2004,[52] as the court found in this case. His articles on this topic have been posted in several places on the internet. He identifies this case as the first decision on this issue.[53]

More recently he has gone further and suggested that a foreign franchisor awarding a master franchise directly to a Chinese registered corporation, without going through a foreign invested enterprise ("FIE"), may be in breach of the Measures as well as the laws regulating foreign investment.[54] His reasoning is that if the foreign investment laws previously restricted foreign investment in franchising, as the Beijing Chaoyang District People's Court has found, then it is illegal to now do so other than through an FIE that complies with the laws and regulations. In other words foreign investment laws and regulations should govern whether or not the grant of a master franchise to a Chinese corporation constitutes a foreign investment.

Articles 32 to 37 of the Measures do set out special rules for foreign invested enterprises. Article 33 provides in part that:

> 第三十三条 外商投资企业以特许经营方式从事商业活动的，应向原审批部门提出申请增加"以特许经营方式从事商业活动"的经营范围，… (Article 33 In order for a foreign-invested enterprise to carry on business through franchising, it shall apply to the original approval authority to have the business scope expanded by adding "conducting business activities by means of franchising," …)[55]

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[50]最高人民法院关于适用《中华人民共和国合同法》若干问题的解释（一）（中英文对照） (Interpretations The Supreme People's Court of Certain Issues concerning The Application of The Contract Law of The People's Republic of China (Part One) adopted at the 1090th Session of the Adjudication Committee of the Supreme People's Court on December 1, 1999, and effective as of December 29,1999): 第十条 当事人超越经营范围订立合同，人民法院不因此认定合同无效。但违反国家限制经营、特许经营以及法律, 行政法规禁止经营规定的除外。(Article 10 Where the parties entered into a contract the subject matter of which was outside their scope of business, the People's Court shall not invalidate the contract on such ground, except where conclusion of the contract was in violation of state restriction concerning, or licensing requirement for, a particular business sector, or in violation of any law or administrative regulation prohibiting the parties from participation in a particular business sector).

[51] 林晓， 北京博融律师事务所 (Lin Xiao, Bejing Borong Law Office).

[52] See 林晓，"特许连锁系统的崩溃——当前特许经营合同无效化的危机," (Lin Xiao, Franchise Systems Collapse – The Crisis Arising out of the Invalidity of Current Franchise Agreements) available on line at http://www.law-lib.com/lw/lw_view.asp?n0=4107 .

[53] 林晓，"述评：外资违法违规从事特许经营第一案判决 " (Commentary: First Decision Holding a WFOE Engaging in Franchising to Be Illegal) available at: http://www.law-lib.com/lw/lw_view.asp?n0=5818 .

[54] 林晓，当前国际特许面临的法律问题，(Lin Xiao, Current International Franchise Practices Face Legal Test) available at: http://www.law-lib.com/lw/lw_view.asp?no=5861 .

[55] Translation by author.

Notwithstanding this wording not all Chinese lawyers agree that a foreign franchisor may only enter into a master franchise agreement with a Chinese master franchisee by setting up a foreign-invested enterprise in China. The question is currently best described as unresolved.

D. Conclusion

From a legal perspective, franchising in China should not be any more difficult than franchising in Germany or Québec. Aside from concerns about the regulation of foreign investment, the general principles of the legal systems, particularly as applied to franchising are very similar. Disclosure must be made of all material facts.

The Chinese court system is also becoming increasingly transparent. It is now easier to obtain copies of the decisions of Chinese courts in the major cities than it is to obtain copies of the equivalent decisions in Germany or France.

As a country making a very fast transition to a market economy China does have special policy considerations, such as consumer protection or foreign investment, that do give rise to special policy considerations in Chinese law. But generally the barriers to entry for franchisors are less that are perceived by many common law lawyers.