The impact of China's regulatory regime on foreign franchisors' entry and expansion strategies

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Since the Open Door reforms adopted by China in 1978 ended 30 years of isolation, introduced massive economic and legal reforms, encouraged foreign investment and resurrected private enterprise, China has become the world’s third largest and fastest growing economy. Under the influence of China’s WTO accession commitments, China’s markets are increasingly open for foreign investment. These developments, and China’s 1.3 billion population and stable political environment, have led to China becoming an increasingly attractive market for foreign franchise systems.

In China, as in other countries, the law has played a significant role in improving the environment for franchising. But in China, a country where franchising as a business concept was virtually unknown until the 1990s, the law has had a more fundamental role through creating the environment in which franchising was possible. Until the 1997 Interim Franchise Measures recognised franchising as a legitimate method of domestic business operation, franchising was not possible. Until WTO accession commitments led to market liberalisation reforms in 2004 the development of a franchise network by a foreign franchisor was of doubtful validity. Until the 2007 Franchise Regulation provided a unified regulatory regime for domestic and foreign franchisors under which contractual and proprietary rights are recognised and protected the franchising option has been seriously curtailed.

This thesis examines the impact of the law, and law reform primarily WTO induced, on the development of franchising in China from the perspective of the foreign franchisor. It concludes that foreign franchisors’ entry and expansion strategies in China reflect not only cultural, commercial and other environmental considerations which influence any international franchising decision, but also a regulatory regime which has both created and constrained opportunities. The thesis traces the development of the regulatory regime for foreign franchisors and makes recommendations for its further refinement including legislative clarity as to the validity of cross border franchising into China through master franchising and area development agreements.
The Impact of China's Regulatory Regime on Foreign Franchisors' Entry and Expansion Strategies

Zhiqiong June Wang

A thesis submitted in partial fulfillment of the requirements for the Degree of Doctor of Philosophy at the University of New South Wales

Research undertaken in the School of Business Law and Taxation in the Australian School of Business at the University of New South Wales

2009
Originality Statement

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Zhiqiong June Wang

30 August 2009
ABSTRACT

Since the Open Door reforms adopted by China in 1978 ended 30 years of isolation, introduced massive economic and legal reforms, encouraged foreign investment and resurrected private enterprise, China has become the world's third largest and fastest growing economy. Under the influence of China's WTO accession commitments, China's markets are increasingly open for foreign investment. These developments, and China's 1.3 billion population and stable political environment, have led to China becoming an increasingly attractive market for foreign franchise systems.

In China, as in other countries, the law has played a significant role in improving the environment for franchising. But in China, a country where franchising as a business concept was virtually unknown until the 1990s, the law has had a more fundamental role through creating the environment in which franchising was possible. Until the 1997 Interim Franchise Measures recognised franchising as a legitimate method of domestic business operation, franchising was not possible. Until WTO accession commitments led to market liberalisation reforms in 2004 the development of a franchise network by a foreign franchisor was of doubtful validity. Until the 2007 Franchise Regulation provided a unified regulatory regime for domestic and foreign franchisors under which contractual and proprietary rights are recognised and protected the franchising option has been seriously curtailed.

This thesis examines the impact of the law, and law reform primarily WTO induced, on the development of franchising in China from the perspective of the foreign franchisor. It concludes that foreign franchisors' entry and expansion strategies in China reflect not only cultural, commercial and other environmental considerations which influence any international franchising decision, but also a regulatory regime which has both created and constrained opportunities. The thesis traces the development of the regulatory regime for foreign franchisors and makes recommendations for its further refinement including legislative clarity as to the validity of cross border franchising into China through master franchising and area development agreements.
LIST OF PUBLICATIONS

Book Chapter

Report to Ministry of Commerce, China

Refereed Journal Articles


Refereed Conference Papers (Published in Proceedings)


Andrew Terry & Zhiqiong June Wang, 'Franchising in the New China: the Regulatory

Other Publications


Chapter 7 of this thesis draws on material that has been published as ‘China’s Long March to a Franchise Law: the 2007 Franchise Regulation’ [2007] LawAsia Journal.


The researcher was the primary author of these three papers.

All other co-authored papers referred in the thesis have been referenced.
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LIST OF ABBREVIATIONS

CCFA China Chain Store and Franchise Association
CCHIC China Chamber of International Commerce
CCPIT China Council for the Promotion of International Trade
CIETAC China International Economic and Trade Arbitration Commission
CJV Cooperative joint venture (contractual joint venture)
CMAC China Maritime Arbitration Commission
CPC Communist Party of China
CPPCC Chinese People’s Political Consultative Conference
EJV Equity joint venture
FDI Foreign direct investment
FIE Foreign Invested Enterprises or Foreign Investment Enterprises
GATT General Agreement on Tariffs and Trade
GDP Gross Domestic Product
GMD Guomindang, Kuomintang, the Nationalist Party
HCRS Household Contract Responsibility System
IP Intellectual property
JV Joint venture
MOFTEC Ministry of Foreign Trade and Economic Cooperation
MOFERT Ministry of Foreign Economic Relations and Trade
MOFCOM Ministry of Commerce
NDRP National Development and Reform Commission
NPC National People’s Congress
PRC People’s Republic of China
RMB Renminbi
SAIC State Administration for Industry and Commerce
SETC State Economic and Trade Commission
SPC State Planning Commission
SDPC State Development and Planning Commission
TRIMS Agreement on Trade-Related Investment Measures
TRIPS Agreement on Trade-Related Aspects of Intellectual Property Rights
WFOE Wholly Foreign Owned Enterprise
WTO World Trade Organisation
PART ONE

INTRODUCTION AND BACKGROUND

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INTRODUCTION

1.1 RESEARCH BACKGROUND

1.1.1 Franchising Development in China

In the late 1940s when Dick and Mac McDonald (McDonald’s) and Harland Sanders (KFC), and other franchising pioneers were refining their concepts which would within a few years revolutionise the distribution of goods and services, China was preparing for a quite different revolution. The establishment of the People’s Republic of China as a new communist country on 1 October 1949 was to have a profound effect not only on its citizens but also on global commerce. It was not until the Open Door policy in 1978 ended three decades of isolation and re-engaged China with the outside world, that the sweeping economic reforms created an environment in which franchising could be practised.

The decision by Deng Xiaoping in 1978 to open the Chinese economy after 30 years of isolation and to move from a command economy to a “socialist market economy” signalled the start of what has been described as “one of the greatest industrial revolutions in world history”.

Since China’s re-engagement with the international community and commencement of a massive economic reform program, its economic development has been remarkable. With its rapid economic growth and the increasing wealth of its 1.3 billion people, China is potentially the largest consumer market in the world. These factors, in combination with a relatively stable political environment, have made China one of the world’s most popular destinations for foreign direct investment (FDI). The economic reforms have been accompanied by significant law reforms to

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provide the legal framework to accommodate the needs of commercial activity in this new environment.

Franchising, a business concept invented by US entrepreneurs, has thrived in China since the early stage of its opening up. Commercial franchising was developed by US companies such as Singer Sewing Machine Company in the mid-nineteenth century who offered territorial supply agreements to branded dealers to sell and service their products. Modern variations on these exclusive branded distributorship arrangements, today called product distribution franchising or product and trade name franchising, exist today in sectors such as new motor vehicle dealerships and soft drink bottling. Contemporary franchising globally is nevertheless dominated by business format franchising which developed in the US in the 1950s. It differs from product and trade name franchising through the imposition of a business format and an entire management system for conducting a business resulting in standardisation, consistency and uniformity across all aspects of the business. Business format franchising has “transformed franchising from a specialized marketing technique into a highly competitive, innovative vehicle for expansion of retail and service industries” which offers substantial benefits to both franchisor and franchisee.

US franchising companies started to expand offshore from the late 1960s, first to developed countries and later to developing countries. Today, franchising is practised in most industry sectors in most countries. Until the franchise pioneers KFC and

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McDonald's commenced operations in China in the late 1980s and early 1990s, there was no word for "franchise" in the Chinese language. However it has developed rapidly since 1997 when the Chinese government issued the first franchising measures which provided a basic framework for the operation of franchising in China. The measures signalled government support for the franchising concept and encouraged its adoption by Chinese business enterprises. By the end of 2007, with 2,600 franchise systems (according to CCFA statistics), China is the most franchised country in the world in terms of system numbers, although the scale of operations is still very limited from both per capita and percentage of GDP perspectives. (Franchising accounts for only 3 percent of China's retail sales compared to 40 percent in US.) Systems average 43 outlets compared to 540 outlets in the US.

1.1.2 The Role of Franchise Regulation in China

The Organisation for Economic Co-operation and Development (OECD) has noted that:

Entrepreneurship and business activities are shaped not only by markets, but also by regulatory and administrative environments established by governments.

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4 KFC entered into China with its first store opened in Beijing in 1987 and McDonald's entered into China with its first store opened in Shenzhen 1990. See further discussion in Chapters 8 and 9.

5 The China Chain Store and Franchise Association (CCFA) statistics are not independently audited and might be inflated by the inclusion of non-franchised chain operations and very basic product and trade name systems which are not usually included in franchising statistics. After introducing the mandatory filing system by the 2007 Franchise Regulation which leads to more accurate statistics, 1147 enterprises had registration with the Ministry of Commerce or its provincial offices by 7 July 2009. See detail in Chapter 8.


Franchising in China is a case study which clearly illustrates this proposition. The legal and regulatory reforms over the last decade (discussed in Chapters 4, 5, 6 and 7) have provided the necessary foundation on which the franchise sector has been built and without which the development of franchising would not have been possible. The economic reforms following the adoption of the Open Door policy\(^9\) created the environment in which franchising was possible. The law reforms allowing private enterprise and liberalising foreign investment provided the platform to facilitate the development of domestic and foreign franchising. The introduction of a specific regulation regime for franchising which both recognised franchising as a valid business strategy and regulated its operation was a necessary requisite. China’s WTO accession commitments,\(^10\) and obligations to open retail, services and franchise sectors to foreign competition,\(^11\) coupled with stronger intellectual property protection under the TRIPS Agreement\(^12\) have had a profound influence on the development of franchising in an increasingly open and flexible economy.

Franchise regulation in China – and in developing and transitional economies generally – raises issues which every domestic franchise sector must face: how to balance entrepreneurship with protection of the franchisee arising out of the information and power imbalances inherent in the typical franchisor-franchisee relationship. In developing and transitional economies there are nevertheless additional considerations which arise from the challenges of evolving legal systems

\(^9\) At the Third Plenary Session of the Eleventh CPC Central Committee convened in December 1978, under the new leadership of Deng Xiaoping, the Chinese central government made a strategic decision to focus on socialist modernization and revitalization of the domestic economy and opening up to the outside world. It is discussed in Chapter 2.4.1.

\(^10\) WTO, World Trade Organisation, is the most influential international organisation dealing with the rules of trade between nations. It currently has 153 members. On 11 July 1986, China formally applied to resume its membership of the General Agreement on Tariffs and Trade (GATT). In November 2001 China was finally admitted to the WTO (the successor to GATT), 51 years after withdrawing from the then international trade system.

\(^11\) China’s commitments on opening the distribution sector is included in the Part II - Schedule of Specific Commitment on Services, the Report of the Working Party on the Accession of China (WT/ACC/CHN/49/Add.2), WTO, 1 October 2001 which is a part of the Appendix of the Report of the Working Party on the Accession of China WT/MIN (01) 3 WTO, 10 November 2001.

\(^12\) The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement) is Annex 1C of the Marrakesh Agreement Establishing the World Trade Organization, signed in Marrakesh, Morocco on 15 April 1994.
and the accommodation of new methods of business operation. Terry has commented that the subjecting of an embryonic franchise sector to the straightjacket of regulation can be criticised for risking the entrepreneurial development for franchising. There was for example, wide criticism of franchise specific regulation in Russia which was introduced in advance of any viable franchise sector. Its critics nevertheless acknowledge that:

In regulating this ‘new’ form of doing business, the drafters saw an opportunity to educate the public on the nature of franchising. Where in western Europe franchising developed gradually after its introduction from the United States and functions without or with minimal regulation, the drafters felt the need to...provide potential franchisors and franchisees guidance when negotiating the substantial terms and conditions of the franchise agreement, and thus encourage its development in the country.

Russia’s new Civil Code gives entrepreneurs, yet unaccustomed to franchising, a guiding model of franchise transactions in an effort to promote this form of distribution and marketing of products in the country. Educating entrepreneurs is a chief reason for introducing a specific chapter on franchising.

These considerations have undoubtedly been prominent in the introduction of franchising regulation in the 1990s in Asian countries when franchising was in its infancy. In the initial regulatory instruments of China, Korea and Indonesia such objectives feature prominently – ‘standardising franchise operations’ and promoting the growth of ‘chain business’ (China), ‘promoting balanced and mutually complementary development’ (Korea), ‘creating orderliness’ in franchising, ‘providing business and legal certainty’, ‘nurturing and developing franchises’ (Indonesia). Vietnam, which introduced its first Franchise Law in 2006, provides

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15 Corina Wissel, id. In Brazil, prior disclosure legislation is credited with playing an important role for the improvement of franchise systems: Business Franchise Guide CCH para [7435].
another example. Although the *doi moi* economic reforms which commenced in 1986 led to a market environment in which franchising could operate, the development of the franchise sector was constrained by the lack of a clear legal framework. Until the introduction of the new regulatory regime, franchising was not recognised as a discrete business relationship and, in a country where the general rule is that anything not specifically permitted is not allowed, franchise development was not practicable. It has been suggested that:

> Without a legal frame of reference Vietnamese authorities simply consider a franchise agreement as a trademark licence, technology transfer contract, and/or service agreement. Such agreements will therefore be subject to different regulations under [then] current Vietnamese law.

Instead of entering the sector through a franchise agreement, an intending franchisor entered through one or several other contracts which was like "hammering a square peg into a round hole" discouraging both potential domestic and foreign franchisors.

The Chinese experience is similar and the development of franchising is inextricably associated with the introduction of a legal regime to recognise and support franchising. Franchising is as much a creation of the law as it is of business.

Reference is made in Chapter 7 to the November 1997 *Measures on the Administration of Commercial Franchise Operations (Trial Implementation)*, issued by the Ministry of Internal Trade, which created the first regulatory framework for franchising in China. The *Franchise Measures* were established to "standardise framework for regulating franchising relationship which is addressed in detail in the 2006 *Decree Making Detailed Provisions for the Implementation of the Commercial Law with Respect to Franchising Activities* and the 2006 Ministry of Industry and Trade, *Circular Providing Guidelines on Procedures for Registration of Franchising Activities*.

Andrew Terry, ibid.


Giles Cooper, op cit note 18.
franchising activities, to protect the legal interests of the franchisor and the franchisee and to promote the development of chain operations” (Article 3). While in some, perhaps most, national franchise sectors regulation may be regarded as an unwelcome, albeit increasingly common, intrusion into the free enterprise system, in China the introduction of a rudimentary franchise law in 1997 was a significant and necessary step in the development of franchising. Legal uncertainty is a particular problem in China and a framework for franchising was both necessary and welcome. In the Chinese system, in which business activity is generally prohibited unless it is expressly authorised, the introduction of the Franchise Measures was a significant development. Although franchising commenced in China a decade earlier its sustained development was closely linked to the introduction of a regulatory framework.

From a Western perspective the Franchise Measures were not particularly sophisticated. In effect they described how franchising works rather than setting out a comprehensive regulatory regime for franchising. The Measures were written more as a general guide to basic rights and obligations than as a detailed statement of such rights and obligations and contained no provisions dealing with their contravention. In the context of a system in which activity which is not expressly authorised is, by implication, prohibited, the Measures, despite being administrative rules of a general nature, had a significant role in the official recognition and, by implication, encouragement of franchising as a distinct method of business operation. As expressed by Philip Zeidman, “in the final analysis, it may well be that the sheer act of regulation and, in the process, the recognition of franchising, the stripping away of its ‘second class’ status – is more important than the contents themselves”.

Writing of the draft, and later abandoned, 2004 Provisional Measures on the Administration of Foreign Invested Enterprises Engaged in Commercial Franchising


22 Piper Rudnick, ‘New Franchising Regulations Go into Effect in China’, (2005) March, Franchising World, 40. These comments were made in relation to the 2004 Franchise Measures but are equally applicable to the original 1997 Measures.
proposed to support the newly liberalised regime for foreign investment in China’s franchise sector, Piper Rudnick, a prominent US law firm in the franchise sector, explains the significance of franchise regulation in China generally:

If we step back from the [largely tolerable but obviously flawed set of requirements], we can glimpse a larger reality: this legislation may be that rare example of a law which franchisors do not oppose, but actively seek. Franchisors have historically taken the position that the only legal conditions needed for franchising to thrive are a recognition of the sanctity of contract and protection of intellectual property. China may prove to be the exception to that rule.

The Chinese market is so huge that no franchisor can afford to ignore it. The uncertainties of the Chinese legal system, and the questions hovering over the legal status of the new marketing technique called franchising, have led multinational franchisors to reconsider the historic-opposition to franchising.

For almost two decades we have heard the arguments made in socialist and post-socialist societies, “It doesn’t make any difference that we have not had any real abuses necessary to ‘justify’ a law. What matters is that franchising will never be a fully accepted way of doing business until we have a law addressing it.” For almost two decades we have scoffed at that simplistic approach. We are not scoffing any longer.\textsuperscript{23}

Despite the symbolic significance of the 1997 \textit{Interim Franchise Measures} expressed in the comment of Piper Rudnick cited above, that “franchising will never be a fully accepted way of doing business until [there is] a law addressing it”, they were simply the first stage in the law’s contribution to the development of franchising in China. The next stage was the development of a new and more comprehensive regulatory regime to accommodate the intricacies of contemporary business format arrangements and to provide the legal certainty which business demands from a regulatory system. This sentiment was clearly expressed by the President of McDonald’s Chinese operations who was reported as commenting in 2002 that “McDonald’s will begin franchising only after relevant regulations and

laws are defined in China."\textsuperscript{24} The 2007 Franchise Regulation provides the platform that McDonald's requires to commence expansion through franchising rather than through company owned and managed outlets\textsuperscript{25} which have characterised its (and KFC's) Chinese expansion to date.\textsuperscript{26}

1.2 RESEARCH SCOPE AND OBJECTIVES

Although there is wide attention and rich literature on China's recent development, there is little in-depth study of the legal and regulatory environment for the franchise sector, particularly for foreign franchisors in China. Since franchising emerged as a method for business expansion in the US in 1950s, significant research has been carried out by scholars in the US and other countries, particularly in relation to the theories developed to explain the reasons for firms embracing franchising and international franchising, and factors influencing franchising relationship.\textsuperscript{27} However, China has not featured predominately in this research. Furthermore, the legal environment for franchising development in China has yet to be analysed. The significance of this thesis lies in addressing the following gaps in the research literature:

(i) Research on foreign investment law in China has been primarily in relation to foreign direct investment generally. There is no in-depth research specifically addressing foreign direct investment, and the market liberalisation reforms which have made this possible, in the specific context of franchising.

(ii) There has been little research on the development of the legal environment and the regulatory regime which has allowed and encouraged the development of franchising in China by both domestic and foreign

\textsuperscript{24} Peter Tan, President of McDonald's China Development Co, cited in the Dai Yan, 'International Chain of firms to Expand: McDonald's Mulls over Franchise System after KFC', China Daily, 8 July 2002.
\textsuperscript{25} The legal effect of the 2007 Franchise Regulation is discussed in detail in Chapter 7.
\textsuperscript{26} See Chapter 9.
\textsuperscript{27} Major theories on franchising and international franchising are reviewed in Chapter 3.
franchisors.

(iii) Previous studies based on theories of entry mode choice have been either
general or in relation to developed countries. Entry mode choice theory in the
context of *franchising* in *China* has not been examined in any depth.

(iv) There is little literature on the strategies, vehicles and key considerations for
the expansion within China of a foreign franchisor.

This research examines how the underlying commercial law and franchise specific
legislation, together with market liberalisation reforms, have developed in China
under the influence of WTO negotiation and accession commitments. Furthermore, it
investigates the extent to which law and government policy have been key factors
contributing to a foreign franchisor's entry and expansion mode decisions in China.

The research in this thesis has five main objectives:

(i) to review and analyse the introduction of franchising as a business strategy in
China and its subsequent development;

(ii) to review, analyse and critique the legal reforms and market liberalisation
initiatives pursuant to WTO accession and commitments relevant to foreign
franchisors' market entry to, and market expansion, in China;

(iii) to examine the environmental factors, (particularly legal, political and
cultural factors) in a foreign franchisor's entry mode and expansion choice;

(iv) to analyse and critique the development of a regulatory regime for the
operation of franchise business in China by foreign franchisors;

(v) to assess the influence of the above factors on the entry and expansion mode
decisions of foreign franchisors.
1.3 THESIS STRUCTURE

This thesis is in four parts comprising 10 chapters. Part One introduces the background on which this research is built. Part Two examines the legal environment for franchising in China, covering the general commercial law, foreign investment law and franchising regulation. Part Three reviews the development of franchising in China and assesses the impact of the regulatory regime on foreign franchisors' entry to and expansion in China. Part Four summarises the research findings and outlines possibilities for future research.

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Part One consists of three chapters. The introductory chapter sets out the research
background, problems, objectives, methodology, sources, and the structure of this thesis and its research significance. Chapter 2 provides background information on China and examines the historical, cultural, political and economic environment in which franchising was introduced and has developed. Chapter 3 reviews the existing literature on franchising and its international expansion, and the determining factors relevant to a franchisor's international expansion. It explains the theoretical basis for this thesis and its development in later chapters.

Part Two comprises four chapters on the regulatory environment for franchising in China. Chapter 4 reviews the literature on China's legal system reforms to accommodate a 'socialist market economy'. Chapter 5 outlines the development of the commercial laws with most relevance to franchising, in particular contract law and intellectual property law, and their development in China under the influence of WTO accession. Chapter 6 analyses the foreign investment laws of China, in particular those imposing market entry restrictions, and their liberalisation under China's WTO accession commitments. Chapter 7 examines the development of franchising specific regulation in China from the 1997 Interim Franchise Measures to the 2007 Franchise Regulation and analyses the implications of the regulatory environment for foreign franchisors.

Two chapters in Part Three consider the development of franchising in China and the impact of environmental and legal factors on the entry and expansion decisions of foreign franchisors. Chapter 8 reviews the development of the Chinese franchise sector and the impact of environmental factors on entry and expansion strategies through the lens of the two most prominent foreign invested franchised fast food companies operating in China – KFC and McDonald's. Through a case study the following questions are examined: (i) whether Chinese laws have impacted heavily on foreign franchisors’ choice of entry model into China and expansion strategies in China; (ii) whether changes in Chinese laws and market liberalisation have resulted in franchisors’ changing their entry and expansion modes; (iii) what are the major factors influencing foreign franchisors’ strategies in China?
Part Four comprises a concluding chapter which brings together the major findings from Parts Two and Part Three, and links them to the research questions posed in Part One.

1.4 RESEARCH METHODOLOGY AND SOURCES

1.4.1 Research Methodology

The multi-disciplinary nature of this thesis has required a number of approaches for evaluating the regulatory framework governing the foreign franchisor's entry to and expansion in China and the impact of the developing regulatory framework on the foreign franchisor's strategy and operation in China.

Part Two (Chapters 4-7) is based on traditional legal research methods combined with comparative methodology, historical methodology and critical theory. Each research method has its limitations and no single method alone can serve the need for comprehensive analysis of a developing legal system in transitional China. In-depth analysis of the legal provisions, combined with comparative methodology, historical methodology and critical theory allows the most appropriate method to be applied to each specific area of the analysis. Adopting multiple approaches better explains the development of law in China since its opening up and how the laws of China compare with laws in other countries, and whether these laws comply with China's WTO commitments. Vertical and horizontal comparisons have been used where appropriate.

In Part Three (Chapters 8-9), an empirical research methodology has been used to identify foreign franchisors' attitudes to China's law reform and the extent to which the law has influenced the choice of entry and expansion strategies. A qualitative approach has been adopted as the appropriate research methodology for this research. Semi-structured interviews with senior managers of two foreign systems were conducted to obtain detailed data. Reasons for sample selection and data collection,
and analysis, are set out in Chapter 9.2.

1.4.2 Reference Sources

Primary legal sources, government policy documents, WTO reports and other published reports have been used for this thesis. Relevant laws promulgated by the National People’s Congress and its Standing Committee, State Council Regulations, and Measures adopted by various Ministries under the State Council have been accessed. China has a civil law system which means that judicial decisions are not a formal source of law. Consequently, no Chinese judicial decision has been cited as source of law. However, judicial decisions have been cited in this thesis as a reference to current developments of legal system and laws. Many of the original source documents have been translated by the author.

Under China’s legal system, provincial People’s Congresses and local People’s Congresses have power to enact laws provided they are not in conflict with laws passed by the National People’s Congress and its Standing Committee. Such laws are only considered in this thesis where appropriate and necessary.

Due to the dynamics of China’s transition period, it is necessary to decide a cut-off date at which no further legal information would be sought and/or included. The currency of this research on law is limited to 30 April 2009.

1.5 CONTRIBUTIONS

Wide attention has been paid by the business community, professionals and scholars to China’s economic and legal reform, and to the development of franchising.

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28 The legislative authority and competence are further explained in Chapter 4.


This thesis builds on the existing literature and makes the following original contributions to the body of knowledge on impact of China’s regulations on foreign franchise systems’ entry and expansion mode decisions in China in the period 1987 to 2007.

Firstly, this thesis comprehensively outlines the law governing foreign franchise systems’ entry to and expansion in China, and provides an in-depth analysis of
China’s foreign investment law and market entry restrictions and its liberalisation under the influence of the WTO. The research examines whether amendments to China’s law have complied with its WTO commitments on franchising in relation to franchising, both with and without a foreign investment vehicle.

Secondly, this research is an exploratory study on entry and expansion mode decisions by foreign franchise systems. After identifying and analysing the relevant Chinese laws, this research studies the different stages of franchising development in China and the major challenges for foreign franchisors. The research examines the attitudes of Western franchisors towards the regulatory environment for franchising in China and identifies the reasons explaining the entry and expansion modes chosen by foreign franchise systems.

Thirdly, this research is the first study on entry modes in the context of international expansion of franchise systems to China. It reveals both similarities to and differences from international franchising expansion into developed and developing countries and examines whether the existing theory applies to franchising development in China.

Finally, this research will assist international legal professionals and the franchise community to better understand the regulatory framework for franchising into and in China. It exposes some problems with the wider regulatory regime for franchising in China in relation to both entry and operation which will be helpful to the Chinese Government in considering the amendment of it. The discussion partially fills research gaps in franchising research in China in addition to providing a basis for further research and analysis into the regulatory regime.
CHAPTER TWO  
THE HISTORICAL, ECONOMIC AND CULTURAL CONTEXT FOR FRANCHISING IN CHINA

2.1 INTRODUCTION

It is widely accepted that a legal system must be assessed within its historical and cultural context.\(^1\) However, in reality, there is a general trend to assessment based on universality of Western legal forms and legal ideas due to lack of cultural understanding and consideration.\(^2\) This chapter provides the contextual background on China, and explores the political, economic and market environment since China’s Opening Up in 1978, which is essential for understanding the development of the franchise sector and its regulation.

2.2 GENERAL BACKGROUND

2.2.1 Geography

China is located in Eastern Asia, bordered by the East China Sea, Korea Bay, the Yellow Sea, and the South China Sea, and with land borders with Mongolia, Russia, North Korea, Vietnam, Laos, Myanmar, India, Bhutan, Nepal, Pakistan, Afghanistan, Tajikistan, Kyrgyzstan, Kazakhstan. With a land area of 9.6 million square kilometers,\(^3\) China is the fourth largest country by land area in the world.\(^4\) The

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\(^2\) Lubman comments that in relation to the comparative measurement of Chinese legal reforms: “Comparative legal study in general has been conspicuously unsuccessful in developing concepts that aim at cultural neutrality. Some observers generalize from Western law and are quite willing to assume the universality of Western legal forms and legal ideas regardless of the risks of cultural bias”. Stanley Lubman ‘Introduction: The Future of Chinese Law’ (1995) 14 *The China Quarterly* 9 at 9.

\(^3\) 9.6 million square-kilometers is the official figure by the PRC which includes Tibet and Taiwan. The figure by the government of China Taibei (Taipei), based in Taiwan, is 11 million square-
climate in China is extremely diverse; from tropical in the south to sub-arctic in the north.

2.2.2 History

China is an ancient civilisation. The earliest recorded human settlements in China are in the Yellow River basin and date back to 5000 BC. The written history of China dates back to the Xia Dynasty (around 2100 BC – 1675 BC).\textsuperscript{5} China experienced 24 Dynasties\textsuperscript{6} and was divided for long periods of its history. At various times, different regions were ruled by different groups and there was no dynasty ruling a unified China. While most of the dynasties were ruled by the ethnic group of Han, the Yuan dynasty was ruled by the Mongols and the Qing dynasty was ruled by the Man. China is the longest continuous civilisation in the world. For centuries, it was a leading civilisation, outpacing the rest of the world in the arts and sciences. However, in the 19th and early 20th centuries, the country was beset by civil unrest, military defeats, and foreign occupation. China lost the First Opium War (1839-1842) and the Second Opium War (1856-1860) to Britain and then the First Sino-Japanese War (1894–1895) to Japan. These defeats reflected not only the feeble military power of the Qing dynasty (1644-1912), but also the decline of China's technological and economic development towards the end of that dynasty.

A military uprising in Wuchang in October 1911 began a process which eventually

\textsuperscript{4} Whether China or the United States is the third largest country in the world by land area is related to (i) the validity of claims by the PRC on territories such as Aksai Chin and Trans-Karakoram Tract (both territories also claimed by India), and (ii) how the total size of the United States is calculated.


\textsuperscript{6} There are different views on how to divide the dynasties in Chinese history. 24 Dynasties is the most accepted view. See discussion, Mu Qian, *Chinese History Outline* (国史大纲) (1996) The Commercial Press; Shuzhi Fan, *Chinese History Brief* (国史概要) (3rd ed 2006) Fudan University Press.
ended the Qing dynasty. The revolutionaries elected Sun Zhongshan\(^7\) as the first Provisional President of the Republic of China on 1 January 1912. However, they were in a weak position militarily. In March 1912, Sun agreed to Yuan Shikai, the commander of the Beiyang Army, becoming the president. Yuan soon proclaimed himself, on 1 January 2006, as Emperor of the Chinese Empire. His attempt at being the Emperor of China was a short-lived failure but it nevertheless set back the Republican cause by many years and fractured China into a hodgepodge of squabbling warlord factions. With Yuan’s death in June 1916, China was left without any universally recognised central authority and the army quickly fragmented into forces of combating warlords.

The Japanese invasion of China in 1937\(^8\) worsened the situation. In 1945, after the end of the China-Japan war, China plunged into civil war between two major parties, the Guomindang (the GMD)\(^9\) and the Communist Party of China (the CPC). After military defeat, the GMD fled to Taiwan. The CPC proclaimed the People’s Republic of China (the PRC) on 1 October 1949 with Mao Zedong as President and Zhou Enlai as Premier.

### 2.2.3 Population and Ethnic Groups

The population of China was estimated at 1.3 billion at the end of 2007\(^10\) which represented about 20 percent of the world’s population (estimated at 6.7 billion in 2007).\(^11\) China’s urban population is 593.8 million, accounting for 44.9 percent of

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\(^7\) Sun Zhongshan, also translated as Sun Yat-Sen, was the first provisional president when the Republic of China was founded in 1912. He co-founded the Guomindang (GMD) which he later served as its first leader. He is highly regarded as the National Father of modern China and remains unique among 20\(^{th}\) century Chinese politicians for being widely revered in both Mainland China and in Taiwan.

\(^8\) Second Sino-Japan War (1937-1945) was a part of World War II.

\(^9\) Also called the Kuomintang (KMT), the Nationalist Party.


China’s total population. China is one of the most densely populated countries with a national average density of 137 persons per square kilometre. The population is nevertheless distributed very unevenly with more than 400 persons per square kilometre in the east, 200 persons per square kilometre in the centre and less than 10 persons per square kilometre in the high west. Ethnically, the Han Chinese constitute 91.59 percent of the total population. Apart from the Han, there are 55 minority ethnicities including the groups Zhuang, Uygur, Hui, Yin, Manchu, Miao, Tibetan, Mongol and Korean.

2.2.4 Language, Religion and Culture

With its 1.3 billion population, its 56 ethnic groups and its long history, China has great diversity in its cultures, religions and languages.

The official language of Mainland China is Standard Chinese (Mandarin/Putonghua) which is also one of the official languages of Hong Kong, Macau and Taiwan. Other languages spoken in China include Yue (Cantonese, one of the official languages of Hong Kong), Wu (Shanghainese), Min (including Minbei spoken mainly in Fuzhou and Minnan, also called Hokkien/Taiwanese, spoken in Xiamen and most parts of Taiwan), Xiang, Gan and Hakka. These languages are very similar in written form but vary significantly in pronunciation. Chinese always consider them dialects rather than languages. There are in addition 28 other languages spoken by minority groups which are completely different in spoken and written form.

China is a multi-religious country with five main religions, Buddhism, Taoism, Islam,

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Catholicism, and Protestantism. Taoism is native to China with a 1700 year history. Buddhism has been practised in China by different ethnic groups for more than 2000 years with Tibetan Buddhism and Pali Buddhism being most common. Today, freedom of religious belief, and the equal status and coexistence of different religions, are protected by the Constitution. However, the Chinese government has been heavily criticised in the Western media for breaching religious and human rights.

Chinese culture is deeply influenced by Confucianism philosophy (Ru jia) which stresses ethical, moral and social values. According to Confucius, the order and peace of a society can only be achieved by people adhering to virtues known as Ren (compassion, charity and kindness) Yi (righteousness) Li (good manners, politeness) Zhi (wisdom) Xin (faithfulness, fulfilling one's promises). A well-ordered society was seen as a state governed by those virtues for relationships between ruler (emperor) and minister (official), father and son, husband and wife, and elder brother and younger brother. Individuals were no more than members of a family or a social group. Such traditional cultural emphasis on collectivism, social harmony and avoidance of conflicts interacted with family, social structure and political institutions. This attitude has deeply influenced the resolution of disputes, an issue which is discussed at Chapter 4.5.

2.3 STRUCTURE

China is administratively divided into twenty-three provinces, five autonomous regions, four municipalities directly under central government and two special administrative regions. Provinces (sheng) are Anhui, Fujian, Gansu, Guangdong,
Guizhou, Hainan, Hebei, Heilongjiang, Henan, Hubei, Hunan, Jiangsu, Jiangxi, Jilin, Liaoning, Qinghai, Shanxi, Shandong, Shanxi, Sichuan, Yunnan, Zhejiang and Taiwan. The five autonomous regions (zizhiqu) are Guangxi, Nei Monggu, Ningxia, Xinjiang, Xizang (Tibet) and the four municipalities directly under the central government (zhixiashi) are Beijing, Chongqing, Shanghai and Tianjin. China also has Two Special Administrative Regions (tebiexingzhengqu): Hong Kong and Macau.

Figure 2.1 below shows the locations of provinces, autonomous regions, municipalities and Special Administrative Regions.

Figure 1 Map of China

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18 Taiwan is historically a part of China, and is recognized by the United Nations as China’s territory. However, Taiwan has different government and legal system and its situation is beyond the scope of this thesis. Taiwan is excluded in this thesis’s discussion unless otherwise specified.

19 Source: http://www.maps-of-china.net.
2.4 ECONOMIC ENVIRONMENT

2.4.1 From Isolation to the Open Door Policy

The establishment of the People's Republic of China (PRC) on 1 October 1949 was to have a profound effect not only on a country which today comprises over 20 percent of the world's population but also, and increasingly, on the very fabric of global commerce. In the closed, centrally controlled environment which prevailed in the PRC for three decades, private enterprise was a capitalist folly and anathema to the communist ideals of public ownership propounded and rigorously enforced under the leadership of Mao Zedong. It was not until the late 1970s that the Open Door policy of Deng Xiaoping ended three decades of isolation and re-engaged China with the outside world. China's economic development has experienced both smooth growth and severe setbacks since the founding of the PRC in 1949. The economic system, and its reform, can be divided into two major stages: the control system based on the Soviet Model from the establishment of the PRC until the onset of reform in 1978, and the reform stage started in 1978 which has led to the opening of trade with the outside world.\(^\text{20}\)

In the first stage (1949 - 1978), the industry governance system experienced four major periods: the central planning period (1953-1956), decentralization and the "Great Leap Forward" period (1957 - 1961), the period of readjustment (1962-1965) and the Cultural Revolution period (1966 - 1976). Each period involved a different degree of centralisation and control in the relationships between government and businesses, as well as a different emphasis between ideological/moral and economic/material principles. China first went through economic rehabilitation prior to the Cultural Revolution which resulted in a decade of social turmoil, during which China's economic development experienced its most severe setback.

During Mao's era, China was isolated from the western world. The visit by President

Nixon to China in 1972 at the invitation of Chinese Premier Zhou Enlai opened the door between China and the US. However, the Sino-US Communiqué, signed on 26 February 1972, focused on issues from previous wars (including those with Indochina (Vietnam), Korea and Taiwan), and particularly on the recognition of “one China”, rather than on trade. The Communiqué stated that “both sides view bilateral trade as another area from which mutual benefit can be derived, and agreed that economic relations based on equality and mutual benefit are in the interest of the peoples of the two countries”, and agreed to facilitate the progressive development of trade between two countries.21 A formal Sino-US diplomatic relationship, and bilateral trade, did not commence until 1979.22

The landmark event in China’s opening up and reform was the Third Plenary Session of the Eleventh Communist Party of China (CPC) Central Committee convened in December 1978. Under the new leadership of Deng Xiaoping, the Chinese central government made a strategic decision to focus on socialist modernisation and revitalisation of the domestic economy and opening up to the outside world. Deng Xiaoping’s visit to USA in early 1979 was the first made by a leader of the PRC. This visit, and the adoption of Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures23 on 1 July 1979, were significant developments for US enterprises and international companies worldwide, and started the wave of economic revitalisation which has led to China’s current economic strength.24

22 Diplomatic relations between the USA and China were established on 1 January 1979 based on the communiqué released on 15 December 1978 in Washington DC and Beijing. For reference, please see http://www.china.org.cn/english/7832.htm, last accessed 1 June 2008.
23 The Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures was adopted on 1 July 1979 at the Second Session of the Fifth National People’s Congress (NPC), and amended in accordance with the Decision on Amendment to The Law of the People’s Republic of China on Chinese-Foreign Equity Joint Ventures adopted at the Third Session of the Seventh NPC on 4 April 1990 and the 4th Session of the Standing Committee of the 9th NPC on 15 March 2001 respectively.
24 Other laws on foreign investment were adopted much later. For example, Law of the People's Republic of China on Wholly Foreign-Owned Enterprises was adopted on 12 April 1986; Law of the People's Republic of China on Chinese-foreign Cooperated Joint Venture is also translate as Law on Chinese-foreign Contractual Joint Venture, was adopted on 13 April 1988.
China first opened its southern coastal region to foreign investment in 1980. The Special Economic Zones were introduced in Guangzhou Province and Fujian Province as an experiment with policies to attract foreign investment and with the restructuring of the internal economic system to facilitate the operation of incoming foreign-funded enterprises.\textsuperscript{25}

Besides economic integration with the world community, China also sought social and political integration. It signed the \textit{International Covenant on Economic, Social and Cultural Rights} in June 1998 and the \textit{International Covenant on Civil and Political Rights} in October 1998. The Chinese government adopted a more open attitude on cultural exchanges with many countries which have taken various forms. Today, Chinese can be seen in every major university worldwide and people in China appreciate music, sports, films and television programs produced in western countries. The deepening of cultural integration has played an important role in reshaping Chinese people's living habits and customs, and has helped forge a better understanding between China and the world community.

The prolonged negotiations which culminated in China's accession to the World Trade Organisation in December 2001 have led, and will continue to lead, China to further open up and to more market liberalisation. The impact of WTO accession on market economic reform and law reform is discussed in Chapter 6.

\textsuperscript{25} On 15\textsuperscript{th} July 1979 the CPC Central Committee and the State Council jointly approved the reports submitted by Guangdong and Fujian provinces to set up four special export zones. They were renamed Special Economic Zones after the Standing Committee of the Fifth National People's Congress approved "\textit{Regulation on the Special Economic Zones (SEZ) in Guangdong Province}" on 26\textsuperscript{th} August 1980. The Standing Committee of the Fifth National People's Congress delegated legislative power, on 26 November 1981, to the Guangdong and Fujian Provincial People's Congress and their Standing Committees to draft economic regulations according to the SEZs' condition and need in accordance with the national laws, regulations and rules. The concept of SEZs has been extended to other cities.
2.4.2 The Open-door Policy and Economic Reform

2.4.2.1 Agricultural Household Contract Responsibility System

The initial economic reform started in the countryside in the late 1970s. A liberal political atmosphere which was created through the discussion on the "criteria of truth" in the second half of 1978 encouraged peasants and grass-root leaders to unofficially adopt the agricultural Household Contract Responsibility System (HCRS).

The land reform of 1950 to 1953, which involved a massive redistribution of land and property to poorer peasants, was widely welcomed at the time. However, peasants were soon assigned to 'People’s Communes' which had an average size of 4,550 households. Within these People's Communes, the peasants had no individual rights to produce or distribute agricultural products.\(^2^6\) During the Great Leap Forward (1957-1961) an attempt was made to accelerate economic development and the transition to Communism. During that period, 70 to 90 percent of peasants were driven into the communal farming and dining system which resulted in over-consumption and losing the incentive for hard work.\(^2^7\)

The HCRS created various forms of contracting output, or grain quota, to households that were assigned a plot of land and farm animals. Peasants were given wide-ranging production freedom. This stimulated the peasants' enthusiasm to work diligently and efficiently to produce more.\(^2^8\) There were a few attempts to adopt the HCRS in 1950s and 1960s but they were suppressed by Mao Zedong for fear this would lead to dismantling the agricultural collectivism – the people’s commune. The HCRS resurfaced in the late 1970s and progressed from being a local experiment. It gained central approval and was rapidly introduced countrywide. This boost to incentives and other factors (such as higher prices) led to a remarkable improvement in rural income. The United Nations estimated that rural income increased at an

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\(^2^8\) Yanlai Wang, op cit note 26 at 114.
average annual rate of 12.8 percent 1978-1985\textsuperscript{29}. The restoration of the independent peasant producer has created an economic and material foundation for the rebirth of private ownership and private enterprises in China.\textsuperscript{30}

2.4.2.2 Special Economic Zones and Coastal Economic Open Areas

To attract foreign investment, technology and management expertise, the Central Committee of the Communist Party of China (CPC) and the State Council jointly approved reports submitted by Guangdong Province and Fujian Province to set up four ‘Special Export Zones’ in which investment incentives, such as preferential tax treatment, would be offered to foreign investors. Four cities, Shenzhen, Zhuhai, Shantou, and Xiamen, were approved as ‘Special Economic Zones’ (SEZs) by the Standing Committee of Fifth NPC on 26 August 1980\textsuperscript{31}. Those cities were chosen for a mixture of demographic and geographic reasons - because they were the hometown of many overseas Chinese and because of their geographic proximity to Hong Kong, Macao and Taiwan. On 26 November 1981, the Standing Committee of the Fifth NPC further delegated legislative power to draft economic regulations for the SEZs to the Guangdong Provincial People’s Congress and Fujian Provincial People’s Congress and their Standing Committees. The Seventh NPC further approved Hainan as the fifth SEZ in April 1988.

The concept of SEZs has since been extended to another 14 coastal cities (the “Coastal Opening Cities”) located in the so-called ‘golden triangles’ – the Yangtze River Delta, the Pearl River Delta and the Southern Fujian Triangle in 1984 – Dalian, Guangzhou, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Zhanjiang and Beihai. In addition, 15 free trade zones, 32 state-level economic and technological development zones, and 53

\textsuperscript{29} United Nations, \textit{World Economic Survey 1993} (World Economic and Social Survey) 187 & 197.

\textsuperscript{30} Yanlai Wang, op cit note 26 at 146.

\textsuperscript{31} The \textit{Regulation on the Special Economic Zones in Guangdong Province} was approved by the 15th Session of the Standing Committee of the Fifth NPC on 26 August 1980.
new and high-tech industrial development zones have been established in large and medium-sized cities. As these open areas adopt different preferential policies, they play the roles of “windows” in developing the foreign-oriented economy, generating foreign exchange through exporting products and importing advanced technologies and of “radiators” in accelerating inland economic development.

2.4.2.3 Socialist Market Economy

The economic reforms – described by the Chinese Government as being from a ‘planned socialist commodity economy’ to a ‘socialist market economy’ – were enshrined in the amendments to the Constitution in March 1993. The principle of establishing a ‘Socialist Market Economy’ was adopted at the Fifth Plenary Session of the Fourteenth CPC Central Committee in 1995 and defined the general framework of China’s economic reform. Thereafter, a series of important reforms regarding pricing systems, state owned enterprises, public finance, taxation, banking, foreign investment, foreign trade and foreign exchange were undertaken.

Enlivening State-owned Enterprises and Restoring of the Private Sector

In 1978, State-owned enterprises dominated China’s economy and accounted for more than 75 percent of total industrial output value. Many of those state-owned enterprises were either operating in deficit or were only marginally profitable. The private sector has developed significantly since its recognition by the Constitution in 1982. Privatisation of the state-owned and collective owned enterprises was endorsed by the National People’s Congress in 1993, and reconstructed through: i) transforming them into limited liability or joint stock limited companies through bringing in domestic private or foreign investment or through selling the net assets to

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32 ‘The Reform of the Property Rights System has Achieved Positive Progress’, Beijing, People’s Daily, 25 February 1994 at 2. The large percentage of non-SOE at that time was collective owned.

33 The constitutional recognition of private sector is further discussed in Chapter 4.
workers and private parties, ii) leasing or selling to individuals or private enterprises, iii) merging with private enterprises, iv) becoming bankrupt.\textsuperscript{34}

These market-oriented economic reforms in combination with legal protection for the private sector led to a structural change in China's economy. The private sector is now firmly entrenched in China. State-owned enterprises still dominate, but their influence and role is steadily declining. In 2007, private sector accounted for 65 percent of China's GDP.\textsuperscript{35} The CPC is developing into a party which embraces not only the working class, cadres, and intellectuals, but also private entrepreneurs.\textsuperscript{36} The claims of a leading private entrepreneur - that the private sector is the driver and most energetic part of China's market economy and that private firms have played a leading role in promoting development of the national economy, facilitating economic restructuring, creating jobs, expanding exports and developing social welfare sectors\textsuperscript{37} - may be regarded as self-serving, but have official backing. Premier Wen Jiabao has acknowledged and confirmed the key role of the private sector in China's economy referring to the non-public sector as "a vital component of China's socialist economy."\textsuperscript{38} In 2004, Premier Wen pledged "unwaveringly to encourage, support and guide the development of the private sector" through a range of initiatives such as granting private enterprises the same treatment as State firms, repealing restrictive laws and removing strict approval and supervision procedures for private enterprises, and granting public and private enterprises equal access to finance.\textsuperscript{39}

Franchising has particular value in economies that have adopted privatisation of


\textsuperscript{36} Yanlai Wang, op cit note 26 at 4.

\textsuperscript{37} Cunhui Nan, Chairman and President of Chint Group, cited by Hui Kan, 'Private Sector Shows Emerging Role', \textit{China Daily}, Beijing, 20 September 2004.


\textsuperscript{39} Ibid.
previously nationalised assets as a national policy. Konigsberg suggests that franchising also provides the catalyst for the conversion of state-owned companies and for job generation. The jobs generated by the franchise sector has indeed been seen as a positive solution for China's raising unemployment rate (which grew from 2.3 percent in 1991 to 3.1 percent in 1997 and 4.3 percent in 2003) and which has created tension between the government and general public. Franchising has been suggested as a possible solution to generate jobs and is encouraged by the government.

**Prices Reforms and Other Reforms**

Until 1979, prices were centralised and enterprises had little price flexibility. Under such centralised administrative control, enterprises were unable to adjust prices in response to market supply and demand. As part of the move to a market orientated economy, China then adopted a policy of gradual and partial price reform. A 'dual' pricing system was established in which market prices were allowed for products bought and sold on the open market in combination with state-controlled prices for products forming part of the state plan. Controls have generally been relaxed over time.

China has also carried out significant tax and currency exchange reforms. The tax reforms have reduced the complexity of the tax system and the gap in tax rates between state-owned and other enterprises. China introduced full convertibility for all current-account transactions in December 1996 although it still restricts convertibility on its capital account. Both foreign invested enterprises and Chinese

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41 Id.
44 Ian Jeffries, op cit note 27 at 402-404.
Foreign Investment

Prior to 1978, China had little foreign investment. However, since China opened itself to the outside world and introduced economic reform, the huge consumer market and the relatively stable political environment have resulted in substantial foreign direct investment (FDI) inflow. China became the world’s largest recipient for FDI in 1993 for the first time.\(^45\) In 2008, FDI in China rose by 23.6 percent to US$ 92.4 billion.\(^46\)

Figure 2 Foreign Direct Investment

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\(^45\) Information by the then Ministry of Foreign Trade and Economic Relations at 20 April 2003, http://www.mofcom.gov.cn. China was the second largest (after the US) for many years but China stayed as the largest recipient for FDI in 2003 -2008.

\(^46\) “China’s FDI up 23.6% in 2008”, 15 January 2009, Beijing (Xinhua), see http://news.xinhuanet.com/english/2009-01/15/content_10662757.htm, accessed on 02/05/2009; information can also be accessed from Ministry of Commerce website.
2.4.3 Economic Performance

In less than three decades since the initiation of reform and opening up, China's economy has undergone a fundamental change from a planned economy to a socialist market economy. Since 1978, China's economic growth rate has been among the world's highest, with an average annual growth of over 8 percent a year for over 20 years. The overall objective for economic construction proposed in 1978, quadrupling the annual industrial and agricultural output value of the year 1980 by the end of the 20th century, was achieved ahead of schedule.\textsuperscript{47} China became the world's third largest economy in terms of GDP in 2008.\textsuperscript{48}

The average income of both urban and rural residents has also quadrupled in the period 1978 to 2000. In 1997, savings deposits of urban and rural residents reached 4628 billion RMB, over 218 times that of 1978 with an average increase rate of 32.8 percent.\textsuperscript{49} The living standard has therefore increased significantly. In 1997, total retail sales of consumer goods reached 2.73 trillion RMB, over 20 times that of 1978 in real terms. Per capita consumption increased from 184 RMB in 1978 to 2,677 RMB in 1997 with an annual increase rate of 7.8 percent if calculated by comparable prices. Figure 2.3 indicates China's economic growth.\textsuperscript{50}

\textsuperscript{47} Information by the then Ministry of Foreign Trade and Economic Relations, can be accessed at http://www.mofcom.gov.cn.
\textsuperscript{50} The National Bureau of Statistics of China, \textit{China Statistical Year Book} (various years 1997-2008), information can be accessed online at http://www.stats.gov.cn.
2.5 WTO ACCESSION AND CHINA TODAY

A milestone in China's efforts to rejoin the international community took place on 11 July 1986 when China formally requested the resumption of its seat on the General Agreement on Tariff and Trade (GATT).\(^1\) To accept the scrutiny of GATT trade policies, and abide by the multilateral trading system's rules, China's economy needed further reform. The establishment of the World Trade Organization (WTO) as the successor to the GATT, and its more rigorous system of dispute resolution and wider coverage of trade issues, has important implications in terms of abiding by 'global' rules\(^2\), not only for China, but for all members. The negotiation process was

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\(^1\) China was involved in the founding of GATT and became a Contracting Party to GATT on 21 May 1948. After the founding of the PRC in 1949, there was a period of time that the Taiwan authorities had occupied the lawful seat of China. In March 1950, Taiwan authority (in representing China) withdrew from GATT and in March 1965, Taiwan obtained the status of an observer at GATT. PRC restored its lawful seats in the United Nations in 1971. In 1982, the PRC Government gained the observer status of GATT. On 10 July 1986, PRC formally submitted an application for the resumption of China's membership in GATT.

\(^2\) East Asia Analytical Unit, Department of Foreign Affairs and Trade China embraces the market: achievements constraints and opportunities (1997) Department of Foreign Affairs and Trade ACT, Australia, 199.
not easy. Fifteen years of negotiation of China’s GATT, and later WTO, accession has driven change to both its legal system and foreign investment policy.

In December 2001 China was finally admitted to the WTO – 51 years after withdrawing from the then international trade system. The WTO Director-General at the time, Mike Moore of New Zealand, described China’s WTO accession as “one of the most significant events of the 21st century."^53

In order to attract foreign investment, and satisfy WTO requirements, China has revised a series of laws concerning the use of foreign capital. Under the WTO agreement, China has committed to:

- continue to open up its market;
- perfect its legal system in relation to uniformity of law, transparency, non-discrimination;
- enhance policy transparency, reform the administrative approval system and reduce administrative intervention by all levels of government.^54

China’s WTO commitments to franchise operations included removing restrictions on geographical location, number, equity ratio and form of establishment for foreign investment by no later than December 2004.^55 The influence of WTO accession on China’s law reform and the compliance issue of China’s WTO commitment on franchising is discussed in Chapter 5 (development of underlying commercial law), Chapter 6 (development of foreign investment law) and Chapter 7 (development of franchise specific law).

Today China is the world’s fastest growing economy and one of the largest recipients of foreign direct investment driven by its fast gross domestic product growth, stability and its large and increasingly open domestic market. China’s ranking in

^55 Schedule of Specific Commitment on Services, the Report of the Working Party on the Accession of China (WT/ACC/CHN/49)
global trade has climbed dramatically since 1979, with the dismantling of a system in which the production and distribution of all commodities were centrally controlled, managed and allocated by state organs. Since reopening to foreign trade and FDI in 1979, China's import and export value has grown 746 fold. China in 2007 was the fourth largest country in the world in terms of foreign trade. China's economy is now rapidly integrating into the world economy and its economic development has a "vital role in reviving global commerce". The economic reforms following the adoption of the Open Door policy created the environment in which franchising was possible. Through allowing private enterprise and liberalising foreign investment the platform was in place for the development of domestic and foreign franchising.

The Open Door policy and WTO accession have not only led to more economic integration but also to cultural and political integration with the world community. China's foreign cultural exchanges have taken various forms, including central and local government sponsored, and commercial performances and exhibitions with every region of the world. By 1999 China had signed cultural co-operation agreements with 138 countries. The broadening of Chinese cultural exchanges with other countries has played an important role in re-moulding people's lifestyle and attitudes towards western products. Cultural exchange and communication have reduced common difficulties facing international franchisors - cultural differences and suitable franchisees. Young Chinese who have studied in western countries are returning to China to take executive positions. They are schooled in western management skills and have an appreciation of both western and Chinese cultures.

2.6 CHAPTER SUMMARY

China is a vast country in terms of territory and population. Since the reforms which

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57 Ibid.
have introduced massive economic and legal reforms, encouraged foreign investment and resurrected private enterprise, China’s economic performance has been increasingly commensurate with its size. The economic reforms following the adoption of the Open Door policy created the environment in which franchising was possible. However, China is complex in terms of its culture, ethnic composition, history, and political control, and these factors have had a significant impact on business activity, including foreign investment and franchising companies’ strategies in China. This chapter has provided a general overview of China, as well as its reforms pursuant to WTO accession, which is essential for understanding the legal and commercial environment for foreign franchisors in China discussed in later chapters.
CHAPTER THREE
LITERATURE REVIEW AND RESEARCH QUESTIONS

3.1 INTRODUCTION

International expansion is always an option for a successful franchise system—particularly a franchise system facing increasing market saturation and competition in its home market. The decision to expand internationally is multi dimensional - the target country, the entry mode and the expansion mode within the target country must be assessed having regard to organisational factors (firm factors) and environmental factors (target country factors).

A franchisor has a range of entry mode options. Entry may be by cross border franchising - direct franchising, master franchising, or area development agreement - which does not require direct investment and a physical presence in the target country as the franchisor services franchisees from its home market. Alternatively, the franchisor may commit to investment through a physical presence in the target country through establishing a branch, subsidiary or joint venture. If a franchisor adopts the latter strategy, it has expansion alternatives and can build its network by company-owned and managed stores and/or by franchised stores, which are controlled and serviced by its establishment in the target country.

This Chapter provides a literature review of existing theory explaining the reasons for an enterprise adopting franchising and for expanding internationally. It analyses the entry and expansion modes available for international franchisors with emphasis on the factors impacting on the choice of entry and expansion modes. The aim is to clarify the foundation upon which this research has been built. Due to the cross-disciplinary nature of this research, the literature on the Chinese commercial legal system is reviewed in Chapters 4 and 5 and the literature on case study methodology in relation to the case study on foreign invested franchisors operating through a foreign investment vehicle in China is reviewed in Chapter 9.1.
This Chapter contains six sections. Chapter 3.2 reviews the development of franchising as a concept, focusing on the key features of the franchising relationship and the theories on franchising and international franchising which have been developed by scholars in previous research. Chapter 3.3 examines the classification and characteristics of the alternative international expansion modes available to franchising companies and their respective advantages and disadvantages. Chapter 3.4 analyses the considerations in the choice of expansion modes, with a particular focus on legal considerations. Chapter 3.5 reviews the existing literature on franchising in China. Chapter 3.6 explains the research questions which the researcher has developed.

3.2 FRANCHISING GENERALLY

3.2.1 Introduction and Development of the Franchising Concept

It has been suggested that the McCormick Harvesting Machine Company is the earliest example of franchising. Around 1850, the McCormick Company commissioned 'exclusive local agents' who were independent business people to sell and service its machinery. However, it is more widely accepted the first firm to adopt a franchise-oriented distribution system was the Singer Sewing Machine Company. In the mid-1850s the domestic sewing machine was an innovative product for which Singer held patents, and the sewing machine industry was in its infancy. Singer did not have the capital to hire a large sales staff, or to open branch offices for selling the products, educating potential customers, and servicing the machines. It used agents working on commission to sell and repair its sewing

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machines instead. This marked the emergence of a basic franchising concept - the granting to a distributor of the right to use the company’s trade mark or brand in an exclusive territory. Franchising nevertheless did not become entrenched as a business strategy until the late 1890s and early 1900s, when the automobile, petroleum and soft drink industries refined the strategy developed by Singer to build their national distribution networks. Until the 1930s, such manufacturing franchises, which are today generally referred to as product distinguishing franchising or ‘product and trade name franchises’, were dominant. Product and trade name franchising is characterised by franchised dealers who ‘concentrate on one company’s product line and to some extent identify their business with that company’. Motor vehicle dealerships and petroleum and soft drink distributors, still widely practise this form of franchising today, although the trend is towards

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3 Singer changed its marketing strategy to sell and service its machines exclusively through company-owned offices during the 1860s.
5 In its Report to the Minister for Business and Consumer Affairs in August 1976, the Trade Practices Act Review Committee (The Swanson Committee) Australian Government Publishing service Canberra 1976, noted at para 5.2 that: [...] the term ‘franchise’ appears to be used to describe one of, or a combination of, three types of business arrangement:

- **A product franchise** is an arrangement whereby a distributor acts as an outlet, whether wholesale, retail or otherwise, for the product(s) of a manufacturer, often on terms that give the distributor the exclusive right to sell the product(s) within a specific market. Franchises of this nature are common, for example, in retailing motor vehicles and petrol.
- **A system franchise** is an arrangement whereby a franchisor develops a unique or individual manner of doing business and permits the franchisee to use that system, in controlled fashion, in the operation of the franchisee’s independently owned business. Examples of industries where franchises of this nature are common are fast food outlets, laundries and dry cleaners and motels. Sometimes the franchisor provides only the trade name and the pattern or formula of the business. In other cases the franchisee is required to sell goods or services provided by the franchisor.
- **A processing or manufacturing franchise** is an arrangement whereby the franchisor provides an essential ingredient or know-how to a processor or manufacturer. Franchises of this nature are common, for example, in the soft-drink industry.

Today the term “business format franchise” is almost universally used for the type of franchise the Swanson Committee identified as a “system franchise” and the term “product and trade name franchise” is commonly used for the types of franchises the Committee identified as “product” and “processing or manufacturing” franchise.
6 Justis and Judd, op cit note 1; Love, op cit note 4.
7 U.S. Department of Commerce (USDOC) Franchise Opportunities Handbook, various years, compiled by Andrew Kostecka, Washington DC.
franchising in its contemporary business format mode characterised by the imposition of a business format and an entire management system for conducting a business ensuring standardisation, consistency and uniformity across all aspects of the business.

It has been suggested that the first business format franchise system was “Harper Beauty Shops” created by Martha Mathilda Harper in the US in the 1890s. Harper’s business model included the components of business format franchising which later came to be defined by the US Department of Commerce as including “not only the product, service and trademark, but the entire business format itself - a marketing strategy and plan, operating manuals and standards, quality control, and continuing two-way communication”. However, it was Kroc (McDonald’s), Sanders (KFC) and other fast food pioneers who refined the business format franchising concept in the 1950s and revolutionised the distribution of goods and services. Ray Kroc of McDonald’s did not invent fast-food, but he invented a unique business strategy under which the discipline of an entire business format was imposed on a looser licensing arrangement. The realisation that a business system could be effectively “cloned”, was the key to the development of business format franchising.

Business format franchising has today become a sophisticated business relationship in which a franchisor with a unique or individual manner of doing business grants to a franchisee, in return for fees, the right to use that system in a controlled fashion in

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8 Robert Justis (1989) at note 1, p13; John F. Love, at note 4, p48. The development from product and trade name franchises to more sophisticated business format franchises is demonstrated by the metamorphosis of petrol retailers from service stations to convenience stores.


10 U.S. Department of Commerce (USDOC) Franchise Opportunities Handbook (various years), compiled by Andrew Kostecka, Washington DC.

11 John F. Love, op cit note 4 at 56.

the operation of the franchisee’s independently owned business. It is characterised by an ongoing business relationship between the franchisor and franchisee which includes not only the product or service, and trademark, but also the entire business operational and management system, and a continuing process of assistance, guidance and supervision. Business format franchising has provided a means for “merging the seemingly conflicting interests of existing businesses with those of aspiring entrepreneurs in a single process that promotes business expansion, entrepreneurial opportunity and shared cost and risk.”

Product and trade name franchises have a greater share of the overall franchise sector turnover due to the contribution of motor dealerships and petrol stations. However, it is business format franchising which has driven the growth of the sector and has “transformed franchising from a specialised marketing technique into a highly competitive, innovative vehicle for the expansion of retail product and service industries”. It offers significant advantages over alternative methods of business operation to both the franchisor and franchisee. It enables the franchisor to enjoy rapid geographic expansion, as franchisees bear the cost of capital investment in establishing their outlets. The franchisee benefits from acquiring rights to a proven system, training and ongoing support.

Franchising is increasingly significant and is the fastest growing method for business

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16 According to the data collected by the US government in 1986 (which is the last year USDOC published such statistics), *product and trade name franchising* accounted for 72.7 percent of all sales by franchised chains. But a report by IFA Educational Foundation and Price Waterhouse Coopers on economic impact of franchising in the US economy suggested that *business format franchising* encompassed 4.3 times establishments and employed 4 times workers as *product and trade name franchising* in 2001. For detailed discussion, please see Blair and Lafontaine (2005) cit op note 9.
expansion in the US. A comprehensive study conducted in 2006 for the International Franchise Association, indicates that franchised businesses in the US then operated over three quarters of a million establishments and generated jobs for more than 18 million Americans. Franchising constituted almost 14 percent of private sector employment, and US$1.5 trillion of economic output representing 9.5 percent of total private sector output. In Australia, where franchising is a more recent phenomenon, the revenue of the franchise sector in 2007 was estimated to be 17.3 percent of national GDP (double the proportion from 15 years earlier). The Franchising Australia 2008 Survey prepared by the Asia-Pacific Centre for Franchising Excellence at Griffith University reveals that the Australian franchise sector continues to expand with approximately 1100 business format franchisors in 2008 (compared with 960 in 2006 and 850 in 2004), 71,400 system units (a growth rate from 2006 to 2008 of 15.4 percent) and a sector turnover of $130 billion. Inspired by such statistics, franchising has been described as “one of the greatest inventions of western capitalism” and “an increasingly popular form of economic organisation providing an alternative means of expanding an existing business or a alternative means of entering an industry”.

3.2.2 Explanations for Franchising

The social, economic and cultural conditions in the US in the mid 1950s were ideal for the development and growth of business format franchising. The post-war

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21 Ibid.
24 Ibid.
economic boom, combined with increased consumer mobility and income, were significant driving factors. Positive attitudes towards small business, and developments in communication systems (particularly television), enabled nationwide brand-name recognition and pervasive advertising. Franchising quickly became a popular business expansion mode domestically within the US.

The motivations for franchising, and reasons why companies choose to expand their market share by way of franchising rather than company-owned and operated outlets, have been widely discussed. Although there is no single theory universally accepted, two major theories, *agency theory* and *resource-scarcity theory*, have been developed to explain the reasons for enterprises expanding through franchising and have been frequently cited. While a comprehensive analysis of franchising theory is beyond the scope of this thesis, major theories are nevertheless briefly reviewed.

**Resource Scarcity Theory**

'Resource scarcity theory' (also called 'resource acquisition theory') suggests that franchising is adopted by a company as a means for expansion in order to extend

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scarce resources. By adopting franchising, a franchisor can more easily raise capital because the franchisees fund the franchise outlet and pay the franchisor various franchising fees, typically including an initial fee and continuing payments. In exchange for the right to use the franchisor’s proven business name, concept and system, a franchisee typically assumes all the financial burden for establishing and running the franchised unit. This reduces the franchisor’s exposure to business risks. Through franchising, a proven business concept can be implemented rapidly to secure market share and minimise the possibility of the business concept being replicated by competitors. Franchising provides an efficient way for franchisor to achieve rapid growth with minimal capital. Hunt suggests that lack of capital was the primary motivation behind decisions to franchise. Later researchers on resource-scarcity theory have focused on the franchisor’s need for human capital and managerial talent and local knowledge. By adopting franchising, franchisors can minimise such resource constraints.

**Agency theory**

While resource-scarcity theory has been well developed in the literature, particularly by scholars of marketing and retail systems, other studies have considered agency theory (also called transaction cost theory) to explain the reasons for franchising.

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34 Hunt, op cit note 31.
37 The term, “transaction costs” is defined as ‘heterogeneous costs that arise in economic activity’. Craig Calhoun ed., Dictionary of the Social Sciences Oxford University Press (2002). Calhoun explains that “in many deals, parties have to find each other, communicate, measure and inspect the goods that are to be purchased, draw up the contract using lawyers, keep records, and so on. In some cases, compliance needs to be enforced through legal action. All these entail costs in terms of real resources and time, termed transaction costs. The reality of these costs contrasts with the frequent assumption of a perfectly clearing, frictionless market’. The term is sometimes
Agency theory suggests that managers (as agents) within a company tend to shirk in their duty to the company (the principal) in cases where their compensation is a fixed salary. A fixed salary is a low powered incentive because it is determined independently of company performance. By comparison, franchisee-owned units are likely to perform better than company-owned units because the financial interests of franchisor and the franchisee are more closely aligned. Although a company can review its financial performance by inspecting accounting data, it can be difficult to reliably attribute performance between managerial effort and other factors outside the manager's (agent's) control. The principal must expend resources (agency costs) to monitor its agents and to ensure that they are performing to agreed standards. In fact, the administrative cost of such monitoring was the inspiration for the development of agency theory.

Within agency theory, two types of agency problems - vertical and horizontal - have been identified. The vertical agency problem refers to the conflict between a company and its outlet managers. Franchising is a solution to the vertical agency problem. Franchisees are motivated to perform, because they get all profits after expenses. The horizontal agency problem refers to the potential for franchisees to obtain a "free ride" from the work or success of other outlets. All outlets within a franchise system operate under same brand name and share the goodwill associated

used interchangeably with 'agency costs' because most transaction costs are related to agency relationships. However, "transaction costs" is broader than "agency cost".


43 Paul H. Rubin, op cit note 38.  

44 James G. Combs, Steven C. Michael, and Gary J. Castrogiovanni, op cit note 38.
with the brand. Customer mobility transfers the goodwill associated with one outlet to other outlets. Franchisees may prefer to get a free ride from others, rather than to invest resources to build the goodwill. Franchisors can address this issue by monitoring to ensure quality, but, to do so will undermine the advantage of franchising as a substitutes incentive for costly monitoring. Franchisors must motivate and monitor outlet managers to solve vertical agency problems whilst ensuring that investment in the brand is maintained to address the horizontal agency problem as well.

Limitation of Resource Scarcity Theory and Agency Theory

There is empirical evidence to support both resource scarcity theory and agency theory. However, resource scarcity theory has been criticised, on the basis that franchising is an inefficient way of raising capital and is an appropriate means for easing resource constraints only for young or small firms. Furthermore, whilst resource scarcity theory is consistent with empirical research results at the sector level, it is not supported by studies conducted at the firm level. Based on 44 empirical studies, Combs and Ketchen used meta-analysis and obtained results which supported agency theory but not resource scarcity theory. Agency theory has nevertheless not escaped criticism. Its key assumption (that an identifiable franchise system brand helps assure customers of uniform product quality) has been criticised on the basis that brand name capital is not the strength of many small and young


46 Paul H Rubin, op cit note 38.


franchise systems. For such firms, brand-name capital and technical expertise require managerial efforts which a company owned network can deliver more efficiently. More recent research suggests that resource scarcity theory and agency theory alone cannot adequately explain franchising. However, the explanatory power of these two theories is improved when these two theories are incorporated. It is suggested that a full explanation of franchising needs to combine both the agency and resource-based perspectives.

In addition to resource scarcity theory and agency theory which explain the significant benefits that franchising offers to franchisors, there are other theories introduced by scholars from other perspectives. The theory of entrepreneurship was adopted to further understand the franchisor/franchisee relationship with a focus on franchising as a vehicle for franchisees to become business owners. Life cycle theory analyses the adoption of franchise in different stages of a business life cycle and the applicability of franchising to new and mature businesses seeking to expand. The performance of franchised stores and the pattern of the ratio of franchised to company owned stores in small and large companies are also explored. The franchisor/franchisee relationship issue has been reviewed from

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51 Brickley and Dark op cit note 49 at 403.
54 Carney and Gedajlovic, op cit note 41; Inma op cit note 48.
55 Generally speaking, franchisee's motivation to join a franchise system is less discussed.
different perspectives. From the management perspective, research has been carried out to better understand the intricacies of the franchisor/franchisee relationship. Franchising also provides significant understanding of the structure of contracts to the economist. Over the recent decades, the development of the franchising concept to multiple-unit franchising and co-branding have been also closely examined.

3.2.3 Internationalisation of Franchising

Until the 1970s, franchising was primarily a US phenomena. It was the international expansion of established and pioneering US franchise systems – particularly KFC, McDonald’s and Pizza Hut – that was catalyst not only for the development of domestic franchising in host counties but also for a growing wave of globalisation which today characterises franchising worldwide. In the late 1960s and early 1970s the expansion of the international franchise pioneers was to developed countries, but the decades of the 1980s and 1990s saw expansion to developing and transitional...
McDonald's made its first move internationally in 1967, to Canada. Other US franchisors also adopted an international expansion strategy. From 1971 to 1985, US franchisors added international outlets at a rate of 17 percent rate per annum, nearly twice the rate of growth for US domestic outlets growth. A study in 1992 found that over 60 percent of US franchisors had overseas outlets at that time. In 1971, 156 US franchisors collectively operated less than 3,500 outlets globally. By comparison in 1986, 354 US franchisors were operating over 31,000 outlets worldwide. In 2007, over 52 percent of McDonald's restaurants were located outside of the US.

The international expansion of US franchising companies has brought the franchising concept to many countries and has stimulated the local development of franchising in most countries. The Australian experience is a typical example of the influence of US franchisors. The introduction of franchising to Australia in the 1970s was led by the US fast food "colonisers". Not only did they introduce Australians to US-style fast-food, but they also introduced local business entrepreneurs to a new and dynamic method of business operation. In 2008, Australia had 1100 business format franchise systems. 91 percent of them were Australian-owned and developed, and 25 percent of those had expanded overseas. Developed European countries have also readily taken to franchising over the past generation, and franchising in

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70 Lorelle Frazer, Scott Weaven and Owen Wright, op cit note 23.
Europe is today of great economic significance. Franchising is now used as a means of international expansion by companies across many countries and industry sectors. More recently, US franchising companies have taken the franchising concept to countries with emerging market economies in Asia, Eastern Europe, the Middle East and South America. Franchising as a method of business operation has "revolutionised the distribution of goods and services" in virtually all industry sectors and has transformed the business landscape of most countries.

3.2.4 Theories of the Internationalisation of Franchising

International market development provides substantial opportunities for franchising development. In many countries, a shift from manufacturing to services, urbanisation, rising disposable incomes, and expanding consumer markets have created conditions similar to those which originally supported franchising growth in the US. Economic reform and market liberalisation in developing economies, often pursuant to WTO commitments, have provided opportunities for established franchisors to access foreign markets. The success of franchising generally, and of international franchising in particular, stems not only from its benefit for all stakeholders, but also from its adaptability to different cultures and economic systems at various stages of development, and its flexibility as a business and legal technique.

76 Andrew P. Loewinger 'Introduction' International Franchising Law (1999) iii.
The international expansion of US franchisors has long been a subject of academic interest. In 1976, Hackett conducted a survey of 353 American franchising firms. He examined their motivations, geographic focus and ownership strategy and found that large US firms were expanding to East Asia and Latin America at that time. He further claimed that franchising was the most frequently used expansion strategy for US franchisors in international markets. Resource-based and agency theories which were developed to explain domestic franchise expansion have been applied to explain international franchising. In addition, theories of domestic market saturation and opportunity recognition have also been introduced to explain international expansion. The domestic market saturation theory suggests that in a mature market for industry sectors, established firms with substantial domestic market share may seek growth through expansion into foreign markets. It is generally believed that the rapid growth of international franchising in Asia, South America, Central America and Mexico is partially due to the market saturation in developed countries. Opportunity recognition theory suggests franchisors expand to countries where substantial market opportunities are believed to exist. Because of advanced communications and information technologies, many business have a global focus from inception. Reasons for international franchising and choice of target country examined by scholars fall into two categories: internal (organisational

78 Ibid at 74.
factors) and external (environmental factors). This thesis examines the environmental factors effecting foreign franchisors' strategies for entry to and expansion in China. Literature on environmental factors is provided in detail but a comprehensive literature review of organisational factors is beyond its scope.

3.2.4.1 Organisational Factors

Theories of internal factors focus on the characteristics of a company which leads it to internationalise and include organisational explanations to which resource-based and agency theories have been applied. Alon nevertheless suggests that the application of agency and resource scarcity theories to international franchising is not identical to their application to domestic franchising. These two theories were developed to explain why companies prefer franchised to company-owned outlets in the domestic context. In the international context, however, the focus is on the decision to internationalise. The key organisational factors of international franchising - franchising life cycle, domestic market saturation, resources-based theory, and agency theory have been examined. Alon takes retailing, hotel and professional business service industries as his sample for empirical research, and finds positive support for these organisational factors. Root suggested that international expansion through franchising is particular attractive to service and

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85 Ilan Alon, op cit note 68 at 24.
87 Ilan Alon, op cit note 68 at 24.
88 Ibid.
91 Ilan Alon, op cit note 68 at 21.
92 For general discussion, see Ilan Alon, op cit note 68.
retailing firms, as it requires low levels of financial involvement and therefore lower risk.\textsuperscript{93}

With the emergence of born global firms, franchisors do not necessarily wait until domestic market saturation has been reached before expanding offshore.\textsuperscript{94} Other internal factors motivating a franchisor to expand internationally have been summarised by Königsberg from a practical perspective. Factors other than market saturation include: i) the initiative taken by an interested party other than the franchisor to initiate the decision making process; ii) reasons of ego, including the excitement of turning a domestic company into an intentional company; iii) a quick fix for earnings, where a franchisor is lured by the receipt of initial master franchise or development fees; iv) pre-emptive competition, where a franchisor is concerned that someone in the foreign country will copy or emulate their franchise system, making it more difficult to enter the market later; v) a leader's impulse ambition, where a franchisor develops an expansion program as an outlet for the leader's energy; vi) a promise made to an investor or franchisee, where the franchisor has made a commitment to an investor or a franchisee that they will expand internationally within a certain period of time; vii) impulse and serendipity.\textsuperscript{95}

\textbf{3.2.4.2 Environmental Factors}

While theories of organisational factors focus on the characteristics of a company which leads it to internationalisation, theories of environmental explanations focus on the macro environmental factors in relation to the target country which leads to the choice of country or choice of entry strategy.\textsuperscript{96} Opportunity recognition theory suggests the franchisors expand to countries where substantial market opportunities

\begin{itemize}
\item Ilan Alon and David Mckee ‘Towards a Macro Environmental Model of International Franchising’ (1999) 7 (2) \textit{Multinational Business Review} 76-82 at 78.
\end{itemize}
are believed to exist. Environmental factors can explain why some countries have higher shares of international franchising, or why a particular method of entry was chosen. Research on environmental factors suggests that the key environmental explanations are the differences between a franchisor's home country and the host country. The key environmental factors of a host-country affecting international franchising companies have been classified into four categories - economic, demographic, distance, and legal and political factors. These four factors have been integrated by Alon and McKee to develop a normative macro-environmental model of international franchising companies from the US.

**Economic**

The market potential of a foreign country is one of the key determinant factors for a US franchisor's decision on whether or not to expand into that country. Economic factors include income/GDP, income growth, level of urbanization, and the maturity of the country's retail, service and tourism sectors. Thomas Friedman's "Golden Arches Theory of Conflict Prevention" expounded in *The Lexus and the Olive Tree* which states that no two countries in which McDonald's have a physical presence have fought a war against each other since each got its McDonald's may be seen as an expression of this environmental factor. For Friedman, McDonald's is a metaphor for a globalised and interconnected world. If a country has developed economically to the extent that it can support a sophisticated and globalised business strategy such as business format franchising, represented by McDonald's, there are strong incentives for not making war. Friedman argues that:

...when a country reached the level of economic development where

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98 Ibid.

99 Ibid.

100 Ibid.

it had a middle class big enough to support a McDonald's network, it became a McDonald's country. And people in McDonald's countries didn't like to fight wars anymore, they preferred to wait in line for burgers.  

**Demographic**

The existence of a substantial middle class has been posited as the most important demographic factor. Population has also been considered in relation to choosing a host country and has been found to be positively related. A significant relationship has also been found to exist between the expansion of US fast-food franchise systems and both the level of education and female participation in the labour force within the host country. Welch suggested that international franchisors require their host countries to have a large service sector.

**Distance**

Both physical distance and cultural distance have been found to be important by researchers. Physical distance is one of the most mentioned factors in US international franchising expansion. Geographic proximity is also suggested by Konigsberg as a motivation for franchising companies to expand internationally. Cultural distance refers to the differences between the culture and language of the host and home countries. Cultural differences, particularly Western/Eastern cultural

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102 In light of the Kosovo War in 1999, Friedman restated his theory to “People in McDonald’s countries don’t like to fight wars anymore, they prefer to wait in line for burgers – and those leaders or countries which ignore that fact will pay a much higher price than they think”. (Thomas Friedman, *The Lexus and the Olive Tree* (2000) Anchor Books, 253).


104 Ibid.

105 Ibid.


107 Welch (1989) op cit note 89.


109 Konigsberg op cit note 95.
differences, impact on a firm’s management and business activities and can create uncertainty as well as problems in a business context. Contract negotiation, hiring and operational protocols can vary significantly. Fladmoe-Lindquist states that “the transferability of the [franchise] system becomes a function of cultural distance between the foreign and domestic cultures. The very strength of a franchising format, its standardization, makes its successful replication in foreign markets difficult.”

Tes and Pan conclude that two cultural dimensions (power distance and uncertainty avoidance) greatly affect the choice of market entry mode. They found that firms with a more distant culture prefer an equity-based entry mode. They also found that firms from countries with a lower uncertainty avoidance culture are more likely to choose the low cost entry modes to avoid risks. As East Asian countries typically have different institutional structures to Western societies, when East Asian firms enter overseas markets, the cultural gap is a significant factor affecting their choice of market entry modes.

**Legal and Political Environment**

Research shows that the perceived attractiveness of an external environment is negatively related to its perceived risk and positively related to the perceived benefits which it offers. This means that the economic, cultural and political stability of a foreign country will increase the likelihood that a franchisor will select it as a

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host country for expansion. Hackett suggested that government interference and red tape are the most pervasive problems for US franchisors abroad.

Franchising, as for any other method of business operation, also requires an underlying legal infrastructure which is necessary to promote and protect business assets. In its Guide to International Franchise Arrangements, UNIDROIT defined a 'healthy commercial law environment' as 'one with general legislation on commercial contracts, with an adequate company law, where there are sufficient notions of joint ventures, where intellectual property rights are in place and enforced and where companies can rely on ownership of trademarks and know-how as well as on confidentiality agreements'. Whether or not a franchise sector requires a franchise-specific law to regulate its orderly development is controversial. Further complications can arise in developing and transitional countries, where activity which is not expressly authorised may be, by implication, prohibited and where foreign investment and scale of operation may be approved on a case by case basis. Even adopting franchising as a method of expansion may be subject to approval. In the case of China for example, the introduction of the first rudimentary law on franchising gave official recognition to and, by implication, encouragement of franchising as a distinct method of business operation. Similarly in Vietnam, the development of franchising was hampered until recently by a regulatory framework which did not recognise franchising as a discrete business relationship. Indeed as Philip Zeidman has commented in relation to China, "it may well be that the sheer

118 The implication of the 1997 Interim Franchise Measures is discussed in Chapter 7. See generally Robert Oake, 'How open is the Door? Franchising in Mainland China', can be accessed at http://www.oake.com/franchisors.htm
act of regulation – and, in the process, the recognition of franchising, the stripping away of its ‘second class’ status – is more important than the contents themselves.”

As emerging markets become important for international franchising, the importance of host country evaluation increases. This thesis analyses a set of environmental factors in China, an emerging market, and considers the extent to which these factors have influenced the decision of international franchisors to expand to China. In particular, the legal and political environment of China will be reviewed to identify its relationship to the entry mode chosen by international franchisors which have entered the China market.

### 3.3 INTERNATIONAL EXPANSION MODES

#### 3.3.1 Characteristics of Alternative International Expansion Modes

When a firm decides to expand into a foreign country, the strategic decisions to be made in relation to foreign market entry intrinsically include:

- the choice of a foreign market;
- the goals in the foreign market;
- the entry mode to penetrate the foreign market;
- the marketing plan to penetrate the foreign market;
- the control system to monitor performance in the foreign market.

The choice of entry mode is one of the most important decisions as success in the

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foreign market may depend upon an appropriate mode of entry. The market entry mode is defined as the institutional arrangement by which a firm exports its products, technologies, human resources, or other resources into a market. Root classified entry modes into:

- *export entry modes* including indirect export, direct export through agents and distributors, branch and subsidiaries;
- *licensing mode* (contractual entry modes);
- *investment entry modes* including joint manufacturing ventures and new manufacturing plants (see figure below).

Other international researchers have further divided the investment entry mode into joint ventures and sole manufacturing ventures to make four groups of entry models: exporting, licensing, joint ventures and sole manufacturing ventures. Although theories and sub-classifications vary, there are basically three consistent classifications of entry modes: export entry modes, contractual entry modes, and investment entry modes.

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127 Anderson and Gatignon op cit note 122; Root, op cit note 122; and Young, S., Harnill, J., Wheeler, C., & Davies, J.R., id. The figure is adopted from Root.
Export entry modes are the simplest form of expansion in a target country, in which the products of a company are not manufactured within the target country. Exports can be achieved directly through agents or distributors in the target market or indirectly by domestic agents within the company’s home country, such as trading companies or export brokers. The exports require minimal investment and thus the risk is low.

Contractual entry modes include licensing, franchising, technical agreements, service contracts, management contracts, construction/turnkey contracts, manufacturing contracts, co-production agreements. These entry modes are distinguished by a transfer of technology or skills from home to target country, but without any equity association between companies in the home and target countries.

The company in the home country, however, generally makes a contractual undertaking to provide technical assistance to the foreign firm. Contractual entry modes require very low investment by the home company as the major investment is made by the contacted foreign company, in the target country.

**Investment entry modes** refer to portfolio investment (the purchase of stocks and bonds internationally) and foreign direct investment (FDI).\(^{129}\) Firms use FDI to create or expand a permanent interest in an enterprise which implies a degree of control over the enterprise.\(^{130}\) FDI typically includes some form of ownership by the foreign firm through joint or sole ventures which in either case may be established via acquisition or green-fielding (new investment). Joint and sole ventures have more risks and more controls than the exporting and licensing entry modes. Two or more companies who want to share ownership will normally form a joint venture in which each company contributes a complementary competitive advantage.

Each entry mode has its own characteristics of control, dissemination of risk, resource commitment, flexibility and ownership. These are summarised in the following table\(^{131}\).

<table>
<thead>
<tr>
<th>Entry mode</th>
<th>Control</th>
<th>Dissemination of Risk</th>
<th>Resource commitment</th>
<th>Flexibility</th>
<th>Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Export</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Contractual</td>
<td>Medium</td>
<td>Med-High</td>
<td>Med-High</td>
<td>Medium</td>
<td>Med-High</td>
</tr>
<tr>
<td>Investment</td>
<td>High</td>
<td>Low</td>
<td>High</td>
<td>Low</td>
<td>High</td>
</tr>
</tbody>
</table>

### 3.3.2 International Expansion of Franchising Firms

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Generally speaking, a company expanding into a foreign country can adopt any of the above-mentioned entry modes. Most companies adopting business format franchising are in retail sectors - industries in which export entry modes cannot be applied. When choosing an entry mode for international expansion, franchising companies need to decide on the choice between company ownership and franchising, and the choice between different franchising modes.

Konigsberg divides international expansion models available to a franchisor into three categories: direct franchising; master franchising; joint venture arrangements.

**Mode 1:** direct franchising; including:
- (a) direct unit franchising;
- (b) establishment of a foreign subsidiary or branch office;
- (c) area development agreements;

**Mode 2:** master franchise agreements;

**Mode 3:** joint venture arrangements.

This classification is based on the nature of franchising agreements. All three methods in **Mode 1** involve a direct franchising agreement without intervention of a third party. However, the three methods in **Mode 1** differ significantly. If a franchisor adopts **Mode 1 (a)**, direct unit franchising, the franchisor grants a franchisee for an individual franchise outlet from its home country without an investment and a physical presence in the target country. By adopting **Model (b)**, a franchisor can establish a subsidiary or a branch in a foreign country which requires investment to establish the physical presence and either grant franchise rights to a franchise or opens and manages its own outlets. If a subsidiary is adopted, it is a separate legal person from the franchisor which enjoys independent legal status.

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132 The USDOC (1988) statistics suggested 'retailing dominates franchising, accounting for 87 percent of all franchising receipts in 1987'. For companies involving traditional product and trade mark franchising (eg. Coca-cola), exporting is frequently used.


Under *Mode 1(c)* a franchisor grants rights to an area developer to own and operate multiple outlets in a particular territory. The differences between a franchisee in *Mode 1 (a)* and an area developer in *Mode 1(c)* include an area developer having the right and obligation, to open multiple units and, usually, holding the exclusive territorial rights. Konigsberg’s classification of *Mode 1* was based on no third party intervention, but a foreign subsidiary is legally a different person, even though the franchisor has full control by virtue of ownership. In relation to the financial burden, and control and risk factors, *Modes 1(a) (b) and (c)* are nevertheless very different.

In examining the different commercial vehicles available for entering a foreign country, Konisberg identified five alternatives, each the subject of a separate chapter of his authoritative text, *International Franchising*: 136

- **direct franchising** - the franchisor directly franchises from its home country through contracts with individual franchisees for individual franchise units in a foreign country, without the intervention of a third party;
- **subsidiary or branch** - the franchisor establishes a subsidiary or branch office in a foreign country, for the purpose of granting franchises in the foreign country;
- **area development agreement** - the franchisor directly enters into a development agreement with a developer in the foreign country for the developer to develop and own all of the franchise outlets in the foreign country (or in a particular territory within it);
- **master franchise** – the franchisor grants a master franchise to a sub-franchisor, permitting the sub-franchisor to grant sub-franchises, as well as in most cases to establish their own franchise outlets, in the foreign country;
- **joint venture agreement** – the franchisor enters into a joint venture agreement

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136 Konigsberg, op cit note 135.
with an enterprise in a foreign country to establish a joint venture\textsuperscript{137}, which then enters into either a development agreement or, more typically, a master franchise agreement with a sub-franchisor in the foreign country.

However, other scholars take a slightly different approach. Mendelsohn suggests seven methods are commonly in use:

- company-owned only operations;
- direct franchising;
- the establishment of a branch operation;
- the establishment of a subsidiary;
- the establishment of an area developer;
- the grant of master franchise rights; and
- the entry into of a joint venture.\textsuperscript{138}

Mendelsohn distinguishes branch operations from subsidiaries as methods of international expansion. Such classification recognises the legal differences which exist between a branch and a subsidiary in which the subsidiary is a legal person and legally separate from its parent company. Mendelsohn included company-owned only operations as a way of international expansion - which refers to a franchisor expanding in the foreign market through company owned and managed stores - as a type of international expansion.\textsuperscript{139} However, to operate in the foreign country through company owned stores, a franchisor has to register its business with the authority in the host country, typically as a branch or a subsidiary, before conducting business activities.\textsuperscript{140} Thus, “company-owned only operations” is not a method of international expansion as an option for entering a target country market which can

\textsuperscript{137} Typically, a joint venture in Western countries is not a corporation. However, a joint venture in China can be either a company with separate legal identity or simply a contractual relationship as in Australia (see generally Chapter 6.3).
\textsuperscript{139} Ibid at 32.
\textsuperscript{140} To conduct business in the target country via company owned stores is normally bind by the local law and regulation.
only be achieved after the establishment of the branch or subsidiary.

The classification of entry modes by Duniach-Smith has further developed these theories. \textsuperscript{141} International franchising entry modes are divided into direct and indirect modes based on whether there is a third party in the relationship between the franchisee and the franchisor.

\textbf{Figure 5 Entry Mode Choices by Duniach-Smith}

![Diagram of entry mode choices]


Irrespective of which of the above modes is used by a franchise company to enter a foreign country, there will always be an agreement between the franchisor and the entity in the foreign country which is granted franchising rights. International franchising has been defined as “a foreign market entry mode that involves a relationship between the entrant (the franchisor) and a host country entity, in which the former transfers, under contract, a business package (or) format, which it has

developed and owns, to the latter.\textsuperscript{142} The entity in the host country can be a franchisee, a master franchisee, or an entity which is wholly or partly owned by the franchisor. For such reason, some scholars insist that the international expansion of a franchise company should be defined as international franchising to distinguish it from foreign direct investment, regardless which form of entry mode is used.\textsuperscript{143} Early research suggested that franchising is different from direct investment, given that franchising in its purest form does not involve any equity investment by the franchisor.\textsuperscript{144} However, later research has shown that different modes of international franchising require different levels of financial exposure.\textsuperscript{145}

Three categories of characteristics - firm characteristics, source country characteristics, and recipient country characteristics, were subsequently proposed to distinguish international franchising from other forms of international business expansion.\textsuperscript{146} From a franchisor’s perspective, it is more immune to foreign exchange risk because most inputs are provided locally.\textsuperscript{147} From a home country perspective, international franchising is generally not associated with home-country job loss because most franchising operations are services and not suitable for exporting.\textsuperscript{148} From a host-country perspective, the balance of payments is not as severely affected as in foreign direct investment, because of the minimal imports, and little repatriation of profits (due to the ownership often being local).\textsuperscript{149} Because of those characteristics, Aydin and Kacker have distinguished international franchising from foreign direct investment.\textsuperscript{150} Burton and Cross also claim that international franchising modes of entry should be treated as a separate construct.

\textsuperscript{143} Alon op cit note 68 at p13; Krista Duniach-smith op cit note 141.
\textsuperscript{145} Alon op cit note 68 at 13.
\textsuperscript{146} Aydin and Kacker op cit note 90.
\textsuperscript{147} Aydin and Kacker op cit note 90.
\textsuperscript{148} Alon op cit note 68 at 13.
\textsuperscript{149} Aydin and Kacker op cit note 90.
\textsuperscript{150} Aydin and Kacker op cit note 90.
Although from the perspectives of firm, source country, and recipient country characteristics, differences exists between franchising expansion and FDI, some of the distinctions are nevertheless unique to particular industries rather than inherent distinctions of franchising expansion. For example, to open hotels in foreign country does not necessarily result in job loss in the home country regardless of whether FDI or franchising is adopted. Furthermore, when franchising firms choose the subsidiary/joint venture as entry modes, a high level of control can be achieved through actual control of the foreign entity and it will face repatriation of profits as FDI.

While some scholars distinguish international franchising from foreign direct investment, many other scholars have simply used the term ‘international expansion’ without consideration of the differences, especially if an actual monetary investment (through subsidiary or joint venture) and a physical presence in the target country is involved. It is not the purpose of this research to discuss the theoretical differences between international franchising and other international expansion methods. From a legal perspective, when a subsidiary or joint venture is chosen by a franchisor to expand offshore, the law on foreign investment (if any) in the target country will apply. Taking into consideration the differences between entry modes from the legal perspective, this research classifies entry modes available to a franchisor for international expansion into:

- direct franchising;
- master franchising;
- area development agreement;
- branch;
- subsidiary, and
- joint venture.

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152 Königsberg always uses the term 'international expansion'.
3.3.3 An Examination of the Alternative Entry Modes

3.3.3.1 Direct Franchising

Direct franchising involves a direct contractual relationship between the individual franchisee and the franchisor without an intermediary. The contemporary forms of direct franchising include single unit and multiple unit franchising. Direct franchising is widely used in domestic franchising. Where two countries are geographically close and culturally similar, or when the nature of the franchise system is uncomplicated, direct franchising can well serve the international expansion of a franchising firm. Direct franchising is also used in situations where legal restrictions make setting up a subsidiary of branch office difficult or impossible or where tax benefits can be achieved without a physical presence in the foreign country. Direct franchising makes the provision of services by a franchisor to franchisees increasingly difficult as geographic distance increases. However, if a franchisor wants to open up only a minimum number of franchise outlets in a target market, or if a franchisor can serve individual franchisees in the foreign country effectively by employees of the franchisor in the home country due to the uncomplicated nature of the franchise system, direct franchising can be used.

Direct franchising offers financial advantages to a franchisor in both the short term and the long term. It requires a low capital investment at the initial stage as a franchising firm can use in-house personnel without a presence in the target country. In the long term, it is more profitable as the franchisor collects royalties and other fees and does not need to share these with a third party. By contrast, in master franchising and joint venture arrangements, the franchisor has to share the financial benefits with the sub-franchisor or joint venture partner. Direct franchising allows a franchisor rapid market entry and total control of the franchise system including in respect of advertising and promotion. In some situations, it may serve as an alternative to overcome the legal impediments which may exist in relating to

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153 Konigsberg, op cit note 135 at 87.
154 Ibid.
subsidaries or joint ventures. However, although direct franchising provides a franchisor the opportunity to enter a foreign market quickly, it also limits the speed and scale of the franchise system’s expansion. The franchisor has to negotiate and train each franchisee and service them from the home country which can be difficult and time consuming.

3.3.3.2 Master Franchising

In master franchising, the franchisor enters into a master franchise agreement with a sub-franchisor, who has the right to develop its own franchise outlets and to sub-franchise outlets to sub-franchisees. Master franchising is the most popular international expansion method. Research suggests that 50 percent of US franchisors use master franchise agreements to establish their franchise systems in foreign countries. Master franchising is one of the indirect franchising modes as the sub-franchisor plays an important role in promoting and developing the franchise system in the target market. When the franchisor does not have capital or management personnel carrying on operation in a foreign country, or does not want to invest financial and other resources into the target country, master franchising becomes a attractive choice. The sub-franchisor takes most of the financial burden in the target market which minimises the use of the franchisor’s financial resources and management personnel. Another advantage of master franchising is that it can facilitate the development of the franchise system in the target country as the sub-franchisor is familiar with the law, the local market and the culture. However, although master franchising provides lower risk for the franchisor as the sub-franchisor assumes the risk and the financial burden, the failure of a sub-franchisor may result in the failure of the territory granted which is frequently the entire

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155 However, as discussed in Chapter 7, direct franchising from a foreign country is not expressly legitimised under the Chinese law.
157 Bruce J. Walker, 'A Comparison of International vs Domestic Expansion by U.S. Franchise Systems' *International Franchise Association*
country or at least a substantial region of it. Master franchising also lowers the franchisor’s profit as the franchisor share the profit with the sub-franchisor.

3.3.3.3 Area Development Agreement

In an area development arrangement, the franchisor enters into a development agreement directly with a developer under terms that the developer agrees to develop, own and manage all of the franchise outlets in an exclusive area. On the one hand, an area development agreement is similar to direct franchising, as the franchisor enters into direct contractual relationship with franchisee/developer without the intervention of a third party. On the other hand, an area development agreement is similar to master franchising, as the developer/sub-franchisor assumes the financial burden of promoting the system in the target market which requires financial and management resources. An area development agreement is a cost-effective and relatively straightforward way to expand globally as the franchisor only needs to deal with one (in the case of a country developer) or a limited number (in the case of territory area developers) of franchisees, and relies on the developer to secure locations and to administer the franchise system in the target country. A developer normally has to pay an area development fee in addition to the franchising fee upon execution of the area development agreement which makes the area development agreement an attractive choice for the franchisor economically although the franchisor has to share profit with the developer. However, the failure of a developer may lead to more serious injury to the franchise system because the developer owns all stores in the area and all outlets are therefore affected.

3.3.3.4 Subsidiary

The franchisor can establish a subsidiary in the target country. The subsidiary can

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158 See discussion Konigsberg, op cit note 135 at 91-94.
159 Ibid.
open its own stores or act as the franchisor in granting franchises to franchisees in the host county. In most jurisdictions, the subsidiary, a legal person as opposed to a branch office, will insulate the franchisor from liability and deflect litigation in the event of disputes with franchisees or other third parties. The subsidiary offers the franchisor the same advantages as direct franchising as there is no third party between franchisor and franchisee. The franchisor remains in full control of its trademark and other intellectual property. A subsidiary involves a substantial investment into the target country by the franchisor, but it also offers advantages which direct franchising cannot offer. The franchisor can establish a pilot outlet to train franchisees in the target country and can also service franchisees and thus overcome the limitations of direct franchising. By having a physical presence in the foreign country, a franchisor has better access to management personnel who are familiar with the local market. By establishing a subsidiary, a franchisor can more easily bring legal action against a defaulting franchisee. The major disadvantage of a subsidiary is that the franchisor has to assume the costs and potential risks associated with the business, albeit it not being liable in law for the subsidiary’s debts.

3.3.3.5 Branch

A branch offers some of the advantages that the subsidiary offers, such as servicing franchisees and providing training in the target country. However, a branch office is not a separate legal person and the franchisor will be exposed directly to litigation in the foreign country. The decision for choosing between a branch offices or foreign subsidiary is usually one based on by tax and legal considerations. If the franchisor expects losses in the initial years, a branch office would be a better choice as, in most jurisdictions, the franchisor can offset the losses a branch office makes

161 Konigsberg op cit note 135 at 93.
162 Konigsberg, op cit note 135 at 91.
against the profits earned in home country. However, overall, both franchisors and franchisees in the target market favour a subsidiary over a branch office as the entry vehicle.

### 3.3.3.6 Joint Venture Agreement

A franchisor can enter into a joint venture agreement with a local partner (or partners) to establish a presence in the foreign country. The parties can establish a joint venture company which is a separate legal person or make a contract enshrining an unincorporated joint venture relationship. The joint venture can obtain franchising rights from the franchisor through a development agreement or, typically, a master franchise agreement to expand in the target country via either joint venture owned outlets or franchised outlets. It is generally believed that joint venture agreement is suitable for situations similar to those which favour master franchises and area development agreements. The local partner provides financial capital and management personnel which reduces the franchisor's burden and risk. It is familiar with the laws, market and culture which increases the likelihood of success in launching and expanding the franchise system in the target country. Having a local partner may also give a franchisor greater opportunity to access governmental subsidies or grants or obtain approval required. By having equity in the joint venture, the franchisor has better control over the franchise system and the trademark and can share the profits of the joint venture which makes it more profitable than master franchising and area development agreements. However, a local partner in the joint venture may lead to franchisor being disadvantaged. The joint venture may not operate in the way the franchisor wants, or may even be unable to act due to disagreements between the joint ventures. Many commentators suggest that due to its own inherent problems, careful consideration should be taken before choosing the

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163 Ibid.  
164 Ibid.  
165 See discussion Konigsberg op cit note 135.
joint venture over other entry methods. Königsberg also suggests, without discussion, that the joint venture may be the only practical alternative available to international expansion franchisors into Eastern European, China and certain South American countries.

3.4 CONSIDERATIONS IN ENTRY MODE CHOICE

3.4.1 General Considerations and Determinate Factors

Mendelsohn suggests that franchising transactions can be broken down into seven stages: i) development of the concept; ii) structuring the franchise package; iii) marketing the franchise package; iv) opening for business; v) long term relationship; vi) termination of the contract; and vii) the consequences of termination. There are different commercial and legal considerations at each stage. When considering the internationalisation of franchising, as discussed in Chapter 3.2.5, there are both organisational factors and environmental factors affecting a franchisor’s choice of whether to expand overseas, choice of target country and choice of entry mode. For example, a franchisor with substantial capital and management resources will have more entry mode choice in comparison with a franchisor with lesser resources. The latter franchisor will have to choose an entry mode which requires a lower resource commitment. If the target country is considered relatively unstable politically, a franchisor may favour the entry mode which disseminates risk.

Generally speaking, direct franchising, master franchising and area development

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166 Königsberg op cit note 135 at 209.

167 In the case of China, as discussed in Chapter 6, the joint venture was the first FDI vehicle defined by law. Liu in KFC in China. Secret Recipe for Success noted that ‘the local Chinese joint venture partners provided singicant, if not pivotal, contributions not only in getting KFC through a complex mase of government licensing and regulatory hurdles, but also in a multitude of other ways”. Warren K Liu, KFC in China. Secret Receipe for Success, John Wiley, Singapore 2008 at 48.


169 Ibid.
franchising require less capital compared with the branch, the subsidiary and the joint venture. The subsidiary is the most costly as it is more substantial than a branch and has no partner sharing the cost as in a joint venture, but it offers full control and greater potential in a foreign market. Direct franchising allows franchisor entry into a foreign market quickly, but it limits expansion scale in long term. Furthermore, although direct franchising gives the franchisor control, if the geographic and cultural differences are great, it is difficult for franchisor to control the standard of its system from its home country. By adopting master franchising or area development, the franchisor has less control of the system and has to share profit with master franchisee/developer. Termination of the franchise agreement in the case of the unsatisfactory performance of the sub-franchisor/developer is difficult as they will control the system outlets in the target country. The failure of the sub-franchisor may result in the failure of the franchise system in the target country. The disadvantage of the branch in comparison to the joint venture and the subsidiary is to expose the franchisor to liabilities.

Table 3: Comparison of Entry Modes

<table>
<thead>
<tr>
<th>Entry mode</th>
<th>Control</th>
<th>Resource commitment</th>
<th>Dissemination of Risk</th>
<th>Profitability</th>
</tr>
</thead>
<tbody>
<tr>
<td>direct franchising</td>
<td>high</td>
<td>low</td>
<td>medium</td>
<td>high</td>
</tr>
<tr>
<td>subsidiary</td>
<td>high</td>
<td>high</td>
<td>medium</td>
<td>high</td>
</tr>
<tr>
<td>branch</td>
<td>high</td>
<td>medium</td>
<td>low to medium</td>
<td>high</td>
</tr>
<tr>
<td>master franchising</td>
<td>low</td>
<td>low</td>
<td>high</td>
<td>low</td>
</tr>
<tr>
<td>area development agreement</td>
<td>medium</td>
<td>low</td>
<td>high</td>
<td>low to medium</td>
</tr>
<tr>
<td>joint venture</td>
<td>medium</td>
<td>low to medium</td>
<td>medium</td>
<td>medium</td>
</tr>
</tbody>
</table>

Cost, control, risk, expansion speed, taxation and many other factors are of concern to a franchisor in choosing entry modes. Such a choice is a strategic choice for a firm when expanding overseas. However, in certain countries, due to restrictions in law and political influence, entry mode choice may be limited by regulatory and political
Among the 17 major environmental determinants of entry mode choice by franchisors, local regulation is the 4th most important factor after the country's financial situation, economic risk and brand protection conditions.  

**Table 4: Environmental Determinants of Entry Mode Choice by Franchisors**

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Environmental factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Financial situation of local partners</td>
</tr>
<tr>
<td>2</td>
<td>Economic risk</td>
</tr>
<tr>
<td>3</td>
<td>Brand protection conditions</td>
</tr>
<tr>
<td>4</td>
<td>Local regulations</td>
</tr>
<tr>
<td>5</td>
<td>Market size</td>
</tr>
<tr>
<td>7</td>
<td>Political risk</td>
</tr>
<tr>
<td>8</td>
<td>Competitive situation</td>
</tr>
<tr>
<td>9</td>
<td>Level of economic development</td>
</tr>
<tr>
<td>10</td>
<td>Cultural differences</td>
</tr>
<tr>
<td>11</td>
<td>Source of supply</td>
</tr>
<tr>
<td>12</td>
<td>Conditions of out-going money transfer</td>
</tr>
<tr>
<td>13</td>
<td>Tax system</td>
</tr>
<tr>
<td>14</td>
<td>Geographical/physical distance</td>
</tr>
<tr>
<td>15</td>
<td>Franchisor's national culture</td>
</tr>
<tr>
<td>16</td>
<td>Penetration rate of foreign firms</td>
</tr>
<tr>
<td>17</td>
<td>Marketing infrastructure</td>
</tr>
<tr>
<td>18</td>
<td>Importance of franchising in the host country</td>
</tr>
</tbody>
</table>

Given that the brand protection condition is largely dependent on the law and regulatory environment in the target country, local regulations are particularly important.

### 3.4.2 Legal and Political Issues in Entry Mode Choice

It is not surprising that a third of the environmental factors listed in Table 3.3 directly relate to legal and political issues. Political issues influence legal and regulatory regimes which in turn have a pervasive and fundamental impact of the

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Krista Duniach-Smith op cit note 141.
conduct of any business in any country. The law, and the political system which shapes it, must be taken into account at each stage of franchising development and is a significant consideration in the entry and expansion mode decisions and strategies of internationally expanding franchisors. This thesis examines these issues in the context of China – a young but rapidly developing franchise market which holds great interest for foreign franchisors because of its massive potential but which is characterised by a regulatory system in transition which complicates entry and expansion mode strategies.

3.5 RESEARCH QUESTIONS DEVELOPMENT

An internationally expanding franchisor usually has range of alternative entry modes to a target country – direct franchising, master franchising, area development agreements, joint venture, subsidiary and branch. The foreign franchisor who has entered a host country through establishing a physical presence in the country also has a range of alternative expansion options including building a network through a chain of directly owned and managed outlets or through franchising. The strategic choices to be made in relation to entry and expansion are critical decisions which have a real impact on the foreign franchisor’s performance in the target market. Research has been carried out by international scholars to identify factors influencing a foreign franchisor’s entry and expansion mode decisions and the advantages and disadvantages of each mode. There is extensive literature covering the laws affecting franchising in developed countries. Much less research has been undertaken on franchising in emerging markets and developing economies. The first research question focuses on an area which has yet be examined in depth – the regulatory environment for foreign franchisors in China and its impact on strategic entry and expansion decisions.
Research question 1:

How have the laws governing the entry mode for, and expansion strategy of, foreign franchisors in China developed under the influence of China’s WTO negotiation and accession commitments and to what extent do they provide an appropriate regime for foreign franchisors?

The decade 1997 - 2007 was a decade of development for franchising in China as regulation of franchise operations progressed from rudimentary industry rules under the 1997 Franchise Measures to a comprehensive and authoritative instrument under the 2007 Franchise Regulation. The second research question examines the political, legal and commercial influences driving this reform and assesses its likely impact in laying a foundation for the future development of the Chinese franchise sector.

Research question 2:

What have been the major influences driving the development of China’s regulatory regime for the operation of franchising in China and to what extent does it provide an appropriate regime for domestic and foreign franchisors?

While the law inevitably impacts on, and shapes, business activity, in relation to franchising in China the regulatory regime has had a more fundamental role. Unlike the situation in developed countries where franchising is a product of business, in China franchising is a product of law. The development of franchising in China effectively commenced with the introduction of the 1997 Interim Franchise Measures which for the first time recognised franchising, signalled government’s support for it and provided a rudimentary framework for operation. The third research question analyses the role of the specific franchise laws and the liberalisation of regulatory constraints on the development of franchising.

Research question 3

To what extent has the legal and regulatory environment influenced the
development of franchising in China and the entry mode and expansion decisions of foreign franchisors?

3.6 SPECIAL NOTES

It is business format franchising which is driving the growth of the franchise sector. For this reason, this thesis focuses on business format franchising and, unless otherwise specified, 'franchising' refers to business format franchising.

This thesis addresses Chinese Law. Hong Kong and Macao are under the sovereignty of China, and Taiwan is officially a part of China, but different legal systems and laws apply in Hong Kong, Macao and Taiwan. This thesis addresses laws in Mainland China only unless otherwise specified, and 'China' refers to Mainland China.

To avoid confusion and ensure uniformity, all authors' names are provided with given name first and surname last regardless of the custom in their language when cited in the footnotes. Names in the bibliography are listed according to the alphabetical order of the surname, with a comma after the surname and before given name. However, when in the text, if a name is cited in the native language as surname first and given name second and such usage has been widely accepted in the English speaking countries and is used by Western media, the tradition is followed to avoid confusion. In such situations, no comma is used after the surname. For example, Deng Xiaoping is written as surname (Deng) first, given name (Xiaoping) second without a comma. When more than one translations of a name from Chinese into English exist, standard Mandarin Chinese is used in the main text, although other translations may be given in the footnote if the translation has also been used frequently and has been well received.

Three current franchise specific laws in China, are attached in both Chinese and English as Appendix I, II and III. Other laws referred in the thesis are noted, but not provided in full text. When different translations/interpretations of such laws exist
due to ambiguity in their original expression in Chinese or from misunderstandings resulting from cultural and/or other differences, the relevant provision is provided in Chinese in a footnote where the English translation is referred to, but the Chinese version is not provided otherwise.

It is the common practice in China that, if a law is amended, the law will be re-issued and article/provision numbers will be changed accordingly.\textsuperscript{171} This practice has caused confusion as it is different from the Western legal tradition. Article/provision numbers cited in this thesis are based on the current law unless otherwise specified.

\textsuperscript{171} For example, if article 2 is deleted by the amendments, article 3 of the original law will become article 2 in the amended law when the law is re-issued after the amendments.
PART TWO

LEGAL ENVIRONMENT
FOR FRANCHISING IN CHINA

CHAPTER 4  CHINA’S LEGAL SYSTEM – TOWARDS THE RULE OF LAW

CHAPTER 5  DEVELOPMENT OF THE UNDERLYING COMMERCIAL LAW SYSTEM

CHAPTER 6  FOREIGN INVESTMENT AND MARKET ENTRY

CHAPTER 7  FRANCHISE SECTOR REGULATION AND THE FOREIGN FRANCHISOR
CHAPTER FOUR

CHINA'S LEGAL SYSTEM: TOWARDS THE RULE OF LAW

4.1 INTRODUCTION

As discussed in Chapter Three, the legal environment of the target market is an important factor affecting franchisors' international expansion decisions. This factor is particularly important when expanding to a developing country such as China because it generally has an immature legal system and restrictive foreign investment laws. Part Two of this thesis comprises four chapters on China's legal environment for franchising, with a particular focus on the legal and regulatory environment for foreign franchising.

This first chapter of Part Two provides a general introduction to the Chinese legal system. A broad understanding of the complex history of China's legal system is necessary to better appreciate the extent of the reforms of the last two decades and the current constitutional, legal and political environment which shapes business operations today. Firstly, it reviews the tradition of the Chinese legal system and its development following the Cultural Revolution, and provides the important background context to understanding the complications of law reform and legal culture in China. Legislative power under the current Chinese Constitution, and dispute resolution mechanisms, are also examined. While it is beyond the scope of this thesis to provide a comprehensive introduction to China's legal system, trends have been considered regarding transparency and stability of legislation, and judicial competence and independence – these being essential to an appreciation of the regulatory environment for foreign franchisors.
4.2 CONSTITUTIONAL DEVELOPMENT AND LEGISLATIVE POWER

4.2.1 History

Early Chinese theories of law are often classified as *Lizhi*, traditionally associated with Confucianism, and *Fazhi*, associated with Legalism.\(^1\) Confucianism suggested that people should restrain their behaviour in accordance with principle of ‘*Li*’\(^2\) and that emperors should control the common people by using moral rules rather than punishment. Legalism promoted the use of law rather than the use of any man-power to control the state and the people. For over two thousand years, until the early 1900s, China had a developed legal system with detailed legal codes, legislative procedures, rules specifying the hierarchy of different legislative sources, and a multi-level court system.\(^3\) Procedural rules covered all aspects of litigation from the filing of a complaint to pre-trial investigation, the trial, the issuance of the judgment, and the appeal.\(^4\)

By the end of the Qing Dynasty (1644-1912), China’s defeats in wars with Great Britain and Japan had shaken the confidence of its rulers and citizenry who had presumed that Chinese civilization and its ideological belief of Confucianism were superior.\(^5\) Many reformers proposed institutional and legal reforms, and a Law Codification Commission was established to study foreign law and the reform of Chinese law.\(^6\) They translated Western legal ideas into Chinese and prepared a draft

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2. ‘*Li*’ means good manner and politeness, See Chapter 2.2.
3. Randall Peerenboom, ibid, 36.
4. Randall Peerenboom, ibid.
5. Jianfu Chen, op cit note 1 at 23; Kui Hua Wang op cit note 1 at 23.
6. Those reformer included Liang Qichao and Sun Zhongshan, who are also well know for their achievements as revolutionaries. The establishment of the Law Codification Commission was seen as the commencement of a new era. Tien-His Cheng, a former Chinese judge at the Permanent Court of International Justice, in ‘The Development and Reform of Chinese Law’ 1948 (1) *Current Legal Problems* 170 at 179.
civil code modeled on the German Civil Code.\(^7\) The drafts were never formally adopted before the Qing Dynasty ended in 1911. After the failure of the attempt to move to a republic in the 1910s, China was governed by combating warlords throughout the 1920s and 1930s.\(^8\) Legal reforms proposed had little lasting impact, due to the turbulence of foreign invasions (the China-Japan war, which was a part of World War II, 1937-1945) and civil war (between Guomindong and Communist Party of China, 1945-1949). Although a *Civil Code* was officially adopted by the Republic of China in 1930, widespread civil strife meant that it was never effectively implemented.\(^9\)

Soon after the establishment of the People’s Republic of China (PRC) in 1949, the Communist Party of China (CPC) abolished the Guomindong (GMD) government’s legal system which was considered to have supported “semi-feudal” or “semi-colonial” rule.\(^10\) Under the leadership of Mao, the PRC carried out nationalisation and collectivisation measures as part of the move to communism. From the 1950s, the government launched several legislative projects with the help of the Soviet Union. The first Constitution of the PRC was promulgated in 1954\(^11\), followed by laws relating to the structure of the State. The *Marriage Law*, the *Trade Union Law*, and the *Land Reform Law* were soon issued.\(^12\) The drafting of a *Criminal Code*, *Civil Code* and *Criminal Procedure Code* commenced. Legal institutions were

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\(^8\) As discussed in Chapter 2.2.2.


\(^10\) China was governed by various war lords and China into war with Japan 1937-1945. The domestic war (1945-1949) between the CPC and KMT ended in 1949 with the CPC established the PRC on 1 October 1949.

\(^11\) The first Constitution of the PRC was enacted by the 1st Session of the 1st NPC on 20 September 1954.

strengthened. The concept of judicial independence was introduced and law schools were established to train judges and lawyers. Alongside the CPC hierarchical system, China developed a strong government bureaucracy with power centered around the President as head of state. However during the subsequent Cultural Revolution (1966-1976), all legal institutions were abolished and China was governed by CPC policies rather than by laws.

4.2.2 The Contemporary Legal System

4.2.2.1 From Rule by Man to Rule of Law

For thousands of years, China had a deep-rooted legacy of feudalism, under which the emperor had an absolute monopoly of power. Despite the fact that the Imperial legal system was well-developed in many respects, it could not be characterised in terms of rule of law. Influenced by this feudal legacy, Mao strongly advocated ‘rule by man’ which he believed was more effective than ‘rule of law’. Mao’s ‘rule by man’ meant that China was ruled according to the CPC’s decisions and policies at the beginning of his leadership. In the early years of the PRC, a collective process based on multi-party coalition principles was maintained in the drafting of the Constitution, basic laws and principal policies.

The 1954 Constitution centered policy-initiating and decision-making powers on

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13 There were 4,072 laws, regulations, and decrees were passed from October 1949 to October 1957 as suggested by Alice E-S Tay in (1976) 6 Sydney Law Review 400 at 411. For discussion, see Jianfu Chen, op cit note 1 at 39-49.
14 Yanlai Wang, China’s Economic Development and Democratization (2003) ASHGATE.
15 In many ways, Mao’s words were law at that period. See general discussion in: Tony Saich, Governance and Politics of China (2nd 2004) Palgrave Macmillan, pp110-111; Yanlai Wang, op cit note 14 at 55-90.
16 Yanlai Wang, op cit note 14.
17 Randall Peerenboom, op cit note 1 at 41.
19 Yanlai Wang, op cit note 14 at 56.
20 Yanlai Wang, op cit note 14 at 56-57.
the President, which challenged the traditional political and military authority of the Chairman of the CPC. Consequently, President Liu Shaoqi was targeted during the Cultural Revolution and, in 1968, was ousted from all party and government posts. Mao became the supreme power. Mao discarded the party collective decision-making process and issued instructions directly to party members and the people at large. The role of President was deleted from the state system and was not reinstated until 1983. During the Cultural Revolution, law schools were closed down, lawyers were persecuted and courts were combined with military-controlled public security bureaus. All instructions and orders came from Mao. In January 1975, the Cultural Revolution was institutionalised through Constitutional amendments. The office of President was officially removed as was the provision that ‘everyone is equal in law’.

The reform process did not start when the Cultural Revolution ended upon Mao’s death in 1976. His successor, Hua Guofeng, followed Mao’s ideology and called for the ‘safeguarding of whatever decisions Chairman Mao had made and the upholding of whatever instructions Chairman Mao had given’. The concept of the ‘post-Mao era’ and the ‘reform and opening up era’ implicitly started in December 1978 when the Third Plenary Session of the Eleventh Central Committee of the CPC introduced reforms.

The need for reform and a move to the rule of law was not discussed until after the publication of an article entitled ‘Practice is the only Criterion for Testing Truth’ in

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21 The current President of China also holds the position of Chairman of the CPC.
22 Yanlai Wang, op cit note 14 at 56.
23 Yanlai Wang, op cit note 14 at 75-82.
24 During the Cultural Revolution, the party members, cadres and masses were organized to listen to Mao’s Supreme Order from the radio broadcasting everyday usually in the evening. The book of quotations from Mao, known as The Little Red Book, was considered the rule for daily life for all citizens. Yanlai Wang, op cit note 14 at 77.
25 The 1975 Constitution of the PRC was introduced by the 1st Session of the 4th NPC on 17 January 1975.
26 Article 85, the 1954 Constitution.
27 This was referred to as ‘Two Whatevers’ in China.
the *Guang Ming Daily* on 11 May 1978. This article espoused Deng Xiaoping’s view of ‘seeking truth from facts and promoting democracy’. The resulting public discussion led to an ideological consensus among academics, the general public and the ruling elite. Deng Xiaoping then made a speech in late 1978 outlining his vision for modernising China. His vision included a focus on economic reconstruction and strengthening the legal system. Deng stated that:

> In order to safeguard people’s democracy, the legal system must be strengthened. Democracy needs to be institutionalised so that such a system and such laws would not change merely because of a change of leadership or a change in the leaders’ views and attention. The present problem is that the laws are incomplete; many laws have not yet been enacted. Leaders’ words are often taken as ‘law’, and if one disagrees with what the leaders say, it is called ‘unlawful’.

Under Deng’s leadership, the rule of law was soon widely advocated and was written into the 1982 Constitution, Article 5 of which states: *All state organs, the armed forces, all political parties and public organizations and all enterprises and institutions must abide by the Constitution and the law.* The amendments of the

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29 The article was originally written by Yang Xiguang. It was revised by a working group arranged by the Chief Editor, Yang Xiguang, which included the author, editors of *Guang Ming Daily* and two researchers from the Theoretical Research Unit of the Part School of the CPC Central Committee. It was first published in the *Theoretical Trend*, an internal magazine of the Party School of the CPC Central Committee on 10 May 1978. It was reviewed and approved by Hu Yaobang, Vice Principal of the Party School and reprinted on *Guang Ming Daily* in the second day. It was reprinted by *People’s Daily* and many national and provincial newspapers afterwards. Interesting, Hu Yaobang served as Chairman of the CPC, which virtually the most powerful position in China, from 1982-1986. His death was the direct trigger of the Tiananmen Square Event in 1986.

30 Xiaoping Deng, speech delivered at the Third Plenary Session of the CPC Tenth Central Committee in July 1977 when Deng was formally reinstated to his position as vice-chairman of the CPC and Deputy Primer; published in Xiaoping Deng, Selected Works of Deng Xiaoping 1975-1982 (1983) Shanghai People’s Press, Shanghai pp39-44.

31 Xiaoping Deng, ‘Emancipated the Mind, Seek Truth from Facts, Unite and Look Ahead’ speech delivered at the closed session of the Working Conference of the CPC Central Committee on 13 December 1978 which made preparations for the Third Plenary Session of the Eleventh Central Committee of the CPC that immediately followed; published in Xiaoping Deng, Selected Works of Deng Xiaoping 1975-1982 (1983) Shanghai People’s Press, Shanghai; the English version was translated by the Central Compilation and Translation Bureau, published by Foreign Language Press, Beijing, in 1983.

32 Ibid.

33 The current Constitution was adopted at the Fifth Session of the Fifth NPC and promulgated for implementation by the announcement of the NPC on 4 December 1982. It is discussed further in 4.2.2.2 below.
Constitution introduced in 1999 added phrase "yi fa zhi guo", which can be literally translated as 'rule the Country by law'. Paul Jones comments that:

While there is considerable debate as to whether this phrase is the equivalent of the English maxim 'rule of law' in a Chinese context, this appears to be a significant move forward in the development of a legal foundation of a market economy.

Despite the constitutional changes, there were differing views on the role that law and the courts should play in relation to the CPC’s leadership and policy. The lack of expertise in drafting laws necessary to safeguard the functioning of a socialist market economy slowed the reform process. The CPC’s policy, and its leader’s actions, continued to guide business activity when the law was silent. Deng Xiaoping was realistic about the challenge that lay ahead for China in developing its legal system:

There is a lot of legislative work to do, and we do not have enough trained people. Therefore, legal provisions will inevitably be rough to start with, then be gradually improved upon. ... In short, it is better to have some laws than none, and better to have them sooner rather than later.

Although it is difficult to precisely define the extent to which the Open Door policy influenced the move towards the rule of law, there is no doubt that legal reform benefited from its spirit of openness. China issued many new laws in the 1980s, and restored its justice system. However, these laws were frequently criticised for

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34 "yi fa zhi guo" 依法治国 was added to Article 5 of Constitution by the Article 13 of Amendments to the Constitution of the People’s Republic of China adopted by the Second Session of the Ninth NPC on 15 March 1999.
37 The decision of opening up was first made at the meeting of the CPC Central Committee, and Deng’s trip south in 1992 was understood as reigniting the reform engines regarding to foreign trade and investment after the 1989 Tiananmen incident, are evidence of that. See general discussion in Tony Saich op cit note 15; Yanlai Wang op cit note 14.
39 Randall Peerenboom, op cit note 1 at 58.
being vague and inconsistent.\(^{40}\) Much discretion remained with government agencies which led to differential treatment between domestic and foreign enterprises.\(^{41}\)

On 11 July 1986, China formally applied to resume its membership of the General Agreement on Tariffs and Trade (GATT)\(^{42}\), and its successor, the World Trade Organisation (WTO). Fifteen years of negotiations for GATT accession forced on China the realisation that it must accept international scrutiny of its trade policies and abide by the multilateral trading system’s rules. Many new laws were introduced and many existing laws were amended.\(^{43}\) It was observed that the “Chinese government is using the WTO accession to achieve internal reform”.\(^{44}\) 51 years after withdrawing from the international trade system, China was admitted to the WTO in November 2001.\(^{45}\)

China’s increasing engagement in the global community, and its accession to the WTO, have since influenced and stimulated further reform and improvement in the quality of its laws. Under its accession obligations, China committed to:

- make and apply laws in a ‘uniform, transparent, impartial and reasonable’ manner;\(^{46}\)

\(^{40}\) Jianfu Chen, ibid; Yanlai Wang op cit note 14.

\(^{41}\) In addition to different treatments between domestic and foreign invested enterprises create by law which is discussed in Chapter 5, there had been substantial treatment of business entities which material supply, taxation and quotas for loans are all allocated in all allocated through vertical and regional administrative networks which left private sector disadvantaged. Xudong Zhao ‘Certain Problems in Chinese Corporate Legislation’ (1991) 1 Journal of China University of Political Science and Law 43.

\(^{42}\) General Agreement on Tariffs and Trade (GATT) was formed in 1947 replaced by the World Trade Organization (WTO) in 1995. Main objective of GATT was to reduce barriers to international trade through the reduction of tariff barriers, quantitative restrictions and subsidies on trade through a series of agreements between member nations/regions (signatories to the GATT).

\(^{43}\) Relevant amendments are discussed in Chapters 5, 6 and 7.


\(^{45}\) Director General of the WTO at that time, Mike Moore, described China’s WTO accession as “one of the most significant events of the 21st century.” The Australian, 24 September 2001.

\(^{46}\) Article 10 of the General Agreement on Tariffs and Trade (1947) contains requirements respecting transparency and the impartial administration of law. The corresponding provisions are also in the GATS. China agreed to establish an official journal dedicated to the publication of
• provide judicial review of administrative decisions;\textsuperscript{47}
• continue to open up its market according to agreed schedules.\textsuperscript{48}

China has undertaken substantial legal reforms to address these commitments which are discussed in Chapters 5 and 6. The detailed laws relevant to franchising are discussed in Chapter 7.

4.2.2.2 Constitution

The current Constitution was adopted at the Fifth Session of the Fifth National People's Congress (NPC) and promulgated for implementation on 4 December 1982.\textsuperscript{49} It contains a Preamble and four Chapters. The Chapters cover general principles, the fundamental rights and duties of citizens, the structure of the State, and the national flag and emblems of the State, respectively. The supremacy of the Constitution is stated in the Preamble:

[The Constitution] ... is the fundamental law of the state and has supreme legal authority. The people of all nationalities, all state organs, the armed forces, all political parties and public organizations and all enterprises and undertakings in the country must take the Constitution as the basic norm of conduct, and they have the duty to uphold the dignity of the Constitution and ensure its

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\textsuperscript{47} The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement) is Annex 1C of the Marrakesh Agreement Establishing the World Trade Organization, signed in Marrakesh, Morocco on 15 April 1994. It sets forth a number of requirements for fair judicial proceedings for the protection of intellectual property right, in particular in Article 41(4).


\textsuperscript{49} Three previous Constitutions -- those of 1954, 1975, and 1978, were superseded in turn. The current Constitution was adopted at the Fifth Session of the Fifth NPC and promulgated for implementation by the Announcement of the NPC on 4 December 1982, amended in accordance with the Amendments to the Constitution of the People's Republic of China adopted respectively at the First Session of the Seventy NPC on 12 April 1988, the First Session of the Eighth NPC on 29 March 1993, the Second Session of the Ninth NPC on 15 March 1999 and the Second Session of the Tenth NPC on 14 March 2004 respectively.
The rule of law is directly stated in Article 5 of Chapter One. Chapter Two states that all citizens are equal before the law. Rights protected under the Constitution include the right to vote and to stand for election (for those who have attained the age of 18), freedom of speech, freedom of religious belief, the right to work, the right to rest, and the right to receive education. It also states that men and women shall be considered equal. Chapter Three sets out the governmental structure of the State and specifies the responsibilities and functions of various offices within the State structure.

The 1982 Constitution provided an extensive legal framework for the subsequent liberalisation of economic policies during the 1980s. It allowed the private sector to take a broader economic role, by providing for limited private economic activity. Members of the expanded rural collectives were given the right "to farm private plots, engage in household sideline production, and raise privately owned livestock". The Constitution referred to outside help for the modernisation program, and provided for the considerable body of laws which were subsequently passed to permit and encourage extensive foreign participation.

Amendments to the Constitution must be proposed by the NPC Standing Committee or by one-fifth or more of the NPC deputies. Such proposed amendments must then

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50 The last paragraph of the Preamble, Constitution, official translation by the Xinhua News Agency.
51 As discussed in 4.2.2.1 above.
52 Article 33, Constitution.
53 China has an indirect election system. The election of deputies of the National People Congress is indirect. Election at township level (cities not divided into districts, municipal districts, counties, autonomous counties, townships) has been direct since 1999.
54 Although the Constitution protect people's rights, such as listed, article 34 (right to vote and stand for election), article 35 (freedom of speech), 36 (freedom of religious belief), article 42 (the right to work), article 43 (the right to rest), article 46 (the right to receive education), the implementation of law and practice of such rights in China are far from the theory.
55 Article 48, Constitution.
56 The basic structure of state is discussed in Chapter 2.3 and Chapter 4.2.3 below.
57 The legitimatization of private economy as provided by the 1982 Constitution and its amendments is discussed further in Chapter 5.3.
58 Article 8, Constitution.
59 Preamble and Article 18, Constitution.
be passed by a two-thirds majority vote of all deputies. One of the important amendments made in recent years is the Amendments made in 2004 which clarifies the guarantees regarding private property that "legally obtained private property of the citizens shall not be violated". 60

4.2.3 Legislative Power

4.2.3.1 State Structure

The National People’s Congress (NPC) is the body with legislative power at a national level, with additional People’s Congresses at provincial and local levels with power to make provincial and local laws not inconsistent with national laws. Executive power is conferred on the State Council and its ministries and commissions. The People’s Courts have judicial power, and the People’s Procuratorates have procuratorial power.61 China has not adopted the separation of powers between Executive, Legislature and Judiciary organs of government.62 The Constitution of the PRC stipulates that the NPC is the highest organ of state authority. The State Council, the Supreme People’s Court, and the Supreme People’s Procuratorate are elected by and responsible to, the NPC.

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60 Article 22, Constitution. The Property Right Law was enacted by the 5th Session of the 11th NPC on 16 March 2007, taking effect on 1 October 2007.
61 The People’s Procuratorate is the legal supervision organ of the state which exercises the power of prosecution in criminal cases. It is responsible and reports to, the NPC and its Standing Committee.
62 Although the structure under the Chinese Constitution, which separated the power between the State Council (executive power), the People’s Congress (legislative power) and the People’s Court (judiciary power), is in a way similar to the structure under Western system, however, under the Chinese Constitution, the State Council and the People’s Court work under the supervision of the Standing Committee of the NPC and is responsible to the NPC and the People’s Congress at the respective level (Articles 67, 69 and 128, Constitution).
4.2.3.2 The National People's Congress

The National People's Congress (NPC) currently comprises 2,985 deputies. These are elected by the provinces, autonomous regions, municipalities directly under the Central Government and from the People's Liberation Army. Deputies are elected for five year terms. The NPC has power to amend the Constitution and oversee its enforcement, and to enact and amend Basic Laws. The NPC also elects and appoints members of the central state organs and decides on major issues of State. The NPC normally meets annually unless convened of necessity by its Standing Committee or its members according to stipulated procedures.

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63 Article 62, Constitution. There is no definition for 'Basic Laws' under Chinese law. In practice, presumably, the more important laws should be enacted and amended by the NPC and the importance is decided by the Standing Committee of the NPC. For example, Law on Chinese-foreign Equity Joint Ventures was adopted by the Fifth NPC on 1 July 1979; but Law on Chinese-foreign Cooperative Joint Venture was adopted at the Standing Committee of the Seventh NPC on 13 April 1988, presumably, Equity Joint Ventures Law was the first foreign investment law and thus more important than the later Cooperative Joint Venture Law.
The Standing Committee is the permanent body of the NPC. It currently comprises 175 members, including a Chairman, Vice-Chairman, and Secretary-General. It is elected by the NPC from among its deputies. The Standing Committee continues to function until a new Standing Committee is elected by the next NPC. It has constitutional authority to enact and amend all laws except laws that must specifically be enacted and amended by the NPC. It thus acts as a \textit{de facto} legislative body. When the NPC is not in session, the Standing Committee may partially supplement and amend laws the NPC has enacted, provided that the changes do not contravene the laws' basic principles. The Standing Committee also has quasi-judicial functions to interpret the Constitution and other laws. The Chairperson and Vice-Chairperson of the Standing Committee cannot hold office in any of the administrative, judicial or procuratorial organs of state.\footnote{Presumably, that is for the purpose of the separation of powers, but it did not solve the problems existing under Chinese system such as lack of independence of judicial system and corruption.} The Standing Committee also has supervisory power, the power to decide on major issues of state, and the power to appoint and remove state officials from office when the NPC is not in session.

The NPC is the only institution which has power to amend the Constitution. It enacts and amends Basic Laws pertaining to criminal offences, civil affairs, state organs and other matters. The legislative procedures of the NPC are governed by the \textit{Legislation Law}\footnote{\textit{Law of the People's Republic of China on Legislation} was adopted at the Third Session of the Ninth NPC and promulgated by the President of PRC on 15 March 2000, effective from 1 July 2000.}. The Presidium of the NPC\footnote{The Presidium of the NPC decides on meeting agendas and procedural issues of the NPC sessions. Candidates for the Presidium are nominated by the NPC Standing Committee, and submitted to the pre-session of the NPC for vote after taken suggestions given by various delegation groups. Members of the NPC Presidium include leaders of the CPC and the state, leaders from the central committees of non-Communist parties and deputies from Special Administrative Regions, Hong Kong and Macau, professional, industry and religious groups, and minority ethnic groups. The 2009 NPC Presidium is made up of 171 members and headed by the Secretary General of the NPC legislative session, Wang Zhaoguo, has served as a Vice-Chairman to the NPC Standing Committee since 2003.}, the NPC Standing Committee, the State Council, the Central Military Commission, the Supreme People's Court, the Supreme People's Procuratorate, the special committees of the NPC, a delegation of
deputies and a group of not less than 30 deputies can introduce Bills to the NPC.\textsuperscript{67} In practice, proposals for new laws are submitted by special committees of the NPC and the State Council. This makes the State Council influential in law making.\textsuperscript{68} After a Bill is examined and revised by the relevant special committees, it will be put by the Presidium to a session of the NPC for voting. The Presidium has discretion on whether to put a Bill on the NPC's agenda.\textsuperscript{69} Adoption of a Bill as a law requires a majority vote of all Deputies.\textsuperscript{70}

4.2.3.3 The Communist Party of China and the Chinese People's Political Consultative Conference

The Communist Party of China (CPC) has its National Congress every five years at which it elects a Central Committee (167 members). The leading bodies of the Central Committee are the Politburo (25 members) and the Politburo Standing Committee (nine members). These are elected by the Central Committee. Some scholars have suggested that the CPC effectively controls the Legislature, the NPC and the Executive.\textsuperscript{71} The Head of State, the Premier of the State Council, and the Chairman of the NPC Standing Committee are all members of the CPC Politburo, whilst members of the CPC constitute a majority within the NPC. The influence, and to some extent authority, of the CPC in the legal system and law making is ambiguous, but real, despite the efforts to separate the CPC from legislative authorities.\textsuperscript{72}

China is effectively a one-party state, with the Communist Party of China (the CPC)

\textsuperscript{67} Articles 12 and 13 of the \textit{Legislation Law}.
\textsuperscript{68} 70 percent of all the laws enacted by the NPC and its Standing Committee between 1979 and 2003 were initialed by the State Council. China Internet Information Centre 'Creation of Regulations by the State Council and its Departments', (2003) \url{http://www.china.org.cn/english/kuaxun/7630.htm}, last accessed 10 February 2007.
\textsuperscript{69} Articles 12 and 23, \textit{Legislation Law}.
\textsuperscript{70} Article 64, Constitution.
\textsuperscript{72} The official effort to separate the CPC from the legislature can be seen from the re-establishment of a Bills Commission in the NPC which ended the direct role of the CPC in legislative procedures but there are wide-ranging but ambiguous principles which allowing CPC has control over the law making. See discussion, Jianfu Chen, op cit note 1 at 192-197.
retaining control. There are, however, eight other political parties in China. Other political parties participate in discussion and recommendation of policy making through the Chinese People’s Political Consultative Conference (CPPCC). As a consultative organisation, the CPPCC and its Standing Committee plays a role in consultation on various matters. The CPPCC National Committee is composed of representatives from the CPC, all democratic parties, persons without party affiliation, mass organisations, all ethnic groups, various sectors of society, representatives from the Hong Kong Special Administrative Region, the Macao Special Administrative Region and Taiwan, returned overseas Chinese and specially invited public figures. The CPPCC is seen as an important institution of multiparty cooperation and political consultation affirmed by the Constitution. However, its influence through meetings and proposals is indirect and unclear.

4.2.3.4 State Council and Delegated Legislative Power

The State Council of the PRC, also known as the Central People’s Government, has the highest Executive power. The State Council is broadly similar in function to the Cabinet in Westminster political systems. However, the Premier as head of the State Council is nominated and appointed by the President, with the nomination reviewed by the NPC. Interestingly, the State Council is responsible for carrying out the principles and policies of the CPC as well as the regulations and laws adopted by the NPC. Members of the State Council include the Premier, a number of Vice-

73 The CPPCC used to be the Legislature, before the National People’s Congress was established in 1954.
74 Preamble, Constitution.
75 The White Paper on Democracy: Building of Political Democracy in China (《中国的民主政治建设》白皮书), issued by the State Council on 19 October 2005 reinstated the non-binding consultation of the CPPCC, but also emphasises the leadership of the CPC and the required support of such leadership. The White Paper on Democracy: Building of Political Democracy in China (中共中央关于加强人民政协工作的意见) can be accessed at http://news.xinhuanet.com/politics/2005-10/19/content_3645697.htm, last accessed 30 July 2009. Similar opinion can also be found in the CPC’s policy such as Opinions on Strengthening the work of the CPPCC issued by the CPC on 8 February 2006, can be accessed http://news.xinhuanet.com/misc/2006-03/01/content_4243798.htm, last accessed 30 July 2009. For further discussion, see Jianfu Chen, op cit note 1 at 106-111.
Premiers and State Councillors, Ministers, the Chairmen of all State Commissions, the State Auditor and the Secretary-General. Since 2003, under the State Council there are 22 ministries, four commissions, the People’s Bank of China, and the State Audit Office. There are also ten national administrative offices and organisations directly under the State Council, including the State Administration of Taxation, the State Administration for Industry and Commerce and the State Intellectual Property Office.

The State Council has legislative power to make regulations within the limits provided by the Constitution and by the laws enacted by the NPC and its Standing Committee. In fact, the State Council has been described as ‘de facto the most powerful law-making institution in China’. The ministries and commissions of the State Council are also empowered to issue regulations ‘in accordance with law and administrative rules and regulations decisions and orders issued by the State Council’. For matters within the authority of multiple departments, the State Council can prescribe administrative regulations or the departments concerned can jointly enact measures. Laws promulgated by the ministries have lower authority than laws promulgated by the State Council.

Although the State Council is responsible to the NPC and its Standing Committee, it has been said that the State Council is more powerful in practice.

4.2.3.5 Provincial and Lower Level Congresses and Governments

Local People’s Congresses at various levels are established in accordance with the

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77 Article 89, Constitution; Article 56, Legislation Law. The legislative procedure is set out in the Legislation Law and the Regulation on the Procedures for the Formulation of Administrative Regulations.
79 Article 90, Constitution.
80 Article 72, Legislation Law.
divisions of State administrative areas. There are four levels:

- People’s Congresses of provinces, autonomous regions and municipalities directly under the Central Government (provincial level),
- People’s Congresses of cities divided into districts and of autonomous prefectures (city level);
- People’s Congresses of cities not divided into districts, and of municipal districts, counties and autonomous counties (county level);
- People’s Congresses of townships, nationality townships and towns (township level).\(^{82}\)

The election of deputies to the NPC and provincial congresses is indirect, but election to People’s Congresses at county level and township level (including cities not divided into districts, municipal districts, counties, autonomous counties, townships, nationality townships and towns) is direct.\(^{83}\) Local People’s Congresses at or above county level have their own Standing Committees.

Provincial level congresses have the power to formulate and promulgate local regulations provided that such regulations do not contravene the Constitution or national laws, administrative rules or regulations.\(^{84}\) They can enact local rules on matters ‘to meet the needs of the local government in enforcing the laws, regulations and local regulations’.\(^{85}\) Local rules must be submitted for recording to the Standing Committee of the NPC and the State Council.

The People’s Congresses at city level have power to formulate local rules in their

\(^{82}\) Article 31 of the Constitution provides for an administrative division.

\(^{83}\) Article 97, Constitution.

\(^{84}\) Article 63, Legislation Law. Article 68 of the Legislation Law stipulates that the legislative procedures for local regulations shall be decided by the people’s congresses concerned in accordance with the Organic Law of the Local People’s Governments of the People’s Republic of China (it was adopted at the second Session of the Fifth NPC on 1 July 1979, amended on 10 December 1982, 2 December 1986, 28 February 1995 and 27 October 2004).

\(^{85}\) Articles 63 and 73, Legislation Law.
respective administrative areas. Such regulations must not contravene the Constitution, or laws, administrative rules and regulations at national level as well as any local regulations formulated by the Provincial People’s Congresses. Rules imposed by city level People’s Congresses are implemented only after approval by the Standing Committees of the relevant provincial level congress. The Standing Committee of the provincial level Congress then submits it to the NPC and the State Council for recording.

Hong Kong and Macao were established as Special Administrative Regions upon their return to China in 1997 and 1999, respectively. Their political and legal systems are different from other parts of the PRC, and are not addressed in this thesis.

### 4.2.3.6 Legislation in China

The legal machinery of legislation in China consists of the Constitution, basic laws, administrative regulations, ministerial measures, local regulations and autonomous or specific regulations.

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86 Such power only granted to People’s Congresses in major cities which including capital cities of proveniences, SEZs, and other major cities approved by the State Council (Articles 63, *Legislation Law*). People’s Congresses in autonomous regions (minority ethnic groups) at the city and county lever can also issue local regulations following the similar procedure (Articles 66, *Legislation Law*).

87 Articles 63, *Legislation Law*.

88 The Special Administrative Regions of Hong Kong and Macau were formally established on 1 July 1997 and 20 December 1999 respectively, immediately after PRC assumed the sovereignty over the respective regions. Under One Country, Two Systems policy, proposed by Deng Xiaoping, which has been written in to the Basic Law of Hong Kong and Macau, Hong Kong continues using English common law and Macau continues using the Portuguese civil law system.

89 Ethnic Autonomous Areas (at provincial, city and county level) can make or alter regulations in their own areas in the exercise of their autonomy. Autonomous (自治条例) and specific regulations (单行条例) are special forms of local legislations in China. For general discussion, see ‘Local Legislation in China’ (2003) at [http://www.china.org.cn/english/kuaixun/76344.htm](http://www.china.org.cn/english/kuaixun/76344.htm), last accessed on 20 July 2009.
Collectively, laws enacted by the NPC and its Standing Committee are called law ('fa') and always titled 'fa'. Laws enacted by the State Council are called administrative regulations (xinzheng fagui). Laws enacted by Ministries are called Ministerial Measures (bumen guizhang). Laws enacted by local People's Congresses are called Local Regulations (difangxing fagui). Laws enacted by local governments are called Local Measures (difang zhengfu guizhang).

In 2002, in recognition of the need to standardise legislative procedure, the State Council issued the Regulation on the Procedures for the Formulation of Administrative Regulations.\(^9\) It stipulates the procedures by which the State Council proposes, drafts, examines, revises, approves and publishes Administrative Regulations. It stipulates that Administrative Regulations should normally be titled as 'tiaoli' (条例), or alternatively as 'guiding' (规定) or 'banfa'. (办法).\(^9\) The

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\(^9\) It was promulgated by the State Council on 16 November 2001, took effect on 1 January 2002.
\(^9\) Article 4, Regulation on the Procedures for the Formulation of Administrative Regulations.
Regulation on the Procedures for the Formulation of Measures,\textsuperscript{92} which stipulates the legislative procedures for ministries and provincial governments was issued on the same day. It specifies that \textit{guizhang} (laws made by the ministries and provincial governments) may alternatively be titled as \textquote{guiding}, \textquote{banfan}, but shall not be titled as \textquote{tiaoli}.\textsuperscript{93} It effectively suggests that laws issued by the State Council and Ministries and Provincial Governments can be titled the same (\textquote{guiding}, \textquote{bafan}).\textsuperscript{94}

Available English translations of terms for Chinese laws vary. For consistency, this thesis adopts the term \textquote{Regulation} for \textquote{fagui}, \textquote{guiding} or \textquote{bafan} from the State Council, and \textquote{Measure} for \textquote{guizhang}, \textquote{guiding} or \textquote{banfa} from the Ministries and provincial governments. Further complications arise as the State Council and Ministries occasionally issue \textquote{probational} \textquote{(zanxing)} laws or \textquote{experimental} \textquote{(shixing)} laws, before a more carefully drafted law can be adopted. \textquote{Interim} is added in the title to designate such laws.\textsuperscript{95}

China has been active in law making since 1978. The People\textquotesingle s Congress and its Standing Committee have issued more than 200 laws, and the State Council has issued more than 650 Regulations. Provincial level People\textquotesingle s Congress have issued more than 7500 local regulation and Ethnic Autonomous regions have issued more than 600 autonomous regulations from 1978 to 2004.\textsuperscript{96} Advances in the development of Western style commercial laws and the implementation of reforms designed to establish a more transparent and predictable regime for business dealings has been impressive, but the reform process is far from complete. A recent paper on the complexities of the Chinese legal system explains that:

\begin{itemize}
  \item \textsuperscript{92} It was promulgated by the State Council on 16 November 2001, took effect on 1 January 2002.
  \item \textsuperscript{93} Article 6, \textit{Regulation on the Procedures for the Formulation of Measures}.
  \item \textsuperscript{94} It is clarified that laws issued by Ministries and Provincial Governments can not be titled as \textquote{tiaoli}. Article 4, \textit{Regulation on the Procedures for the Formulation of Administrative Regulations}; Article 6, \textit{Regulation on the Procedures for the Formulation of Measures}.
  \item \textsuperscript{95} May also translated as tentative, interim or provisional. The 1997 \textit{Franchise Measures} was an \textquote{experimental} (shixing) regulation. Such regulation can be replaced by the more formal law which in this case by the 2005 \textit{Franchise Measures}. Sometimes,
  \item \textsuperscript{96} Jintao Hu, Speech delivered by the Hu Jintao, the President of China, on 15 September 2004, can be accessed at http://news.xinhuanet.com/newscenter/2004-09/15/content_1984333.htm, last accessed on 14 December 2008.
\end{itemize}

The final but not unimportant reason for the chaotic state of Chinese law lies in Chinese legal drafting. The fundamental principle of Chinese legislative drafting is that primary legislation should be both ‘general’ (yuanzexing) and ‘flexible’ (linghouxing). The justification for this principle of generality and flexibility is to facilitate the implementation of the legislation throughout the country and also adaptation to local conditions. In China, national legislation must not only be unitary in nature, it must also allow for regional diversity. In addition, it must also allow for legislative stability (wendingxing) in that the law can be effectively amended through changes in interpretation rather than through alterations in the actual text.\(^7\)

Apart from the Chinese-specific drafting considerations noted above, China has embraced a civil law system which is characterised by broad principles set out in laws of general application.\(^8\) Western franchisors, particularly those from a common law countries, would obviously prefer it if subordinate regulations promulgated by the State Council and other administrative organs could be in more precise language.\(^9\) The language and phrasing of Chinese legislation create wide scope for discretion in interpretation because a major goal of Chinese legislative drafting is "flexibility".\(^10\) One consequence of the vague drafting of national legislation is that it loses its capacity to constrain subordinate regulations.\(^11\) Subordinate regulations are also often drafted in the same broad and indeterminate language as the primary legislation. They often lack the very detail which they are supposed to provide.\(^12\)

### 4.3 LEGAL INSTITUTIONS AND DISPUTE RESOLUTION

Dispute resolution is a key feature of any legal system. There are three dispute resolution methods in China — litigation, arbitration and alternative dispute

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\(^9\) The confusion in relation to foreign investment laws and franchising regulation are discussed in chapters 6 and 7 respectively.


\(^11\) Lay-Hong Tan, op cit note 97.

\(^12\) The broadness and ambiguity of Franchise Regulation in China is discussed in Chapter 7.
resolution methods. Alternative dispute resolution mechanisms in China include most of those commonly used in the West. Conciliation, mediation and arbitration are popular for dispute resolution between Chinese and foreign businesses.\textsuperscript{103}

4.3.1 Courts

The Constitution and the \textit{Organic Law of the People's Courts (Courts Law)}\textsuperscript{104} stipulate that the judicial organs of China are the People's Courts. Four levels of the People's Court exist in China:

- Supreme People's Court at the national level,
- High People's Court at the provincial level,
- Intermediate People's Court and
- Local People's Court.

The Supreme People's Court, located in Beijing, is the highest court in China. The High People's Courts are established in provinces, autonomous regions, and municipalities directly under the Central Government.\textsuperscript{105} Under that, there are Intermediate People's Courts and Local People's Court. A Local People's Court may also establish People's Magistrate Courts within its jurisdiction.\textsuperscript{106} There are also Special People's Courts under the supervision of the Supreme People's Court. These are Military Courts\textsuperscript{107}, Maritime Courts\textsuperscript{108}, and Railway Transportation Courts.\textsuperscript{109}

\begin{footnotesize}
\begin{enumerate}
\item Kui Hua Wang, op cit note 1 at 280.
\item It was adopted at the Second Session of the Standing Committee of the Fifth NPC on 1 July 1979 and amended on 2 September 1983, the latest amendment was made on 31 October 2006, took effective on 1 January 2007.
\item Article 23, \textit{Court Law}.
\item Article 18, \textit{Court Law}.
\item Article 124, Constitution; Article 27, \textit{Court Law}.
\item The \textit{Decision on the Establishment of Maritime Courts in Coastal Port Cities} was adopted at the 8\textsuperscript{th} Meeting of the Standing Committee of the 6\textsuperscript{th} NPC and promulgated for implementation on 14 November 1984.
\end{enumerate}
\end{footnotesize}
The Supreme People's Court is responsible to the NPC and its Standing Committee.\(^{110}\) Three levels of courts under the Supreme Court are established according to administrative regions and are responsible to the People's Congress at the corresponding levels and their Standing Committees.\(^{111}\) As at 2008, there were 3,300 Local People's Courts, 300 Intermediate People's Courts, and 31 Higher People's Courts in China.\(^{112}\)

Within the higher level courts, the administration of litigation and the quality of legal

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\(^{109}\) Article 124, Constitution; Article 27, Court Law. The Higher People's Railway Transportation Court was removed in 1987 by Supreme People's Court and now it has two levels of courts which equivalent to local and intermediate level courts.

\(^{110}\) Article 124, Constitution.

\(^{111}\) Article 128, Constitution; article 17, Court Law.

decision making has developed considerably. However, for local courts the influence of local government, through its funding of the courts, remains strong and undermines judicial independence. Reforms to improve judicial independence have been widely discussed, and proposals to fund all courts through the National Treasury were approved by the CPC Central Committee in 2008. Relevant laws which may foster the interference of local government on judicial independence are currently being revised by the Treasury and the Supreme People’s Court.

4.3.2 Legal Profession

Judges

Until 1995, judges in China were recruited from the military or police and there was no formal educational or professional qualification requirement. In 1987, only 17 percent of judges had a post high school education. This changed in 1995, when the Law on Judges established an examination as a prerequisite for judicial appointment. Consequently, by 1997, 80 percent of judges had at least a junior college education. An amendment introduced in 2001 further elevated the academic qualification prerequisites for judges and made them subject to a unified National Bar Examination for all legal professions, including judges, procurators and

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114 The Suggestions on Further Reform on Legal System and Working Mechanism was approved at the meeting of the CPC Central Committee on 28 December 2008.


117 The Law on Judges was adopted at the 12th Session of the Standing Committee of the Eighth NPC on 28 February 1995, took effect on 1 July 1995, amended on 30 June 2001, took effect on 1 January 2002.

118 Judges appointed prior to the implementation of the Judges Law did not to meet the education and qualification requirements, but were required to receive training within a prescribed time limit (Article 9).

119 Stanley Lubman, op cit note 115.
However, there is residual problem. Unlike their counterparts in Western countries, the judges in China are paid by local government. In comparison to common law countries, the judges in China have usually never worked as lawyers. The lack of independence of courts and the lack of expertise of judges impede the move to the rule of law.\textsuperscript{121}

\textbf{Lawyers}

Lawyers and legal advisory offices started to operate in the early 1950s upon the recognition of the right of an accused to a defence under both the Constitution\textsuperscript{122} and the \textit{Organic Law of the People’s Courts}\textsuperscript{123}. The lawyer system was, however, soon damaged by the Anti-Rightist Campaign and later destroyed by the Cultural Revolution.\textsuperscript{124} The economic reforms and Open Door policy adopted in 1978 nevertheless created a need for lawyers to handle commercial transaction and disputes and legal advisory offices were re-established in 1979. They developed steadily after a speech by Deng Xiaoping stating that a lawyer system was indispensable in China, and that more than 500,000 lawyers were needed.\textsuperscript{125}

The \textit{Interim Law on Lawyers}\textsuperscript{126} was adopted in 1980. It set up academic and professional qualifications.\textsuperscript{127} From 1981 to 1984, about 34,000 people were admitted to practise law through the certification system of the judicial

\footnotesize{\textsuperscript{120} Article 9 of the \textit{Judges Law} was amended to require a degree and Article 12 of the \textit{Judges Law} on requirement on National Bar Examination was introduced in the 2001 amendments.}

\footnotesize{\textsuperscript{121} See general discussion at Stanley Lubman, op cit note 100.}

\footnotesize{\textsuperscript{122} The first Constitution was introduced in 1954 at discussed in section 4.2.2.2.}

\footnotesize{\textsuperscript{123} It was adopted in September 1954. For generally discussion, please see Daniel CK Chow, \textit{The Legal System of the People’s Republic of China in a Nutshell} (2003) Thomson.}

\footnotesize{\textsuperscript{124} Charles Chao Liu, ‘China’s Lawyer System, Dawning upon the World through a Tortuous Process’ (2002) 23 \textit{Whittier Law Review} 1037 at 1053.}

\footnotesize{\textsuperscript{125} Carlos Wing-Hung Lo and Ed Snape, ‘Lawyers in the People’s Republic of China: A Study of Commitment and Professionalisation’ (2005) 53 \textit{American Journal of Comparative Law} 433 at 433; Cited by Charles Chao Liu as note 124 at 1057.}

\footnotesize{\textsuperscript{126} The \textit{Interim Law on Lawyers} was adopted at the Fifteenth Session of the Standing Committee of the Firth NPC on 26 August 1980, took effect on 1 January 1982.}

\footnotesize{\textsuperscript{127} Article 8 of the \textit{Interim Lawyers Law} listed certain academic and professional training to be the minimum requirement to practice as lawyer, but did not make tertiary legal education a requirement.}
administration authority. In 1986, the certification system was replaced by a National Bar Examination, administered by the Ministry of Justice. Over 1.3 million people sat for the Bar Examination between 1986 to 2001 with 102,886 passing and obtaining the qualification to practise law. The requisite academic qualification was raised when the Lawyers Law was introduced in 1996, and further raised again through the amendments of it in 2001.

Developments within the legal system in relation to the legal profession since the late 1970s have been remarkable. The number of lawyers has grown substantially from 2,300 in 1980 to 130,310 in 2006. In 1987, less than 40 percent of lawyers had a college education and less than 10 percent had a law degree. This was an extremely low average level of education compared to Western countries, but was nevertheless surprisingly higher compared to the average education level of judges (as discussed above). By 2007, about sixty five percent of lawyers in China had undergraduate degrees and about ten percent had a postgraduate qualification.

Fundamental reforms relating to legal advisory officers has been ongoing. In the 1980s, legal advisory institutes were state owned and lawyers were ‘State’s legal

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129 The first National Bar Examination took place in September 1986.
130 Bensen Li, op cit note 128, 46.
131 The Law of the People’s Republic of China on Lawyers was adopted at the 19th Meeting of the Standing Committee of the Eighth NPC and promulgated on 15 May 1996 and took effective from 1 January 1997; first amended at the 25th Meeting of the Standing Committee of the 9th NPC on 29 December 2001, took effect on 1 January 2002; further amendments were adopted at the 30th Session of the Standing Committee of the 10th NPC on 28 October 2007. The 1996 Lawyers Law raised the academic qualification and required one year’s training in a law firm before fully qualified. The 2001 Amendments made an undergraduate degree a prerequisite to sit for the Bar Examination (Article 6).
135 Ibid.
workers'. The Tentative Measure for Cooperative Law Firms was introduced by the Ministry of Justice in 1988. It allowed law firms to be 'funded by lawyers collectively' and to be 'financially independent of the government'. The 1996 Lawyers Law officially provided that a law firm can be established as a partnership. The 2007 amendments of the Lawyers Law for the first time legitimises sole practitioner firms. The nature and role of a lawyer was also re-defined in 1996 from 'State's legal workers' to a 'practitioner who ... provides legal services to the public'. In 2007, further amendments provided that a lawyer as a 'practitioner who ... on acceptance of entrustment or appointment, provides legal service to the parties concerned'.

State-funded law firms have been converted to private practices. By the end of 2006, 1,470 state-funded law firms accounted for 11 percent of the 13,096 law firms in China, whereas partnership law firms accounted for 71 percent. The current Lawyers Law has made China's lawyer system comparable to those of many Western societies.

4.3.3 Arbitration and Alternative Dispute Resolution

Chinese government first established a Foreign Trade Arbitration Commission within the China Council for the Promotion of International Trade (CCPIT) in

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136 Article 13 of the Interim Lawyers Law specified that legal advisory offices were 'public institution' under the supervision of the state judicial administrative authority.
137 It was issued by the Minister of Justice on 3 June 1988 and replaced by the 1996 Lawyers Law.
138 Article 15, 1996 Lawyers Law.
139 Article 16, 2007 Lawyers Law.
140 Article 1, Interim Lawyers Law.
141 Article 4, 1996 Lawyers Law.
142 Article 2, 2007 Lawyers Law.
143 Kay-Wah Chan, op cit note 132 at 123.
It was renamed to the *Foreign Economic and Trade Arbitration Commission* in 1980, and renamed again as the *China International Economic and Trade Arbitration Commission* (CIETAC), in 1988.\(^{146}\) Although CIETAC has a long history, it only started to play an important role in the late 1980s. It was established with its headquarters in Beijing with sub-commissions added in Shenzhen in 1989 and Shanghai in 1990.\(^{147}\) The *China Maritime Arbitration Commission* (CMAC) was originally established in 1959 based on a decision made by the State Council.\(^{148}\) Both CIETAC and CMAC are independent bodies under the auspices of the CCPIT and the *China Chamber of International Commerce* (CCOIC).

To meet the growing demand for arbitration, other arbitration commissions were established after the *Arbitration Law* was passed in 1995. The Beijing Arbitration Commission and the Guangzhou Arbitration Commission were both founded in 1995, and many other domestic arbitration commissions at various levels were established.\(^{149}\) CIETAC remains the best known.\(^{150}\) It has several centres throughout China and is highly regarded both domestically and internationally.\(^{151}\) It is one of the busiest arbitration tribunals in the world in terms of the number of cases handled.\(^{152}\) The foreign parties involved in CIETAC arbitration cases represent 45 different


\(^{146}\) CIETAC website, [http://www.cietac.org/AboutUS/AboutUS.shtml](http://www.cietac.org/AboutUS/AboutUS.shtml), last accessed on 20 November 2008.

\(^{147}\) CIETAC website, [http://www.cietac.org/AboutUS/AboutUS.shtml](http://www.cietac.org/AboutUS/AboutUS.shtml), last accessed on 20 November 2008.

\(^{148}\) The *Decision of the State Council of the People's Republic of China Concerning the Establishment of a Maritime Arbitration Commission within the with the China Council for the Promotion of International Trade* was adopted at the 82\(^{nd}\) Session of the State Council on 21 November 1958.

\(^{149}\) There are more than 120 domestic arbitration commissions in China today.

\(^{150}\) CIETAC has handled a great many disputes. In 1994, it accepted 829 cases, involving a total amount of approximately US$975 million.


In 1986 China became a signatory to the *United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards* (1958 *New York Convention*). The Convention requires signatory states to implement arbitral awards made in the territory of another signatory state. China also acceded to the *Convention on the Settlement of Investment Disputes between States and Nationals of other States* (1965 *Washington Convention*) in 1992. Under the *Washington Convention*, disputes involving foreign direct investment in China can be submitted to the *International Centre for Settlement of Investment Disputes* (ICSID) for conciliation or arbitration once the conflicting parties have exhausted China’s own administrative or judicial remedies. In practice, it is rarely economically feasible to refer an investment related dispute to the ICSID.

The *Civil Procedure Law of the People’s Republic of China* provides rules regarding arbitration in China. It specifies that parties involved in a Sino-foreign economic, transportation or maritime dispute are not allowed to undertake litigation if they have an arbitration clause in their original contract or have agreed after the dispute arose to submit the dispute to arbitration.

Arbitration in China is governed by the *Arbitration Law of the People’s Republic of China* and is conducted through officially recognised arbitration institutions.

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153 Investors from USA was the leading user with 66 cases, followed by 36 cases involving in companies from South Korean and 30 cases involving companies from Japan. Xiahua News Agency, ibid.
154 China officially became a member of the *Washington Convention* on 2 February 1993.
155 International Centre for Settlement of Investment Disputes was created by the Washington Convention with its headquarter in Washington DC.
156 Kiu Hua Wang, op cit note 1 at 306.
157 It was adopted at the 4th Session of the Seventh NPC on 9 April 1991, took effect on 9 April 1991.
158 It was amended at the 30th Session of the Standing Committee of the 10th NPC on 28 October 2007 and took effect on 1 April 2008.
159 Article 255, *Civil Procedure Law* (it was article 257 of the 1991 *Civil Procedure Law*).
160 The *Arbitration Law of the People’s Republic of China* was adopted at the Eighth Session of the Standard Committee of the Eighth NPC on 31 August 1994, took effect 1 September 1995.
The *Arbitration Law* has mirrored the *Civil Procedure Law* in excluding the jurisdiction of the courts when the parties have specifically agreed to arbitration as their means of dispute resolution. It has broadened the scope of disputes that may be submitted to arbitration to contractual disputes and other disputes concerning property rights and obligations between citizens, legal persons and other organisations of equal status\(^{161}\). Furthermore, it allows arbitration to be valid even if the underlying contract is found to be invalid\(^{162}\). The *Arbitration Law* also provides guidance on the format for drafting an arbitration clause in a contact.\(^{163}\)

Chinese law permits parties to foreign trade and foreign investment contracts to include a provision for the arbitration of disputes that may arise under the agreement. Two important laws governing foreign investment enterprises in China support arbitration.\(^{164}\) Article 14 of the *Equity Joint Venture Law*\(^{165}\) requires conciliation or arbitration if consultation fails, and Article 26 of the *Cooperative Joint Venture Law*\(^{166}\) prescribes the resolution of a dispute through arbitration or litigation if negotiation and conciliation should fail. Foreign investors increasingly include arbitration clauses in their joint venture contacts with Chinese parties in order to avoid the unfamiliar court system of China and to reduce legal costs and preserve business relationships.\(^{167}\)

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\(^{161}\) Article 2, *Arbitration Law*.

\(^{162}\) Article 19, *Arbitration Law*.

\(^{163}\) Article 16, *Arbitration Law*.

\(^{164}\) It was suggested such provision in law revealed government’s inclination towards arbitration. John F Bourke and Rosemary Lucadou-Wells, ‘Commercial Dispute Resolution in China’ in Patricia Blazey and Kay-Wah Chan (ed) *The Chinese Commercial Legal System* (2008) 89 at 124, Thomson.

\(^{165}\) The *Law of People’s Republic of China on Chinese-Foreign Equity Joint Ventures (Equity JV Law)* was adopted at the Second session of the Fifth National People’s Congress on 1 July 1979; amended on 4 April 1990 and 15 March 2001.

\(^{166}\) The *Law of the People’s Republic of China on Chinese-Foreign Cooperative Joint Venture (Co-operative JV Law)* was adopted on 13 April 1988.

\(^{167}\) Kiu Hua Wang, op cit note 1 at 279.
4.3.4 Enforcement

Enforcement of court and arbitral awards is in practice a great problem and the difficulty of enforcement (zhixing nan\textsuperscript{168}) has not only caused great concern in the West, but has also been frankly acknowledged by Chinese officials and discussed by Chinese scholars and practitioners.\textsuperscript{169} In 1993 the then President of the Supreme People’s Court, Ran Jianxin, acknowledged the problems and categorised the major factors as: the inability of enterprises to pay if they were deeply in debt, interference by local protectionism and departmental protectionism, and parties avoiding their obligations.\textsuperscript{170} It is suggested that at the end of June 1999, more than 850,000 applications for enforcement of decisions or judgments were pending involving 250 billion RMB in claims.\textsuperscript{171} Cases concerning violence against judicial personnel carrying out enforcement order have been frequently reported in China.\textsuperscript{172}

As a major weakness in the Chinese legal system, zhixing nan not only undermines foreign investors’ confidence, but also puts the authority of the court in question. A campaign to declare 1999 a ‘Year of Enforcement (of judicial judgments and rulings)’ was launched by the Supreme People’s Court and supported by the CPC to reduce zhixing nan.\textsuperscript{173}

\textsuperscript{168} Difficulty in enforcement is commonly referred to as ‘zhixing nan’ (执行难) by Chinese.


\textsuperscript{170} Work Report of the Supreme People’s Court, delivered at the 1\textsuperscript{st} Plenary Session of the 8\textsuperscript{th} NPC on 31 March 1993, Published in Gazette of the Supreme People’s Court of PRC (No.2, 1993) 《最高人民法院公报》 at 55. Translated by Jianfu Chen, see discussion in Jianfu Chen, op cit note 1 at 661-673.


\textsuperscript{172} The statistics from twenty-one provinces and municipalities between 1995-1998 indicated 3,473 incidents of violence against the enforcement of judgements, resulted in 2,378 judicial personnel injured and four died. Reported by Legal Daily 《法制日报》 on 25 August 1999.

\textsuperscript{173} Notice of the Central Committee of the CPC on Transmitting the Report of the Party Committee of the Supreme People’s Court on Resolving Certain Problems Causing Enforcement Difficulties Facing the Courts (No. 11, 1999) was issued by the Central Committee of the CPC and Notice Concerning Handling Seriously the Violation of Law and Discipline in Dealing with Zhixing Nan Encountered by the People’s Courts (No. 17, 1999) jointly issued by the Central Disciplinary
Today, China's continuous efforts in enforcement of judicial rulings have improved the legal environment, but lack of judicial independence and local protectionism remain as major issues. It has nevertheless been suggested that "enforcement [in China] is neither as hopeless as foreign investors believe nor as problem free as officials suggest". However, there are increasingly positive comments in recent years and China currently ranks 18th on contract enforcement by the international organisation - *Doing Business*.

### 4.4 THE LAW, COMMERCIAL RELATIONSHIPS AND CHINESE LEGAL CULTURE

A judge of the New South Wales Supreme Court has recently commented that "Chinese cultural attitudes have an importance in this case which I am not really equipped to fully understand". Commercial relationships are defined and protected by law. However, there are different attitudes in different cultures towards law which influence commercial relationships. The legal culture of a society may be defined as the 'attitudes, values and opinions' of the society to the 'law, the legal system and its various parts'. The legal culture of a society is shaped by a number of factors such as the history, culture, politics, economic condition and system, and the religious development of that society. As discussed in Chapter 2, Chinese culture is strongly influenced by Confucianism which emphasises social harmony. Disputes manifested

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177 *Xu v Shi* [2009] NSWSC 955 para 1 per Bryson AJ.
179 Kay-Wah Chan, op cit note 132 at 139.
as conflicts between parties are thus considered as violating social harmony.\textsuperscript{180}

Law had held no special sanctity in China. It was seen as a tool of party policy and propaganda.\textsuperscript{181} It has been suggested that:

The elevation of law over politics is very new in China and the extent to which it is to be taken seriously is not always clear to the Chinese involved. The Chinese official and the Chinese citizen are part of a political structure in which the Party's will and policies have long been the most effective law... Laws and regulations have to be understood in this wider context of a society in which the formal legal position is only one consideration and still often not the most important.\textsuperscript{182}

Concern is expressed by foreign investors that contracts are not accorded the sanctity they enjoy in the West and, at a business if not a legal level, are regarded more as memoranda of understanding inviting renegotiation at regular intervals. In the words of one commentator, "the written word is not considered the final authority of meaning. In China, words and contracts are merely the beginnings of understanding, not sacrosanct agreements".\textsuperscript{183} Such views are echoed widely. It was suggested that Chinese view a contract as an expression of a long-term cooperative and friendly relationship, rather than as a document with legal ramifications.\textsuperscript{184} Ordish and He, however, observe that the view that contracts are statements of agreement at the time of signing and subject to change as the relationship changes over time is gradually "changing as Chinese business becomes more used to the role of a contract and as options for the enforcement of agreements become stronger. However, it is important for foreign franchisors actively to manage the relationships with their Chinese

\textsuperscript{180} Bobby KY Wong, 'Traditional Chinese Philosophy and Dispute Resolution' (2000) 30 Hong Kong Law Journal 304 at 306.
\textsuperscript{181} Kui Hua Wang, op cit note 1 at 37.
franchisees to ensure they continue to comply with their obligations.\textsuperscript{185}

China's economic and legal reforms are also changing popular values, and, in turn, increasing the acceptability of formal legal institutions.\textsuperscript{186} The increasing scale of litigation in China reflects changing attitudes by Chinese people towards enforcement of their rights in court.\textsuperscript{187} However, the thousand-years-old culture will not change overnight. In China, less formal methods of resolving disputes are still preferred.\textsuperscript{188}

\section*{4.5 CHAPTER SUMMARY}

Since the launch of the Open Door and reform policy, China has continued to build its legal system as a civil law system to support the move to a 'socialist market economy'. Although it is difficult to assess the extent to which China has brought its legal system, in theory and in practice, in line with the Western principle of 'rule of law',\textsuperscript{189} the developments over the last three decades have been significant and provides increasing comfort for international enterprises doing business in China.

\begin{itemize}
\item \textsuperscript{185} Rebecca Ordish and Rose He, 'The Franchising Regime in China: Is It Worth the Risks?' (2005) 62 Intellectual Property Forum 41.
\item \textsuperscript{186} Stanley Lubman, op cit note 100.
\item \textsuperscript{187} Kay-Wah Chan, op cit note 132 at 142.
\item \textsuperscript{188} Kiu Hua Wang, op cit note 1 at 279.
\item \textsuperscript{189} Randall Peerenboom has classified rule of law into thin and thick version and introduced a specific set of assessment criteria to accommodate countries at different levels of development and suggested that Chinese legal system is moving towards a regime that complies with the basic elements of a thin rule of law, op cit note 1.
\end{itemize}
CHAPTER FIVE
DEVELOPMENT OF THE UNDERLYING COMMERCIAL LAW SYSTEM

5.1 INTRODUCTION

In its *Guide to International Franchise Arrangements*, UNIDROIT defined a 'healthy commercial law environment' necessary to support franchising as 'one with general legislation on commercial contracts, with an adequate company law, where there are sufficient notions of joint ventures, where intellectual property rights are in place and enforced and where companies can rely on ownership of trademarks and know-how as well as on confidentiality agreements'.

Whether or not a franchise sector requires in addition a franchise-specific law to regulate its orderly development is controversial. What is not controversial is the need for an underlying legal environment capable of supporting the complexities of franchising - a sophisticated, intricate, interdependent, long term contractual relationship.

China's economic reform under the Open Door policy and the shift towards a 'socialist market economy' required a well-structured legal framework to be established. From the late 1970s, a fresh period of institution building and legal reform began. The development of China's commercial law system over the last two decades has resembled the development of its economy – rapidly developing, yet largely *ad hoc*.

For all franchisors, but in particular for international franchisors operating in an unfamiliar legal environment, contract and intellectual property laws are always of

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2. Currently, there are 30 countries/regions which have franchising specific regulations. For a general discussion of the necessity for franchising specific regulation, see Andrew Terry, ‘Franchise Sector Regulation: the Australian Experience’ (2003/2004) LAWASIA Journal 57. The regulatory debate is discussed further in Chapter 7.
particular concern. This chapter reviews the development of these laws and the underlying liberalisation of the private sector which has led to the refining of the concept of legal personality and the available structures for business. Chapter 5.2 reviews the development of the civil law in the context of the contemporary legal framework in the absence of an overarching Civil Code. With no Civil Code in China, the laws in the commercial sector have developed separately and independently. The development of law on Business Entities, Contract Law, and Intellectual Property Law - the commercial laws of most direct relevance to franchising - are examined in Chapters 5.3, 5.4 and 5.5 respectively. The focus of this part of the thesis is very much on the development of these laws which has been a necessary prerequisite for the development of franchising rather than on the content of these laws which is an undertaking beyond the scope of this thesis.

5.2 CONTEMPORARY LEGAL FRAMEWORK FOR COMMERCIAL MATTERS

Contemporary commercial law in China is mainly a product of the 20th century. Its development has been based on the Continental European concept of civil law. Until recently the civil law, as a distinct and separate branch of law, was underdeveloped. The first Civil Code, introduced by the Guomindang (GMD) government between 1929 and 1930, was strongly influenced by the models of Japan and Germany. Due to its inherit defects, and the unrest in the country at that time, the GMD Civil Code had very little effect and was subsequently abolished when the

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4 This is not to say that there were no civil law provisions in China in earlier periods. There were 'rules' concerning civil matters such as on marriage, contract, and limitation of civil actions. But it is generally accepted that the traditional Chinese law was primarily the Confucian concept of 'Li', not law. See generally, Jianfu Chen, op cit note 3 at 328; Jinfan Zhang (ed), A General History of the Chinese Civil Law (2003) Fujian People’s Press.

Communist Party took power and established the People’s Republic of China (PRC) in 1949. It nevertheless influenced the early draft of the Civil Code of the PRC. The first two attempts to codify the civil law which occurred in the 1950s and 1960s under PRC, were un consummated due to the political campaigns and the Cultural Revolution. China’s third attempt at establishing a civil code started in 1979 when the Standing Committee of National People’s Congress (NPC) established a Civil Law Drafting Group soon after the launch of the economic reforms. This attempt to create a comprehensive civil code was interrupted due to the urgent need to enact specific laws. Deng Xiaoping suggested the approach of enacting law ‘step by step’ which was adopted by the Standing Committee of NPC.

After the reform process started in 1978, and with a comprehensive civil code not available, the General Principles of Civil Law (GPCL) was introduced in 1986 to provide general principles for creating and defining the structure of civil law and establishing the basic civil law institutions such as legal personality, civil acts, and civil rights and liabilities. The GPCL defined a ‘legal person’ for the first time and established the institution of legal personality which applied to both foreign and

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6 Jianfu Chen, op cit note 3 at 330.
7 The first attempt at codification the 1956 Civil Code was made in 1950s based on the 1922 version of the Civil Code of the Russian Soviet Federated Socialist Republic. The first effort to draft comprehensive codes was abruptly ended by the Anti-Rightists Movement and the ‘Great Leap Forward’ in late 1950s. The second attempt in the 1960s moved away from the Soviet model due to the deterioration of the China-Soviet relationship. It did not last long due to the start of the Cultural Revolution in 1967. See general discussion in Jianfu Chen op cit note 4.
8 The Civil Law Drafting Group was established within the Legislative Affairs Committee of the Standing Committee of NPC and held its first meeting in Beijing on 3 November 1979. See Zhenxiang Zhou and Jingchun Shao (eds) A Chronicle of Forty Years of Construction of the Chinese New Legal System (1990) Press of the Masses, Beijing, at 448.
9 Jianfu Chen, op cit note 4 at 335.
11 Legal person first appeared in the 1981 Economic Contract Law which is discussed below. But the term was not defined by Law or by any legislative organs until the introduction of the GPCL in 1986.
However the definition and classification of legal persons in the GPCL moved away from the formalistic approach to the concept of legal personality found in the European Continental models, such movement having been criticised by many Chinese scholars. The GPCL also set out, inter alia, property rights, and civil obligations under contract, tort and statute, and provided for their enforcement. As a general principle, Article 4 provides that:

In civil activities, the principles of voluntaries, fairness, making compensation for equal value, honesty and credibility shall be observed.

Although the GPCL played a positive role in providing guiding principles for the development of civil law in China in the early years of reform, it has been criticised for being an unworkable piece of legislation for settling specific disputes. China has developed separate laws such as contract law, property law and company law, in part in disregard of the constraints imposed by the GPCL. While a comprehensive Civil Code has not been included in the agenda of China’s successive ‘Five Year Legislation Plans’, China has promulgated and amended essential commercial laws over the last three decades.

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12 Article 36 of the GPCL defines legal person as “an organ which possesses civil legal capacity and capacity for civil acts and which, according to the law, independently enjoys civil rights and assumes civil obligations.” Article 41 of the GPCL states that enterprise legal persons include three forms: state-owned enterprises, collective owned enterprises and foreign invested enterprises.


14 Articles 85, 89, 91 and 111-116 of the General Principles of the Civil Law, these are discussed further under the Contract Law below.


17 Jianfu Chen op cit note 3 at 361.
5.3 PRIVATISATION AND TRANSITION OF BUSINESS ENTITIES

5.3.1 Legitimising the Private Sector

Due to Mao’s campaigns to eliminate the exploiting classes and the private ownership of capital, by 1977 there were only 150,000 self-employed producers and traders in urban China (a decrease from 8,830,000 in 1952) and they consciously kept a low profile for fear that their businesses would become the target of official persecution.\(^{18}\) The protection offered by the 1982 Constitution in stipulating that the private economy was allowed to complement socialist public ownership (which included whole people ownership and collective ownership\(^{19}\)) under the socialist planned economy was significant for the development of private ownership.\(^{20}\) The GPCL which was subsequently enacted, correspondingly classified “enterprise legal persons” into state-owned enterprises, collective enterprises and foreign invested enterprises. Private enterprises were not included.\(^{21}\) The most interesting and important amendments made to the 1982 Constitution related to private ownership.

To ‘permit’ the private economy to exist and develop was added to Article 11 of the Constitution by the 1988 Amendments, and further amended to ‘encourage, and support’ the private economy in the 1999 Amendments, while the role of the private sector\(^{22}\) also changed from ‘complementing’ ‘socialist public ownership’, to being

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\(^{18}\) Figures sourced from *China Statistical Yearbook*. The small commodities market was considered as an example of ‘Restoration of Capitalism’ and often had been closed down. The operator might even have been arrested and sentence for the ‘illegal’ income. See discussion Kui Hua Wang, *Chinese Commercial Law* (2000) Oxford University Press, United Kingdom, 147-148.

\(^{19}\) Whole people ownership (全民所有制) is similar to the concept of State-owned. Collective ownership (集体所有制) is ownership by a designed group, which are mainly workers of the enterprises.

\(^{20}\) Articles 6, 7, 11 and 15 of the in the original version of 1982 Constitution enacted by the 5\(^{th}\) Session of the 5\(^{th}\) NPC on 4 December 1982. As discussed in Chapter 4, it has been amended by the NPC in 1988, 1993, 1999, 2004.

\(^{21}\) Article 41 GPCL. The State Council issued the *Provisional Regulations on Private Enterprises* (1988) to legalise ‘private enterprise’, which had existed for many years outside law, in responding to the amendment of the Constitution made in 1988 in regarding to private enterprise as discussed below.

\(^{22}\) The term for ‘private sector’ used in the original 1982 Constitution is ‘私营经济’ (which in Chinese implied as to include only proprietorships and partnerships) which the inclusion is unclear. The term ‘other non-public economy’ was introduced in the 2004 amendment. For simplicity, it is translated as private sector.
an 'important component' of 'the socialist market economy'. The 1982 Constitution also enshrines the protection of foreign investment in China.

The privatisation of state-owned enterprises and the reconstruction of these enterprises, also started in the early 1990s. Reconstruction, through separating control and management from the ownership of the State, legitimised state-owned enterprises as independent legal persons. The 1992 Regulations on Transforming the Management Mechanisms of State-owned Industrial Enterprises extended 14 new rights to enterprises to enhance their autonomy and authority in management.

Since 1982, the private sector has gradually achieved equal status with state-owned and collective owned enterprises, at least in theory, as a result of Constitutional amendments. Many laws, administrative regulations and local regulations have been enacted to address this trend and to legitimise the private sector. However, there has been, until recently, substantially different treatment of business entities in relation to enterprise planning, material supply, taxation and quotas for loans, which were all allocated in accordance with the form of ownership, and which has left the private sector disadvantaged.

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23 Article 11 of the Constitution as per amendments made as op cit note 20. Amendments of Constitution of Article 15 made in 1993 included a change of Chinese system from 'planed economy' to 'socialist market economy'.
24 Article 18, Constitution.
25 As discussed in Chapter 2.4.
26 State-owned enterprises as mentioned in Article 7 the 1982 Constitution, in Chinese term '国营', meant State-operated. It was changed into '国有', means State-owned enterprises by the 1993 Amendments.
27 The Regulations on Transforming the Management Mechanisms of State-owned Industrial Enterprises was promulgated by the State Council in 1995.
28 The differential treatment to enterprises according to ownership still exists in regulations and in practice as discussed below. For example, to obtaining bank loans, the state sectors continue to have priority over the private sectors.
29 For example, the Provisional Regulation on Private Enterprises issued by the State Council in 1988 and the Provisional Regulations Concerning the Administration of Individual Industrial can Commercial Household in Cities and Township issued by the State council in 1987.
30 Xudong Zhao 'Certain Problems in Chinese Corporate Legislation' (1991) 1 Journal of China University of Political Science and Law 43, suggested that: "today, planing is still in a predominate position and production plans, material allocation, product sales and quotas for loans are all allocated through vertical and regional administrative networks...". Some differences remains in practice and law until today but most of the differential treatments were removed in law.
Legitimising the private sector has provided the opportunity for franchising development in China through providing a legal base for foreign franchising enterprises (through Constitutional recognition of foreign investment as a part of the economy) and by reviving small and medium businesses which are a potential pool from which franchisors and franchisees may be drawn.

To fully review and examine the laws introduced and/or amended as a result of the strategic decision of the government – the shift toward market economy and encouragement of the private sector – is beyond the scope of this thesis. The most important business structures currently adopted in China are nevertheless outlined below with a focus on the substantial differences from Western law and practices, and whether the amended laws meet international standard practice. Because of the significantly different treatment, until recently, in relation to laws for foreign invested enterprises (FIE) (discussed separately in Chapter 6) in comparison with the laws applying to domestic invested enterprises, reference is not made to FIEs in this Chapter unless otherwise specified.

5.3.2 Transition towards a Modern Enterprise System

Even with the Constitution legitimising the private sector in 1982, and the GPCL prescribing economic equality in 1986, a unified legal framework to define and support a modern enterprise system developed slowly. This was primarily due to the ideology of China’s ‘socialist civil law’ at the early stage of reform in relation to the upholding of socialist public ownership which is not consistent with the principles of private law.

The term ‘private enterprise’ was introduced and defined by the Provisional

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31 Articles 2-4, GPCL.
32 Jianfu Chen, op cit note 3 at 461.
The Provisional Regulation on Private Enterprises introduced following the 1988 Constitutional Amendments. The Provisional Regulation divides private enterprise into three types: sole investment enterprises, partnership enterprises, and limited liability companies, of which only limited liability companies enjoy legal person status. The Provisional Regulation on Private Enterprises played a positive role in facilitating the growth of the private enterprises, but its classification of enterprises by ownership, rather than by legal capacity, has not been seen to be desirable and has thus been criticised. Jianfu Chen noted that:

The differentiated treatment of business entities on the basis of ownership, administrative subordination, geographical location or the size of business, conflict with underlying philosophy of a market economy which emphasises equal treatment and fair competition in economic activities.

A modern enterprise system, in line with Western concepts but with Chinese characteristics, was nevertheless established in the 1990s during which the Company Law (1993), the Partnership Enterprise Law (1997), and the Individual Sole Investment Enterprises Law (1999) were passed.

**Individual Sole Investment Enterprises (Sole Proprietorship)**

The Individual Sole Investment Enterprises Law adopted in 1999 is considered as an important development in establishing a ‘modern enterprise system’ in which

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33 The Provisional Regulation on Private Enterprises was issued by the State Council in June 1988.
34 Article 2, Provisional Regulation on Private Enterprises defines ‘private enterprise’ to be ‘a privately funded economic entity which employs at least eight persons’ to be distinguished from the ‘individual households’ (个体户). ‘Individual Household’ is governed the GPGL, but its legal capacity (i.e. as natural person or legal person) was never defined under the law.
35 Article 7, Provisional Regulation on Private Enterprises.
36 Article 8, Provisional Regulation on Private Enterprises.
37 Article 9, Provisional Regulation on Private Enterprises.
38 The Law on State-owned Industrial Enterprises was passed by the 7th NPC on 13 April 1988. There are wide criticism and calls for repealing the Provisional Regulation on Private Enterprises, but it remains valid as a supplement when the new Laws on the same issues are silent.
39 Jianfu Chen, op cit note 3 at 491.
40 The Law on Individual Sole Investment Enterprises was adopted by the Standing Committee of the NPC on 30 August 1999.
enterprises are classified according to methods of investment and liabilities, rather than by the form of ownership, business trade or number of employees. It defined "sole investment enterprise" as a business entity which is created by a natural person who owns the enterprise's property and bears unlimited liability.

**Partnership**

Partnership, as a form of enterprise, was governed by the GPCL until the adoption of the Partnership Enterprise Law in 1997. The introduction of Partnership Enterprise Law was an important development to address issues which were not covered by the GPCL, but it has been the 2006 revisions of the Partnership Enterprise Law which have brought the Partnership Enterprise Law into conformity with the standard of international practice in partnership. Although the revised Partnership Enterprise Law provides that "the administrative measures governing the establishment by foreign enterprises or foreign individuals of partnership enterprises in China shall be formulated by the State Council", foreign investors cannot yet establish partnerships in China due to the lack of such measures being formulated by the State Council.

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41 The Law on Individual Sole Investment Enterprises does not apply to state-owned, collective or foreign invested enterprise. It defines a form of investment not specifically distinct by the forms of ownership.
42 The Provisional Regulation on Private Enterprises distinguished the 'private enterprise' from 'individual households' by the number of employees; op cit note 34.
43 Article 2, Individual Sole Investment Enterprises Law.
44 Articles 30-35 GPCL governs individual and enterprises partnership; the GPCL also anticipates the possibility of enterprise partnerships under the section on joint operations (Article 51-53).
45 The Partnership Enterprise Law was adopted by the Standing Committee of the NPC on 23 February 1997 and took effect on 1 August 1997; amended on 27 August 2006 and took effect on 1 June 2007.
46 Important changes introduced by the 2006 revisions include: to perfect the definition of partnership, to introduce new provisions on limited liability partnership and to include professional service organisations, such as law firms, accounting firms, under the partnership.
47 Jianfu Chen, op cit note 3.
48 Article 108, Partnership Enterprise Law.
**Company**

The *Company Law,* adopted in 1993, was described by the Chinese press as an ‘historical leap forward’ and a ‘most important’ piece of legislation for being the first of its kind in the PRC. Prior to the *Company Law,* there were massive local regulatory and policy directives to regulate domestic invested companies. Nevertheless due to the inherent defects of the *Company Law,* it was soon amended.

The amendments in 2004 introduced for the first time a Chapter on Branches of Foreign Companies, however, the most important and comprehensive amendment was made in 2005 in order to apply the *Company Law* to both domestic and foreign invested companies, to allow the establishment of one-person companies, and to relax the capital requirement for incorporation. The current *Company Law*

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49 The *Company Law* was adopted at the 5th meeting of Standing Committee of the 8th NPC on 29 December 1993, took effect on 1 July 1994, amended at 13th meeting of Standing Committee of the 9th NPC on 25 December 1999, and at 11th meeting of Standing Committee of the 10th NPC on 28 August 2004 and 18th meeting of Standing Committee of the 8th NPC on 27 October 2005.


51 Comments made by the then Vice-Chairman of the State Commission for Economics and Trade, Chen Qingtai, cited by *Daily of the Legal System* 《法制日报》 19 January 1994 at 2. See discussion in Jianfu Chen, op cit note 3 at 492. Prior to that, foreign invested enterprises could gain the status of a ‘legal person’ in China through the *Equity Joint-Venture Law* (1979), *Cooperative Joint-Venture Law* (1988) or the *Wholly Foreign-owned Enterprises Law* (1986), but there was no national law for domestic invested companies.

52 For example: the *Tentative Provisions of Shenzhen Municipality on Companies Limited by Shares* (1992), and *Tentative Provisions of Shanghai Municipality on Companies Limited by Shares* (1992). During May, June and July 1992, a set of 15 policy documents regulating the experiment of securitisation was jointly issued by the State Commission for Economic Structural Reform, the SPC, the Ministry of Finance, the People’s Bank of China and the Office of Production of the State Council, including Suggestions on Standards for Limited Liability Companies and Suggestions on Standards for Companies Limited by Shares. These two documents can be found in Gazette of the State Council of the PRC 《国务院公报》 (no. 16, 1992), at 554-592. See discussion Jianfu Chen, op cit note 3 at 491-493.

53 Such as its restrictive requirements and narrow scope of application (it was not applicable to foreign invested companies limited by shares, it applied to foreign companies).

54 Articles 199-205, 2004 *Company Law.* The amendments were adopted by the 11th meeting of the Standing Committee of the 10th NPC on 28 August 2004. Discussed further in Chapter 6.

55 The amendments introduced by 18th meeting of Standing Committee of the 8th NPC on 27 October 2005 (took effect on 1 January 2006) deleted 46 articles, added 41 articles and revised 137 articles.

56 Article 218 of the revised 2005 *Company Law* provides that it applies to domestic invested companies as well as foreign invested limited liability companies and companies limited by Shares (joint-stock company) unless laws governing foreign investment provided otherwise. The laws governing foreign investment are discussed in detail in Chapter 6.

57 Section 3 (articles 58-64) of the *Company Law* is a new section inserted by the 2005 amendment, which for the first time in PRC, allows the incorporation of one-person companies.

58 The incorporation threshold is lowered to RMB 30,000 (from RMB 100,000-500,000) and it applies to all companies (expect one-person companies which threshold is RMB 100,000).
contains 13 chapters comprising 219 articles and covers limited liability companies and companies limited by shares (joint-stock company).

To establish a company, registration is required be carried out according to the Regulation on the Administration of the Registration of Companies (Registration Regulation)\(^5\) and the Provisions on the Administration of the Registration of Registered Capital of Companies (Capital Registration Provisions).\(^6\) The registration authority is the State Administration for Industry and Commerce (SAIC) and its local offices. In this context, there are two important concepts which are rather less understood and discussed outside China.

*registered capital and total amount of investment*

The ‘registered capital’ of a limited liability company is the capital contribution subscribed by all shareholders, or, in case of a company limited by shares, subscribed by all promoters, and registered with the company registration authority.\(^6\) Registered capital can be contributed in the form of cash (a minimum requirement of 30 percent of total registered capital) and non-cash property, such as intellectual property and land use rights.\(^6\) In China, the ‘registered capital’ is a different concept from the ‘total amount of investment’ and the value of the two can be different.\(^6\) The ‘total amount of investment’ refers to the sum of capital funds invested by the shareholders which can be less than the registered capital (as the registered capital is required to be paid in full within two years, or five years if it is a holding company)\(^6\), or more than the registered capital (if the amount of investment is increased or loans are received). Both the registered capital and the total amount

\(^5\) The *Registration Regulation* 《中华人民共和国公司登记管理条例》 was promulgated by the State Council on 24 June 1994; amended and re-promulgated on 18 December 2005, took effect on 1 January 2006.

\(^6\) The *Capital Registration Provisions* 《公司注册资本登记管理规定》 was issued by the State Administration of Industry and Commerce on 27 December 2005, took effect on 1 January 2006.

\(^6\) Articles 8 and 10, *Capital Registration Provisions*.

\(^6\) ‘Registered capital’ is listed in Article 9.4 of the *Registration Regulation*. ‘Total amount of investment’ is listed in Article 9.5 of the *Registration Regulation*. Both are governed by the *Company Law*.

\(^6\) Article 20, *Registration Regulation*; Article 11, *Capital Registration Provision*. 
of investment, and any changes to these amounts, have to be registered with the administrative authority.\textsuperscript{65}

\textit{scope of business operations}

The 'scope of business operation' has to be specified in the application for registration.\textsuperscript{66} The concept of 'scope of business operation' is not defined by law but it is understood to be the category of the industry sector in which the company is involved.\textsuperscript{67} Operating outside of the registered scope of business operation by a company is a violation of the law. Reducing and unifying the capital threshold for companies, and redefining the role of the administrative authorities, have relaxed the restrictions on the scope of business operations for companies. However, to adopt franchising as a way of business expansion, a franchisor has to include franchising in its scope of business operation. Failure to do so may result in undesirable consequences, especially in the case of a foreign invested franchising enterprise. This is discussed further in Chapter 7.

5.4 \textbf{CONTRACT LAW}

Contracts, and their enforcement, are key concerns to franchisors who 'have great faith in the legitimacy of the printed word to guide them through long-term relationships with franchisees'.\textsuperscript{68} Since the reform process commenced, contract law in China has developed significantly and, with the introduction of the \textit{Contract Law} on 1 October 1999, China now has a modern unified contract law regime.

\textsuperscript{65} The \textit{Registration Regulation} and \textit{Capital Registration Provision} have provided situation and procedures for register/filing such information.

\textsuperscript{66} Articles 9 and 15, \textit{Registration Regulation}. Similar provisions also exist in the laws governing other forms of business entities.

\textsuperscript{67} There was no standard way of classification for the categories until the 2005 amendments provided that the categories can be referred according to the National Economic Industry Classification.

5.4.1 Legislation on Contracts Prior to 1 October 1999

Prior to the economic reforms in late 1970s, contract law was not popular under China’s centrally planned economy as business transactions were generally conducted in accordance with state plans rather than private treaty.69 Contracts, if used, which was not often, were only to indicate the quota of national economic tasks assigned to the particular state-owned enterprises (SOE) in question and were not strictly enforced as the state would ultimately be responsible for any damages where a breach of contract occurred.70 The economic reforms to allow private business transactions and the Open Door policy which opened China’s market to foreign investment and shifted China from a centrally planned economy to a socialist market economy required the development of legal infrastructure to safeguard business transactions.

Economic Contract Law

The Economic Contract Law71 was issued in 1981, shortly after China’s reform process commenced, and took effect on 1 July 1982, the sixty-first birthday of the Communist Party of China.72 It originally applied only to contracts between legal persons, but its application was extended to agreements between other economic entities, individual industrial and commercial households, and rural contracting

69 The Tentative Measures on contracts between state-owned enterprises and cooperative enterprises was issued by the then Economic Commission in September 1950, but it had been seldom sought until withdrawn in 1966. There were other provisional regulations issued governing specific kinds of contractual transactions. For discussion, see Li Meng, Contract Law in China, October 2005, http://theory.people.com.cn/GB/49150/49153/3801364.html, last accessed on 20 July 2008; Jiafu Wang at al (eds). Contract Law, (1986) China Social Science Press p141-143.


71 The Economic Contract Law was adopted at the 4th Session of the 5th NPC and promulgated by Order No.12 of the Standing Committee of the NPC on 13 December 1981, and took effect on 1 July 1982; amended in accordance with the Decision on Revision of the Economic Contract Law adopted by the 3rd session of the 8th NPC Standing Committee on 2 September 1993. It has now been repealed by the 1999 Contract Law which is discussed later.

72 The Tentative Measures of Basic Provisions on Contact between Industrial and Agricultural Commercial Enterprises was issued in 1979 as an interim measure when contract law was drafted. See Li Meng, op cit note 69.
households in order to define mutual rights and duties and conclude contracts to achieve certain economic goals. It applied only to contractual relationships between domestic (Chinese) parties. In order to implement the Economic Contract Law, the State Council and other authorised administrative bureaux issued a series of Circulars and Orders regarding its implementation.

*Foreign-related Economic Contract Law*

The Economic Contract Law, which did not apply to foreign parties, was followed by the Foreign-related Economic Contract Law issued in 1985. The Foreign-related Economic Contract Law, as its title suggested, applied to contracts involving foreign parties, with one or more Chinese companies on one side and one or more foreign companies or individuals on the other. It was an important step forward in China’s international re-engagement. However, natural persons of Chinese citizenship were not permitted to conclude a contract with a foreign party. At that time, entry into contracts for trade with foreign companies required a ‘foreign trade licence’ granted by government agencies without which foreign related trade was illegal under Chinese law. Many uncertainties and ambiguities were raised after the promulgation of the Foreign-related Economic Contract Law. To address the problems and questions raised, the Supreme People’s Court issued the *Response to Certain Questions Concerning the Application of the Foreign Economic Contract Law*. 

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73 Article 2, *Economic Contract Law*.
74 Article 45 of *Economic Contract Law* specified that foreign-related contacts shall be governed by the Foreign-related Economic Contract Law which did not implement until 1985.
75 For example, the State Council issued the *Circular on Issues Relating to Implementation of Economic Contract Law* on 4 May 1982; the SAIC issued the *Answers Regarding the Application of Certain Provisions of Economic Contract Law* on 20 August 1983.
76 The Foreign-related Economic Contract Law was adopted at the Tenth Session of the Standing Committee of the Sixth NPC, promulgated by Order No.22 of the President of the People’s Republic of China on 21 March 1985, and effective as of 1 July 1985.
77 Article 2, *Foreign-related Economic Contract Law*.
78 Companies without such licence had to appoint a foreign trade agent who held a licence to import or export.
Law\textsuperscript{79} to clarify issues, including \textit{inter alia} the application of the law, confirmation of invalidation and revocation of contract, and issues after the confirmation of the invalidation or revocation of contracts, and liability.

The \textit{Foreign-related Economic Contract Law} applied to the negotiation of a joint venture contract for establishing a joint venture enterprise\textsuperscript{80} (as discussed in Chapter 6.2), but it did not apply to contracts between a Chinese party and any of the foreign invested enterprises, such as equity joint ventures, cooperative joint ventures or wholly foreign owned enterprises established under the Chinese law, which were governed by \textit{Economic Contract Law}.\textsuperscript{81} China's efforts in addressing foreign-related contracts were further enhanced by its joining the \textit{United Nations Convention on Contracts for the International Sales of Goods (CISG Convention)}.\textsuperscript{82}

\textbf{Technology Contract Law}

The \textit{Technology Contract Law}\textsuperscript{83} issued in 1987, applied to contracts relating to technology development, technology transfer, consulting and management services, provided that the parties to the contract were not foreign enterprises, organisations or individuals.\textsuperscript{84} Technology transfer contracts were defined as 'contracts concluded between parties for the transfer of a patent, transfer of patent application rights and a licence to implement a patent or for the transfer of non-patented technology'.\textsuperscript{85}

\textsuperscript{79} The \textit{Response to Certain Questions Concerning the Application of the Foreign Economic Contract Law} was issued and circulated by the Supreme People's Court on 19 October 1987.
\textsuperscript{80} Indeed, as discussed later, a joint venture contract has to be subject to Chinese law. Parties are not allowed to choose the governing law of another jurisdiction.
\textsuperscript{81} These three types of entities are regarded as Chinese legal persons in the terms of their contractual capacity.
\textsuperscript{82} China ratified the \textit{CISG Convention} in 1986.
\textsuperscript{83} The \textit{Technology Contract Law} was adopted by the 21st Session of the Standing Committee of the 6th NPC on 23 June 1987. Technology has been defined broadly including transfer of know-how, consulting services or management services.
\textsuperscript{84} Article 2, \textit{Technology Contract Law}.
\textsuperscript{85} Article 43, \textit{Technology Contract Law}.
Move to a unified Contract Law

The three separate contract codes, the Economic Contract Law, the Foreign-related Economic Contract Law and the Technology Contract Law - commonly referred to as the ‘three pillars’ of contract law in China, were evidence of China’s efforts in establishing a commercial legal system as well as its unsystematic task-oriented development. Under this system, the application of governing law depended on whether there was a foreign element and whether the subject matter of contract involved industrial intellectual property. These three codes were supplemented by many administrative regulations and local regulations which further complicated the system. Furthermore, the three codes on contract law did not apply to all contract situations. Neither the Economic Contract Law nor the Foreign-related Economic Contract Law applied to a contract between a Chinese individual and a foreign party, as a Chinese individual was not a qualified party under the Foreign-related Economic Contract Law, and a foreign party was not a qualified party under the Economic Contract Law. Such a contract, if ever concluded, could only be governed by the GPCL (contracts other than ‘economic agreements’ were governed by GPCL).

China’s efforts in drafting a uniform contract code started in the early 1990s with the recognition of the need to build a more comprehensive and uniform contract code to solve the problems in the then existing legal framework which were identified as: i) being too vague and general; ii) the inconsistencies among the ‘three pillars’ of the contract law as well as other regulations; and iii) newly emerged types of contracts that were not included which led to a lack of legal regulation. The reform proposal was supported by scholars who demanded that a contract law to treat all parties on an equal basis and respect the fundamental principle of freedom of

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86 The Legislative Affairs Committee of the NPC’s Standing Committee formally commenced the drafting work in early 1993. See Jianfu Chen, op cit note 3 at 448.
87 ‘Explanations on Several Questions Regarding the Contract Law (Draft for Consolidating Opinions)’, General Office the Standing Committee of NPC, 14 May 1997; Such explanations were give to the Fourth Meeting of the Standing Committee of NPC on 24 August 1998 and published in People’s Daily on 25 August 1998.
contract be established.\textsuperscript{88}

\textbf{5.4.2 Unified Contract Law – Legislation on Contracts Post 30 September 1999}

The unified \textit{Contract Law}\textsuperscript{89} which repealed the \textit{Economic Contract Law}, the \textit{Foreign-related Economic Contract Law}, and the \textit{Technology Contract Law},\textsuperscript{90} was adopted in 1999. The \textit{Contract Law}, for the first time, provided a uniform code on contracts and applied to contractual relationships between individuals, legal persons and other organisations including foreign persons (natural or legal).\textsuperscript{91} It has solved a long existing problem regarding the different treatment of parties based upon their nationality and has been welcomed by scholars, professionals and enterprises, both domestic and internationally.

\textbf{5.4.2.1 Structure and Content of the \textit{Contract Law}}

The \textit{Contract Law} has 23 Chapters comprising 428 articles which have been separated into two parts: general provisions and specific provisions. In Part I, there are eight Chapters on General Provisions, covering issues in relation to: the Basic principle (Chapter 1, Articles 1-8), Concluding a contract (Chapter 2, Articles 9-43),


\footnotesize\textsuperscript{89} The \textit{Contract Law of the People’s Republic of China} was adopted at the 2\textsuperscript{nd} session of the 9\textsuperscript{th} NPC on 15 March 1999, took effect on 1 October 1999, the 50\textsuperscript{th} birthday of the PRC. The Supreme People’s Court issued the \textit{Interpretation I on the Application of the Contract Law} on 19 October 1999 to clarify certain issues in relation to the interpretation and application of the \textit{Contract Law}. The term ‘uniform contract code’ (uniform contract code) was used by scholars and the legislature but was abandoned later. Translation is adopted from the bilingual edition of the \textit{Contract Law of the People’s Republic of China}, (1999) published by Law Press, Beijing.

\footnotesize\textsuperscript{90} Article 428 of the \textit{Contract Law} expressly repealed the ‘three pillars’ of the contract law. In reality, many that the administrative regulations and local regulations on contact were be modified or abolished accordingly. But the \textit{General Principles of the Civil Law} still applies. Xinhua News Agency, ‘NPC Session Exams Draft Contact Law’, 8 March 1999 (No 0308014).

\footnotesize\textsuperscript{91} Pursuant to the \textit{Interpretation I on the Application of the Contract Law}, for disputes regarding the performance of a contract concluded before 1 October 1999 (the effective day of the \textit{Contract Law}), if the period time for performance stipulated in the contract goes beyond the effective date of 1 October 1999, should be subject to the Unified \textit{Contract Law}. 

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Validity (Chapter 3, Articles 44-59), Performance (Chapter 4, Articles 60-76), Modification and assignment of contractual rights and obligations (Chapter 5, Articles 77-90), Termination of rights and duties (Chapter 6, Articles 91-106), Liability for breach of contract (Chapter 7, Articles 107-122) and Other provisions (Chapter 8, Articles 123-129)

In addition to the Part I, general provisions, Part II contains Chapters dealing with 15 specific types of contract, namely, sale and purchase of goods; the supply of electricity, water, gas and heating; gifts; loans; leasing; lease financing; hired works; construction projects; transportation; technology; storage; warehousing; trusts; commissioning agencies; and brokerage. Franchise contracts are not specifically addressed in the Contract Law, so they are governed by the general provisions.

To provide guidelines for the interpretation and application of the Contract Law, the Supreme People's Court issued the Interpretation on Application of Contract Law I (Interpretation I) and Interpretation on Application of Contract Law II (Interpretation II) in 1999 and 2009 respectively. The guidelines provide important clarification of inter alia, procedural issues and determination of the validity of a contract.

5.4.2.2 General Principles of the Contract Law

The general provisions of the Contract Law are strongly influenced by the UNIDROIT Principles of International Commercial Contracts. The basic principles of equality

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92 The Interpretation on Application of Contract Law I, Fashi (1999) 9, was issued by the Supreme People's Court on 19 December 1999, effective on 29 December 1999.
93 The Interpretation on Application of Contract Law II, Fashi (2009) 5, was issued by the Supreme People's Court on 09 February 2009, effective on 13 May 2009.
(Article 3), party autonomy (freedom of contract) (Article 4), fairness (Article 5),
good faith (Article 6), public interest (Article 7), stipulated in the Contract Law
reflect the UNIDROIT Principles.

*equality of parties*

The Contract Law defines a contract as an agreement between equal parties and
emphasises that the parties enjoy equality of status in contractual relations.\(^95\) Equality of parties in civil relations is a fundamental principle of the Contract Law.
Equality of parties has been a battleground in China in relation to the political
economic system and the legal system.\(^96\) At the heart of this debate was the ideology
and process of defining the role of the state (represented by its government
bureaucratic authorities) in economic management and activities.\(^97\) Although the
repealed ECL stated that 'the equality of parties' existed, it expressly recognised the
possibility of state intervention in economic activities.\(^98\) These provisions not only
interfered with the implementation of freedom of contract, but also impaired the
equality of parties as government intervention could favour one party over another.

*party autonomy (freedom of contract)\(^99\)*

Freedom of contract was not explicitly stipulated in any of the 'three pillars of
contract law'.\(^100\) The Contract Law has removed certain provisions in the three
pillars of contract law which undermined parties' freedom and provides that parties

\(^95\) Articles 2 and 3, Contract Law. It also removed the general provision on government supervision
of contract performance.

\(^96\) For detailed discussion, see Jianfu Chen, From Administrative Authorisation to Private Law, A
Comparative Perspective of the Developing Civil Law in the PRC, (1995) Martinus Nijhoff
Publisher.

\(^97\) Ibid.

\(^98\) Such as Chapters 5 and 6 of the ECL. For detailed discussion, see Jianfu Chen op cit note 3 at 69.
For a contract law, the ECL was a short document of about 7200 Chinese Characters (less than
5000 words in English translation), but 'state' (国家) was mentioned 25 times and it also
included a provision on the supervision of 'economic contracts' by the government agencies
(Article 43).

\(^99\) It is also translated as voluntariness.

\(^100\) There were provisions which indirectly guaranteed the principle of freedom of contract. The
freedom of contract was included GPCL. Although party autonomy was indirectly guaranteed,
the form of economic contract was required to be in writing (Article 3, ECL; Article 7, FECL;
and Article 8, LTC). Furthermore, these three contract laws imposed various other restrictions.
determine their rights and obligations according to the principle of fairness (Article 5). It removes the written format requirement and provides that a contract can be in writing, oral and in other forms unless laws or regulations require otherwise. Furthermore, it stipulates that parties can alter the contract upon agreement through consultation which provides a relief from the strict requirement for full performance as required by the Economic Contract Law (ECL) and thus restores freedom of contract. The influence of the UNIDROIT Principles on the Contract Law is evident in the method of handling this issue. Both the UNIDROIT Principles of International Commercial Contracts and the Chinese Contract Law deal with freedom of contract in an indirect way rather than as an explicit principle, and allow alteration of contract and discharge after compensation. Although the 1999 Contract Law has made progress on protecting freedom of contract, it has been pointed out that it does not break any new ground in upholding such an important contract principle.

**fairness and good faith**

Rights and obligations stipulated in a contract shall be fair to all parties and the parties shall act honestly and in good faith. As a general principle, fairness and good faith is enshrined in the GPCL (Article 4) and was expressed indirectly or implied in the three pillars of contract law. The Contract Law developed this principle to expressly impose the duty on parties to observe fairness (Article 4) and good faith (Article 6). More importantly, the Contract Law added pre-contractual obligations of good faith which are particularly important in the franchising. Article 42 of the Contract Law provides:

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101 Article 10, *Contract Law*.
102 Under the repealed ECL, continue performance of the contract may be imposed after compensation for the breach (Article 70).
103 It is interesting to note that certain criticism made in this regards also pointed out that to certain extent, it is also a trend of the UNIDROIT Principles or the CISC Convention. For example, Chen suggested out that the UNIDROIT Principles or the CISC Convention both lean more towards actual performance of contract than would normally be required under common law. A detailed discussion on theory on the contract and the principles provided by the Contract Law is beyond the scope of this thesis. Jianfu Chen, op cit note 3 at 457.
In the making of a contract, the party that falls under any of the following circumstances, causing loss to the other party, shall hold the liability for the loss:

- engaging in consultation with malicious intention in the name of making a contract;
- intentionally concealing key facts related to the making of the contract or providing false information;
- taking any other act contrary to the principle of good faith.

As a result of the information imbalance inherent in a franchising relationship, the importance of pre-contractual disclosure by the franchisor is widely recognised.\textsuperscript{104} The expressly imposed obligation of good faith in the pre-contractual relationship is a significant development. The 2007 *Franchise Regulation* further detailed the prior disclosure requirements,\textsuperscript{105} but the development of pre-contractual obligations in the *Contract Law* serves an important role as a general guideline for specific industry regulation as well when no detailed regulation is prescribed.

The *Contract Law* developed the concept of contract avoidance if a contract -

- is entered into under a material misunderstanding; or
- is obviously unfair; or
- is entered into against the other party's true intention as a result of one party's fraud on the other, or as a result of duress, or when the opposing party is in a seriously disadvantage position.\textsuperscript{106}

It further provides in these situations, that the decision of whether or not to alter or terminate the contract is at the discretion of the injured party.

5.4.2.3 Approval/registration, Validation and Foreign-related Issues

A contract generally comes into effect as soon as the agreement is concluded or at

\textsuperscript{104} See discussion in Chapter 7.2.
\textsuperscript{105} Pre-contractual disclosure required by the 2007 *Franchise Regulation* is discussed in detail in Chapter 7.4.5. For detailed discussion on pre-contractual obligation, see Paul Jones, Paul Jones, 'The Regulation of Franchising in China and the Development of a Civil Law Legal System' (2006) 2 (1) *Chinese Law & Policy Review* 78.
\textsuperscript{106} Article 54, *Contract Law*. 

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the time stipulated for its commencement unless approval and registration are required. There were, and still are, certain approvals or registration required before a contract can take effect. Article 9 of the *Interpretation on Application of Contract Law I (Interpretation I)*\(^{107}\) indicates that:

- re Article 9a: if the parties have not completed the approval or/and registration procedures before the conclusion of court debates in the court of first instance, the court shall hold the contract to be ineffective; but
- re Article 9b: if laws or administrative regulations only require a contract to undergo registration formalities, the failure to carry out registration procedures will not invalidate the contract.\(^{108}\)

*Interpretation I* also states that, if a contract is entered into by the parties outside their scope of business operation,\(^{109}\) the court will not generally make it invalid, but only render it invalid when the operation involves a restricted business, or is subject to special permission of the State, or where it is prohibited by laws or administrative regulations.\(^{110}\)

In the case *Han MeiYan v Beijing Yinqi Bayi Yinqi Jianmei Limited*,\(^{111}\) the court found that a franchise agreement signed between Han MeiYan, a Chinese individual, and Yinqi Bayi, a foreign invested company, in July 2004, was invalid. The decision was made based on franchising as a method of business expansion being under the ‘restricted’ category in the *Catalogue Guiding Foreign Investment in Industry*. (The defendant was franchising before December 11, 2004, the time China committed to open its franchise sector to foreign investors under China’s WTO accession commitments.\(^{112}\)) The ruling was supported by Lin Xiao, a Beijing franchising

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107 Op cit note 92.  
109 Scope of business operation is discussed in Chapter 5.3.2.  
110 Article 10, *Interpretation I*.  
111 Han MeiYan (韩美艳) v Beijing Yinqi Bayi Yinqi Jianmei Ltd (北京印气巴凯印气健美有限公司), Beijing Chaoyang District Court, (2005) Chaominchuzi No. 5967. This decision has been upheld by the Beijing Second Intermediate Court, *Beijing Yinqi Bayi Yinqi Jianmei Limited v Han Meiyan*, Beijing Second Intermediate Court (2005), Erzhongminzhongzi No. 14880.  
112 Under China’s WTO commitment, it fully opens it franchise sector to foreign investors by no later than 11 December 2004.
lawyer, as a correct interpretation of the *Contract Law*, the Supreme Court's *Interpretation I*, the 'restriction' on foreign investment under the *Catalogue for Guiding of Foreign Investment Industries* and the then 2005 *Franchise Measures*. Lin has published several articles on this issue and has claimed that the Chinese franchise sector was facing collapse due to the crisis arising out the invalidity of franchise agreements (signed before 2005) between Chinese parties and foreign franchisors.

The crisis and the possible collapse of franchise sector, which Lin feared, did not happen and is unlikely to happen. Lin's position, which echoed the court's interpretation of the *Regulation on Guiding Foreign Investment Direction*, the *Catalogue Guiding Foreign Investment in Industry* and China's WTO commitments in relation to franchising, is discussed in Chapter 7. In relation to contract, one of the important propositions Lin put forward, which the court did not discuss in detail in the judgment, is the application of Article 9 of the *Interpretation I*, or in other words, whether the requirement under Article 36 of the 2005 *Franchise Measures* was an approval or a registration requirement without which, the franchise contract would be invalid. The 2005 *Franchise Measures* provided that:

Foreign invested enterprises which are already conducting business activities using franchise before the implementation of this Measure shall file with the original approval authority a report of its franchise business. For foreign invested enterprises which would like to continue to engage in business activities using franchise, they shall follow the procedures provided in this Measure.

This indicates that the procedure required by a foreign invested franchisor already engaging in franchising is to file/register a report rather than to obtain approval.

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113 The implication of the *Catalogue for Guiding of Foreign Investment Industries* is discussed in detail in Chapter 6.4.


116 Article 36, 2005 *Franchise Measures*. 
Thus Article 9b as stated above should apply and the franchise contract in the *Han MeiYan v Beijing Yinqi Bayi Yinqi Jianmei Limited* case should have not have been invalidated on the basis of the application of contract law and the 2005 *Franchise Measures*.

The *Contract Law* has clarified that if a foreign party is involved in a contract, the parties can choose the contract’s governing law; or, if a governing law is not chosen, the law of the place which has the ‘closest connection’ with the contract shall apply.\(^{117}\) It has also specified that when disputes arise, parties can seek mediation, arbitration or the court to solve their disputes.\(^{118}\) The *Contract Law* also permits the use of two or more languages that may be equally authentic.\(^{119}\)

### 5.4.2.4 Overall assessment

The *Contract Law* in China has developed significantly as a civil law system, although enforcement remains a key concern to franchisors. Concern is expressed by foreign franchisors that contracts are not accorded the sanctity they enjoy in the West and, at a business - if not a legal level, are regarded more as memoranda of understanding which invite renegotiation at regular intervals. In the words of one commentator, “the written word is not considered the final authority of meaning. In China, words and contracts are merely the beginnings of understanding, not sacrosanct agreements”.\(^{120}\) However, there has nevertheless been positive trend in the development toward a unifying and more comprehensive regulatory regime.

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\(^{117}\) Article 126, *Contract Law*. The concept of ‘closest connection’ is not defined in the *Contract Law*, but the provisions of the Supreme People’s Court to *Certain Questions Concerning the Application of Law in Cases of Disputes over Foreign-related Civil Contract or Commercial Contracts* (Fashi 0227 No 14, issued by the Supreme People’s Court on 23 July 2007) sets out the guidelines for deterring ‘the law of the place which has the closest connection’ with the contract.

\(^{118}\) For example, the *ECL* imposed full discharge on performance of contract, and prohibited contract in violating state plans (which was a policy rather than law).

\(^{119}\) Articles 125 and 126, *Contract Law*.

5.5 INTELLECTUAL PROPERTY LAW

5.5.1 Development of IP Law: Meeting the Challenge

Although there were some regulations on IP protection in the first 30 years of the PRC,\(^1\) a comprehensive legal regime for IP protection was not launched until the late 1970s. Realising that an intellectual property protection system plays a significant role in ensuring the market economy and is one of the basic environmental conditions for conducting international exchange and cooperation in science, the Chinese government considered the protection of intellectual property as an important part of its economic reform and Open Door policy. China joined the World Intellectual Property Organisation in 1980 shortly after the promulgation of the *Chinese-Foreign Equity Joint Venture Law*.\(^2\) Since then, China has been active in enacting domestic laws to protect intellectual property rights. The promulgation of the *Trademark Law*\(^3\) in 1982 was an important step for China and was followed by the *Patent Law* in 1984\(^4\), the *Copyright Law* in 1990\(^5\), and the *Anti-Unfair Competition Law* in 1993\(^6\). China is also a signatory to most global intellectual property treaties including the *Paris Convention for the Protection of Industrial Property* in 1985, the *Madrid Agreement for the International Registration of Marks*

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\(^2\) The *Law of People’s Republic of China on Chinese-Foreign Equity Joint Ventures (Equity JV Law)* was adopted at the Second session of the Fifth National People’s Congress on 1 July 1979; amended on 4 April 1990 and 15 March 2001. It is discussed further in Chapter 6.

\(^3\) The *Trademark Law* was adopted at the 24th Session of the Standing Committee of the 5th NPC on 23 August 1982, as amended in 1993 and 2001.

\(^4\) The *Patent Law* was adopted at the 4th Session of the Standing Committee of the 6th NPC on 12 March 1984, amended 4 September 1992 and 25 August 2000. The most recent amendments were approved by the 6th meeting of the Standing Committee of the 11th NPC on 27 December 2008 and to be effective on 1 October 2009.

\(^5\) The *Copyright Law* was adopted at the 15th Session of the Standing Committee of the NPC on 7 September 1990, and revised in accordance with the decision on the *Amendment of the Copyright Law* adopted at the 24th Session of the Standing Committee of the Ninth NPC on 27 October 2001.

\(^6\) The *Anti-Unfair Competition Law* was adopted at the 3rd Session of the Standing committee of the Eighth NPC on 2 September 1993, effective on 1 January 1994.
in 1989, the *Berne Convention for the Protection of Literary and Artistic Works*, the *Universal Copyright Convention* in 1992, and the *Patent Cooperation Treaty* in 1994.\footnote{It is not the researcher's intention to provide a comprehensive list of international agreements China has acceded to. There are other international agreements on IP protections which China has acceded, such as *Treaty on Intellectual Property in Respect of Intergraded Circuits* (1990). They are not included as they are less relevant to franchising.} As a WTO member, China is also bound by TRIPS Agreement. China declared that it had established a basic domestic legal framework on IP protection by the mid-1990s,\footnote{The State Council White Paper, the *Intellectual Property Protection in China* was issued by the Information Office of the State Council in June 1994; published in *People's Daily* (人民日報) on 17 June 1994.} however it was the WTO induced reforms through further amendments in the late 1990s and the early 2000s which brought China in line with TRIPS requirements and international standards.\footnote{Rebecca Ordish and Alan Adcock, *China Intellectual Property Challenges and Solutions* (2008) John Wiley & Sons (Asia) Pte Ltd, 8. It has been suggested that China's IP protection is too strict and sets a standard too high for China, a developing country. See Jianfu Chen op cit note 3 at 656.} As noted by Paul Jones, it is not well known in Western society that China has IP laws that meet international standards.\footnote{Paul Jones, 'Franchising with Chinese Characteristics: A Comparative Introduction to the Law - 具有中国特色的特许经营法的分析比较概況' (Presentation at China Franchise Summit, Beijing, 10 April 2008). Can be accessed at http://www.jonesco-law.ca/89/files/pdfs/PFR%20-%20Beijing%20-%202008-04-10.pdf, last accessed 30 July 2009.} The problematic of enforcement of intellectual property rights in China nevertheless remains a concern.

5.5.2 Trademark Law

Trademarks are regulated by the *Trademark Law* and the detailed rules of the *Regulation for the Implementation of the Trademark Law*,\footnote{The *Regulation for the Implementation of the Trademark Law* was issued by the State Council on 10 March 1983, amended on 3 January 1988, 15 July 1991, 23 April 1995 and most recently 3 August 2002. Re-promulgated on 3 August 2002, took effect on 15 September 2002.} and by many other administrative regulations, ministerial rules and judicial interpretations, including *Measures on the Recognition and Administration of Well-known Trademarks*.\footnote{The *Interim Measures on the Recognition and Administration of Well-known Trademarks* was issued by the SAIC on 14 August 1996, revised and re-issued as the *Measures on the Recognition and Administration of Well-known Trademarks* on 17 April 2003. Other rules includes: *Measures for the Evaluation and Review of Trademarks* (first issued by the SAIC in 1995, revised and re-}
Trademark Bureau and the Trademark Evaluation and Review Board under the SAIC are responsible for trademark registration and administration. In addition, in order to comply with the TRIPS Agreement, *Special Rules on Criminal Sanctions for the Counterfeiting of Registered Trademarks* were issued in 1993 to impose criminal procedures and penalties on wilful trademark counterfeiting or copyright piracy on a commercial scale.

The registration of a trademark in China since 1988 follows the International Classification of the Nice Agreement, but trademarks are granted on a first-to-file basis rather than a first-to-use basis. The commercial need to formulate and register a Chinese version of a brand raises further complications. Special protection on well-known trademarks were not included in the original 1983 *Trademark Law*. After China joined the *Paris Convention* which requires special protection on well-known trademarks, protection was provided on a case by case basis (the ‘Marlboro’ case being the most well known example). The *Provisional Measures on the...* issued on 17 September 2002, further revised and re-issued on 26 September 2005; *Measures Concerning the Administration of Trademarks in Foreign Trade* (jointly issued by MOFTEC and the SAIC on 25 August 1995); *Measures on the Registration and Administration of Collective Trademarks and Certification Marks* (issued by the SAIC on 17 April 2003, and replacing an earlier set of similar rules issued on 20 December 1994); *Administrative Measures on Trademark Agencies* (issued by the SAIC on 2 December 1999); various judicial interpretations issued by the Supreme People’s Court, including the *Interpretations of the Supreme People’s Court on Certain Issues Concerning the Application of Laws in the Adjudication of Civil Dispute Cases related to Trademarks* (issued on 12 October 2002), and the *Interpretation on Certain Issues concerning the Application of Law in the Adjudication of Civil Dispute Cases relating to Computer Network Domain Names* (issued on 17 July 2001 and effective from 24 July 2001). The Ministry of Commerce is also involved in the administration of all foreign trade related trademarks.

*The Special Rules on Criminal Sanctions for the Counterfeiting of Registered Trademarks* was issued the Standing Committee of the NPC in 1993. Article 61 of TRIPS obligates members to impose criminal procedures and penalties on willful trademark counterfeiting or copyright piracy on a commercial scale. Article 61 of TRIPS obligates members to impose criminal procedures and penalties on willful trademark counterfeiting or copyright piracy on a commercial scale. China formally joined the *Nice Agreement Concerning the International Classification of Goods and Services for the Purposes of the Registration of Marks* in August 1994. Article 6bis, *Paris Convention*.

Recognition and Administration of Well-known Trademarks were introduced in 1996 to clarify certain practical issues for the recognition of well-known marks, but compliance with the TRIPS Agreement was not completed until China further amended the Trademark Law in 2001 to add provisions on the protection of well-known trademarks.

In recent years, there has been a discernible trend to stronger intellectual property protection in China. Starbucks' success in 2006, against a rival Chinese company which used a very similar logo, may give hope and confidence to foreign brands that intellectual property protection in China is effective. Starbucks first registered its trademark 'Starbucks' in China in 1996, however the Chinese translation '星巴克' (Xiangbake) was not registered until 29 December 1999, although it had been registered in Taiwan since 1 February 1999, and used in Mainland China in advertising materials since its first store opened in Beijing in January 1999. The defendant, a competitor in Shanghai, registered its business name '星巴克' (Xiangbake) on 20 October 1999. The reasoning of the court in favour of Starbucks was that: (i) Shanghai Xiangbake registered its business name in bad faith knowing of Starbucks; and (ii) the use of the same name caused confusion as to the association between two companies and resulted in unfair competition. In addition, both 'Starbucks' and its Chinese translation '星巴克' (Xiangbake) were famous trademarks having regard to Starbucks' international reputation and extensive

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139 The 1993 amendments of the Trade Mark Law failed to include the protection on famous trademark.

140 Articles 13 and 14 of the 2001 revised Trademark Law. The requirement of extend protection to well-known marks even in relationship to goods, which are dissimilar to which the well-known mark is applied, is under the Article 16 (3) of the TRIPS agreement. The SAIC issued the Measures on the Recognition and Administration of Well-known Trademarks which replaced the 1996 Provisional Measures on the Recognition and Administration of Well-known Trademarks in April 2003.

141 The appeal decision of the Shanghai High People's Court of this case, dated 20 December 2006, is available at http://ipr.chinacourt.org/public/detail_sfws.php?id=5919, last accessed on 1 June 2007.

142 See generally, Rebecca Ordish, op cit note 129 at pp175-192.
promotion in Chinese-speaking societies.  

5.5.3 Implementation and Enforcement Issues 

As discussed above, intellectual property law in China has progressed significantly and today China is close to meeting international standards. However, despite the WTO induced reforms under the TRIPS Agreement, intellectual property in China remains a difficult area for Western businesses – not so much in the obtaining of the intellectual property right but in its enforcement. The serious problems in enforcement of IP rights in China have been widely acknowledged from both inside and outside China.

To raise public awareness of IP rights, campaigns have been conducted on IP rights violations (‘crackdown campaigns’) and also as a part of general legal education.  

‘World IP Day’ was initiated by SIPO, SAIC, and NCA in 2001 and since 2004 has been extended to ‘IP Protection Week’ (19-26 April). During this period, the media gives wide coverage on IP issues, conferences are held and ‘crackdown’ campaigns directed at IP violations are conducted. September 2004 – August 2005 was promoted by the State Council as IP Protection Year.  
The mechanisms for internal review, administrative sanctions and judicial enforcement through civil and criminal sanctions are well established and in place, but despite well published

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143 Starbucks Corporation and Shanghai Tongyi Starbucks Ltd v Shanghai Xingbake Coffee Ltd, Shanghai Xingbake Coffee Ltd. Nanjing Branch (2004 Huerzhongminwu(zhi)chuzi No 1), Shanghai No 2 Intermediate People’s Court, 2004; Shanghai Xingbake Coffee Ltd., Shanghai Xingbake Coffee Ltd. Nanjing Branch v Starbucks Corporation and Shanghai Tongyi Starbucks Ltd. (Hugaominsan(zhi)zhongzi No 32), Shanghai Higher People’s Court, 2006.

144 An important campaign for law is in the form of the Popularising Law which called Pufa (普法) Campaigns. It has been conducted for over 20 years on a five-year plan basis since 1985, see the website of the Ministry of Justice: <www.legalinfo.gov.cn>; for discussion, see Ronald J Troyer, ‘Publicising New Laws: The Public Legal Education Campaign’, in Ronald J. Troyer, John P. Clark and Dean G. Royek (eds), Social Control in the People’s Republic of China (New York: Praeger, 1989), at 70-83; Jianfu Chen, op cit note 3 at 605.

145 It was later extended to the end of 2005.

146 Internal reviews can be sorted at both registration and infringement stages. For registration, there is the Trademark Evaluation and Review Board which, on application, may review the decisions by the Trademark Bureau (Article 2, Measures on Evaluation and Review of Trademarks). For alleged infringements, the Trademark Bureau (or its local departments) of the SAIC (or its local departments) has the power to investigate a complaint lodged by a rights holder or any interested party and the parties involved must provide assistance with the investigation (Article 55, Trademark Law).
problems, it has nevertheless increasingly acknowledged by Western scholars that of IP protection is improving in China.147

5.6 CHAPTER SUMMARY

China has made significant progress in building a commercial law system enshrining internationally recognised ‘rule of law’ principles to support its developing market economy. As Arthur Mitchell, the then General Counsel of the Asian Development Bank, stated in 2004:

_The rule of law, will not by itself, cause countries to perform better economically but it is one of the prerequisites to creating an enabling environment that supports economic growth._148

The development of the underling commercial law in China and the legal infrastructure to support it has been vital in providing an environment in which franchising is possible. The recognition of private enterprise, definition of the concept of legal personality, the introduction of various business entities, and the protection of contractual and intellectual property rights have been significant and necessary developments. China’s rapidly changing commercial law reflects its efforts to meet the challenges of globalisation and international business practice. The move to a systematic and comprehensive commercial law system is not yet complete, but the new unified _Contract Law_, the standardised _Company Law_ and the adoption of WTO IP standards, in combination with increasingly effective enforcement, give increasing confidence to foreign franchisors in China.

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6.1 INTRODUCTION

A well-established legal system, and underlying commercial laws to support business operations, are necessary to provide the legal framework for franchising development. However, in the context of China there are further considerations. China has had a restrictive and highly complex foreign investment regime, and participation in particular sectors – including the domestic consumer market – has been strictly controlled. In addition to an appropriate body of underlying commercial law (which may include franchise specific regulation), and machinery for dispute resolution and enforcement, market access liberalisation is also a necessary prerequisite for franchise sector development. As noted at Chapter 8 the market entry of prominent foreign franchise systems provides the catalyst for domestic franchise development, particularly in developing economies. The pivotal role of KFC and McDonald’s China entry in the initial development of franchising in China is discussed in Chapter 8.2.

When Deng Xiaoping’s Open Door policy and economic reforms were introduced in the late 1970s, China was in urgent need of not only foreign technology and foreign capital, but also foreign management expertise and marketing experience. Deng undertook a gradual process of transformation - politically, economically and administratively - to establish the legal system and the commercial infrastructure necessary to support the reforms.\(^1\) Progress in both areas – underlying business laws,\(^2\) and foreign trade\(^3\) and investment laws – has occurred gradually since then.

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2. See generally Chapter 5.
3. See generally Jianfu Chen, *An Emerging New Legal Framework on Foreign Trade*, April (2002) CCH’s China Law Update, 7-12. Foreign trade law reforms have liberalised licensing and quota systems, and macro-controls involving exchange rates, taxation and loans. Administrative interference has also been reduced. The legal framework for foreign trade has developed from ad
WTO accession commitments have more recently become the major driver of reform.

The Organisation for Economic Co-operation and Development defines foreign direct investment (FDI) as 'international investment that reflects the objective of a resident entity in one economy to obtain a lasting interest in an enterprise resident in another economy'. In the international franchising context, FDI encompasses a foreign franchisor establishing a physical presence in a host country through a subsidiary or joint venture (both of which require investment in the host country) in contrast to cross border franchising from the home country to the host country through direct franchising, master franchising or area development agreements for which no physical presence, and no investment, in the target country is required.

This chapter reviews the development of the regulatory regime in relation to a foreign franchisor's entry into China. Chapter 6.2 outlines the legal framework for foreign investment in China. Chapter 6.3 outlines the available business structures for foreign investment, and the major developments in the relevant laws. Chapter 6.4 analyses the liberalisation of market entry and the opening of the previously foreclosed franchise sector to FDI franchisors operating through a sanctioned commercial foreign investment vehicle.

**6.2 LEGAL FRAMEWORK**

The legal framework in China for foreign investment includes:

1. national laws on forms of FDI which, in principle, provide legal certainty and stability;

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hach rules to systematic regulation, which has increased transparency and brought China in line with international rules and practices. (It is reported that the State Council and its subordinate authorities review a total of more than 2300 regulations and measures, with 830 repealed and another 325 revised: Jianfu Chen, Chinese Law: Context and Transformation (2008) Martinus Nijhoff Publishers, p623.) However, the foreign trade system has little impact on franchising enterprises, and is discussed only when it is particularly relevant to foreign franchisors.

ii) *ad hoc* detailed regulations and measures on implementation of national laws and which change frequently;

iii) laws and guidelines governing market access to particular sectors which have been gradually liberated under China's WTO accession negotiations.

Prior to the Open Door policy, there were virtually no laws regarding foreign investment in China. The process of transformation since then has generated a large body of FDI laws at both national and lower government levels to both promote and protect foreign investment. China is now one of the world's largest FDI recipients. By 1997, foreign investment accounted for 15 percent of China's total investment, and employed 18 million local people which was about 10 percent of the country's non-farming workforce. The fifteen years of negotiations prior to China's WTO accession were accompanied by significant changes to its legal system and foreign investment policy as conditions for its WTO accession. China's WTO commitments in relation to uniformity, opening its markets and reform of its administrative approval system have driven a significant reform agenda.

Foreign direct investment has been possible since 1979 through an *equity joint venture* (Equity JV), since 1986 through subsidiary, known in China as a *wholly foreign owned enterprise* (WFOE), and since 1988 through a *cooperative (or contractual) joint venture* (Cooperative JV). Major amendments to foreign investment law were implemented during China's WTO negotiations, and after its accession, in order to meet, inter alia, the requirements of the *Agreement on Trade-related Investment Measures* (TRIMS), but there is no uniform code for foreign

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8. The *Law of People's Republic of China on Chinese-Foreign Equity Joint Ventures (Equity JV Law)* was adopted on 1 July 1979.
Foreign invested enterprises in China are treated more favourably than domestic enterprises. The foreign investment law offers special incentives for foreign invested enterprises to attract foreign capital, know-how and market expertise, and many of the former restrictions on market entry for FDI franchisors have been relaxed (see Chapter 6.4).

Despite significant reform the legal framework governing foreign investment in China remains highly complex and transitional. The journey is far from complete. This is due to China’s relative inexperience in law making and foreign economic relations, and because of the gradual approach adopted to opening up. At the national level there are two legal systems in China - for foreign invested enterprises and for domestic invested enterprises - although efforts are being made to unify these two. Despite the relevant laws being revised many times, the three principal FDI options – the equity joint venture, the cooperative joint venture, and the wholly foreign owned enterprise – have remained intact although the relevant laws have been revised on many occasions.15

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11 Jianfu Chen, op cit note 1 at 641.
12 Including preferential tax treatment (Article 8, Regulation for Encouragement of Foreign Investment, issued by the State Council on 11 October 1986) and low cost supply of, for example, water, electricity and transportation, through law and policies at national and local level designed to attract FDI. For more discussion, see K.C. Fun, Hitomi Iizaka and Saraj Tong, ‘Foreign Direct Investment in China: Policy, Trend and Impact’ (Paper prepared for China’s Economy in the 21st Century’, Hong Kong, 24 June 2002) can be accessed at http://www.hiebs.hku.hk/working_paper_updates/pdf/wp1049.pdf; Jihong Tong, Amendment of Foreign Investment Law in China, http://www.bianjibu.net/post/305.html, last accessed 30 July 2009.
13 As discussed in Chapters 4.2 (generally) and 5.2 (in relation to Civil Code development).
14 China promulgated a uniform Company law in 1993, and introduced a number of tax regulations applicable to both domestic enterprises and FIEs in the 1990s. China adopted a unified taxation system for all FIEs in 1991. 60 percent of the provisions in the three FDI laws are similar which sometimes confusing. It has been suggested by officials of MOFCOM that further amendments are being considered.
6.3 FOREIGN DIRECT INVESTMENT VEHICLES

When the Chinese government adopted the Open Door policy in late 1978, there was no legal framework for attracting or protecting foreign investment. The National People's Congress (NPC), China's national legislature, sanctioned FDI for the first time on 1 July 1979, when it passed the Law on Chinese-Foreign Equity Joint Ventures (Equity JV Law). It was designed to provide a legal base for FDI which was recognised as having a vital role in the growth of the Chinese economy. The Equity JV Law established the first legal framework for foreign investment and built the bridge for engagement with the international community and the revitalisation of economy. David Bonavia has suggested that:

The decision to welcome joint ventures ... [was] an exciting experiment in mutual tolerance and education, as well as profit, and in future centuries it may be seen as the measure which contributed most to bringing China and the Western world together after two centuries of mutual suspension and conflict. 16

Alternative FDI vehicles were later provided under the Wholly Foreign-Owned Enterprises Law in 198617 and the Cooperative Joint Venture Law in 1988.18 The laws governing these foreign investment vehicles have been amended at various stages to liberalise formerly restrictive requirements under the influence of a desire to attract further foreign investment as well as to satisfy WTO obligations.19 Currently foreign investors in China can carry on business through setting up an Equity JV, a Cooperative JV or a WFOE which are collectively referred to as Foreign Investment (or Invested) Enterprises (FIEs).

The WFOE, a wholly owned Chinese subsidiary of a foreign company is a legal person, a separate legal entity, generally established in China as a limited liability

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17 The Law of the People's Republic of China on Wholly Foreign-Owned Enterprise was adopted at the 4th Session of the Sixth NPC on 12 April 1986.
18 The Law of the People's Republic of China on Chinese-foreign Cooperative joint venture was adopted at the 1st Session of the Standing Committee of the Seventh NPC on 13 April 1988.
19 Equity JV Law in 1990 and 2001; Cooperative JV Law in 2000; and the WFOE Law in 2000.
company. The Equity JV is established as a corporate entity, usually with limited liability, and is also a legal person. The Cooperative JV may be established simply as contractual joint venture without separate legal personality or may be structured with separate legal status. In both Equity and Cooperative JVs, the foreign party or parties must hold at least 25 percent of the investment in the joint venture for it to be a FIE. While the three FIEs are available in China for business operation, restrictions on FDI in particular sectors (including franchising) under the *Catalogue for the Guidance of Foreign Investment Industries* made FIE franchising complex and uncertain until WTO induced liberalisation reforms were implemented by the 2004 *Commercial FIE Measures* (discussed in Chapter 6.4).

Reference is briefly made at Chapter 6.3.4 and 6.3.5 to the representative office and branch of a foreign enterprise. Apart from the inherent limitation as structures for business operation, the market liberalisation reforms discussed in Chapter 6.4 do not extend to them and they are not legally or commercial viable entry modes for foreign franchisors in China.

### 6.3.1 The Equity Joint Venture

The National People's Congress (NPC), passed the *Law on Chinese-Foreign Equity Joint Ventures (Equity JV Law)* \(^{20}\) on 1 July 1979. It sanctioned, subject to State approval, the creation of China-foreign equity joint venture enterprises. An Equity JV requires the formation of a limited liability Chinese company. Joint venture participants are liable for the company's debts and entitled to its profits to the extent of capital contributed. Equity JVs are recognised as legal persons under Chinese law,
and are authorised to exist for up to thirty years (or longer upon approval). An Equity JV can be formed between foreign companies, enterprises, other economic organisations or individuals on the foreign side and Chinese company/companies, enterprises, or other economic organisations (but not an individual) on the Chinese side. An Equity JV must operate within its approved and registered scope of business operations which can nevertheless be amended with approval and re-registration. The contents of the joint venture contract and articles of association are listed in the *EJV Implementation Regulation*.

As a limited liability company, the Equity JV is subject to the *Company Law*. The principal laws (*Equity JV Law*, *Equity JV Implementation Regulation*, and *Company Law*) are supplemented by a substantial body of regulations, measures, governmental notices and local regulations/measures. If it is too harsh to claim that under the Chinese system a business activity is generally prohibited unless it is expressly authorised today, it was definitely true in the 1980s as there was no experience by the governmental officials in handling foreign related investment issues. In addition, the shadow of the Cultural Revolution was still fresh and an anti-capitalism ideology was not unusual among the bureaucrats administering the approval and registration process.

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21 Article 1, *Equity JV Law*.
23 Article 11 of the *Equity JV Implementation Regulation* defines the contents of Equity JV contract, and Article 13, the *Equity JV Implementation Regulation* defines the contents of articles of association.
24 Article 218 of the *Company Law*. The *Company Law* was passed by the 5th Session of the Standing Committee of the Eighth NPC on 29 December 1993, took effect from 1 July 1994; amended in 1999, 2004 and 2005.
25 The *Notice Concerning Legal Questions Raised during the Course of Operating a Chinese-foreign Equity Joint Ventures* was passed by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) on 5 October 1993. It further clarified issues such as amendments and approvals of equity joint ventures, restrictions on general managers and deputy general managers holding positions in other business organisations, and issues relating to increasing investment in existing equity joint ventures. Some other specific FDI regulations also have general application to equity joint ventures to governing procedural issues such as transfer of shares (*Certain Regulation for Changes to Shareholders' Rights in Foreign Investment Enterprises* was promulgated by the MOFTEC and the State Administration for Industry and Commerce (SAIC) on 28 May 1997.) and liquidation (*Measures on Liquidation Procedures for Foreign Investment Enterprises* was suggested by the MOFTEC, approved by the State Council on 15 June 1996, and promulgated by the MOFTEC on 9 July 1996).
There is a minimum 25 percent equity requirement on the part of the foreign partner in an equity joint venture. There is no maximum limit on foreign capital contribution in an equity joint venture. The Company Law currently stipulates the minimum amount of registered capital for a limited liability company as RMB 30,000 subject to any higher requirement under any other specific law and regulation. Under the Equity JV Law, the capital contributions by parties to an equity joint venture can be in cash or in other forms such as buildings, equipment, intellectual property or land use rights. The value of a building, equipment or intangible property must be assessed on fair and reasonable basis through negotiation between joint venture partners or determined by a third party agreed by the parties. A foreign investor can contribute capital to the joint venture in the form of intellectual property (IP) if such IP can markedly improve the quality of existing products and raise productivity; or make notable savings in raw materials, fuel or power. Certificates and other documents in relation to the intellectual property must be presented to the Chinese party and annexed to the joint venture contract. The cash capital contribution by all shareholders of a limited liability company must be no less than 30 percent of the company’s registered capital.

The ‘registered capital’ of an equity joint venture is different from the ‘total amount of investment’ in China. The ‘total amount of investment’ is the sum of capital funds

26 Article 4, Equity JV Law.
27 Article 26, Company Law.
28 Article 5, Equity JV Law and Article 22, Equity JV Implementation Regulation. Leased equipment and machinery cannot be used by foreign investors as capital contributions as specified in the Notice of the MOFTEC Concerning the Questions of Whether Leased Equipment can be used as Registered Capital in a Joint Venture by both Chinese and Foreign Investors was promulgated by the MOFTEC on 5 October 1993.
29 Article 22, Equity JV Implementation Regulation.
30 Article 25, Equity JV Implementation Regulation. The amendments promulgated by the State Council on 22 July 2001 deleted the original Article 28.1 which included capable of manufacturing new products urgently needed in China or products suitable for export.
31 Article 26, Equity JV Implementation Regulation.
32 Article 27, Company Law. It applies to joint ventures according to the Suggestions on Implementation of Several Issues on Implementation of Laws on Approval, Registration and Administration of Foreign-invested Companies 《关于外商投资的公司审批登记管理法律适用若干问题的执行意见》，jointed issued by SAIC, MOFCOM, the General Administration of Customs and the State Administration of Foreign Exchange on 24 April 2006.
and circulating funds as stipulated in the contact and the articles of association of the equity joint venture, and may include loans. By contrast, the 'registered capital' of an equity joint venture is the total capital registered at the administration authority (the State Administration for Industry and Commerce (SAIC) or its local department). It equals the capital contributed by all the parties to the joint venture. In other words, the 'registered capital' of an equity joint venture is part of its 'total amount of investment'. The ratio of a joint venture's registered capital to its total investment is governed by the Provisional Regulation on the Ratio between the Registered Capital and Total Amount of Investment.

Several regulations have been issued by the Chinese government on the procedures for examination, approval and registration to be complied with to establish a FIE. The Decision on the Reform of the Investment System issued by the State Council on 19 July 2004 provides principles for reform from an 'approval' system to 'verification and filing' system which is detailed in the Provisional Measures on the Administration of Verification of Foreign Investment Projects. The major difference between 'approval' under the old system, and 'verification' under the new system is that the old approval system examined both a project's stability for national security and economic development and its sustainability of its operation (ie whether it has sufficient capital and it will be profitable), but the new verification system examines only whether a project meets the requirements, without any checks of the operational level. The new system simplifies the procedures and further authorises local government agencies. The objective is for enterprises to have full autonomy and

33 Article 17, Equity JV Implementation Regulation.
34 Article 20, Equity JV Implementation Regulation.
35 The Provisional Regulation on the Ratio between the Registered Capital and Total Amount of Investment was promulgated by SAIC on 1 March 1987.
36 Including the Principles and Major Points of the MOFTEC Concerning the Examination and Approval of Contracts and Articles of Foreign Investment Enterprises (promulgated by MOETEC on 5 October 1993), the Administrative Measure of the SAIC Authorising the Registration of Foreign Investment Enterprises (promulgated by SAIC on 20 May 1993), and the Notice on Certain Issues on Concerning the Further Strengthening of the Administration of Examination, Approval and Registration of Foreign Investment Enterprises (promulgated jointly by SAIC and MOETEC on 20 November 1994).
37 The Provisional Measures on the Administration of Verification of Foreign Investment Projects was issued by SDPC on 9 October 2004.
control over operational management without the intervention of an administrative authority. The administrative authority for FIEs is MOFCOM or its authorised departments at local levels. Certain situations in which an application to establish a FIE will be restricted are specified including: violation of Chinese laws and regulations; incompatibility with the requirements of China’s national economic development and contractual inequity.

The Chinese partner in a potential Equity JV is required to submit prescribed documentation to the relevant approval authority for the establishment of an Equity JV including a jointly prepared feasibility study; the joint venture agreement; and articles of association; and the nominated chairperson, vice-chairperson and directors. Once the application for the establishment of a FIE (whether Equity JV, WFOE or Cooperative JV) is approved, it should be registered and obtain a business licence from the SAIC or its local branch. The date a business licence is issued is deemed to be the date of establishment of the FIE. Any major changes to a FIE after approval must be submitted to the original approval authority and registered with SAIC accordingly.

6.3.2 The Wholly Foreign Owned Enterprise

A WFOE is an enterprise established in China and wholly owned by foreign investors with their capital, but which is not a branch of a foreign enterprise. The

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39 Article 5 of the WFOE Implementation Regulation includes 1-5; Article 4 of the Equity JV Implementation Regulation includes 1, and 3-6; Article 9 of the CJV Implementation Measures includes 1, 2, 3 and 5.

40 Article 7, Equity JV Implementation Regulation.

41 Strictly speaking, representative office is not a FDI mode as it is an office for liaison purposes and can not carry out activities for payment. Some scholars do not include it in their discussion, for example, Chinese Commercial Law by Kui Hua Wang; Chinese Law: Context and Transformation by Jianfu Chen; The Chinese Commercial Legal System by Patricia Blazey and Kay-Wah Chan. Due to its limit and infrequent use, this thesis will not discuss it in detail.

42 Article 1 and 2, WFOE Law.
usual form of a WFOE is a limited liability company\textsuperscript{43} but other business structures are allowed, with special approval.\textsuperscript{44}

The \textit{Law on Wholly Foreign-Owned Enterprises (WFOE Law)} was introduced on 12 April 1986, seven years after the introduction of the \textit{Equity JV Law}. The \textit{Regulation for the Implementation of the Law on Wholly Foreign Owned Enterprises (WFOE Implementation Regulation)} was promulgated by the Ministry of Foreign Economic Relations and Trade (MOFERT) in 1990. As with the Equity JV, the WFOE is also governed by the \textit{Company Law} regarding the minimum registered minimum capital requirement and other basic requirements for establishing a company in China. As with Equity JVs, the registered capital of a WFOE is subject to the \textit{Company Law}, but an inconsistency exists between the \textit{Company Law} and the \textit{WFOE Implementation Regulation} in relation to the restrictions on the maximum amount of registered capital contribution through intellectual property rights. The 2005 \textit{Company Law} amendments removed restrictions on the maximum ratio of IP rights which could be registered as capital, but Article 27 of the \textit{WFOE Implementation Regulation} continues to stipulate that IP rights may not exceed 20 percent of the total registered capital. As a general rule, and also as provided by Article 218 of the \textit{Company Law}, the specific provisions of the foreign investment law prevail.

There is one additional procedure required for establishing a WFOE as apposed to establishing an Equity JV. A foreign investor is required to submit a detailed report to the appropriate government authority of the proposed location of the project and receive a preliminary approval before applying to MOFCOM.\textsuperscript{45} The preliminary approval from the local government agency, must be submitted with the application for approval and registration to MOFCOM or its local office with the prescribed documentation.\textsuperscript{46}

\textsuperscript{43} Article 18, \textit{WFOE Implementation Regulation}.
\textsuperscript{44} Article 18, \textit{WFOE Implementation Regulation}.
\textsuperscript{45} Article 9 of the \textit{WEOF Implementation Regulation} prescribes the contents of the report.
\textsuperscript{46} Article 10, \textit{WEOF Implementation Regulation}.
6.3.3 The Cooperative Joint Venture

The *Law on Chinese-foreign Cooperative Joint Ventures (Cooperative JV Law)* was adopted on 13 April 1988, nine years after Equity JVs and two years after WFOEs were introduced. Its implementation regulation was not adopted until seven years later, when MOFTEC introduced the *Implementation Measures on Chinese-foreign Cooperative Joint Venture (Cooperative JV Implementation Measures)* on 4 September 1995. To further clarify certain issues, MOFTEC on the same day issued the *Interpretation on Implementing Certain Articles of the Implementation Measures on Chinese-foreign Cooperative Joint Venture*.

The *Cooperative JV Law* states that the parties to a Cooperative JV may be, but are not required to be, a legal person. A Cooperative JV may therefore be a limited liability company with separate legal status or simply a contractual joint venture in which the parties are personally liable essentially as parties on the common law model. As with Equity JVs, the Chinese parties to a Cooperative JV cannot be individuals. For a Cooperative JV, there is no minimum contribution on the part of foreign parties. The participants are free to decide on the distribution of profits and losses irrespective of their contribution of capital. If Cooperative JV participants choose to form a limited liability company, then the *Company Law* will apply. The potential Chinese partner of a Cooperative JV is required to submit prescribed documentation for approval. The contents of the Cooperative JV contract and articles of association are listed in the *Cooperative JV Implementation Measure*.

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47 The *Law of the People's Republic of China on Chinese-foreign Cooperative Joint Venture* was adopted at the 1st Session of the Standing Committee of the Seventh NPC on 13 April 1988, amended at the 18th Session of the Standing Committee of the Ninth NPC on 31 October 2000. It was amended on 31 October 2000.

48 The *Implementation Measures on Chinese-foreign Cooperative Joint Venture (Cooperative Joint Venture Implementation Measures)* was issued by the MOFTEC on 4 September 1995.

49 Article 14, *Cooperative JV Implementation Measures*; para1, *Interpretation*.

50 Article 50, *Cooperative JV Implementation Measures*.

51 Articles 2 and 21, *Cooperative JV Law*.

52 Article 7, *Cooperative JV Implementation Measures*.

53 Articles 12 & 13, *Cooperative JV Implementation Measures*. 

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6.3.4 Representative Office of Foreign Enterprise

A foreign enterprise may register a representative office within China. The first law on representative offices, the *Provisional Regulations for Administration of Resident Representative Offices for Foreign Enterprises*, was issued in 1980. It governed the application, approval and registration of foreign resident representative offices. Fifteen year later, the then Ministry of Foreign Trade and Economic Cooperation (MOFTEC) issued *Detailed Measures for Implementation of the Provisional Regulations Governing the Approval and Control of Resident Representative Offices of Foreign Enterprises (Detailed Measures on Foreign Representative Offices)* which provides that a representative office is not an independent legal entity and cannot directly carry on profit-making business activities. However, it may engage in other business activities on behalf of its parent company including business liaison, product introduction, market surveys and technological exchange.

To establish a representative office in China, the foreign enterprise must meet the following basic requirements: i) be a legally registered enterprise in its country of origin; ii) have a sound business reputation; iii) provide true and reliable documents and information required by law; and iv) carry out the required application procedures.

Generally speaking, the procedure for setting up a representative office is straightforward. Registration with the relevant authorities is the primary requirement. However, it cannot carry on a franchise business and it is not an appropriate entry mode for a foreign franchisor.

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55 As discussed below, a representative office does not have all the functions which a branch may have in Western counties. This section does not discuss branches of FIEs which is treated the same as branches of domestic invested company (apart from the geography, numbers and other limitations for FIEs which are discussed in later).

56 Issued by the State Council on 30 October 1980.

57 Issued by the Decree No. 3 of the then MOFTEC on 13 February 1995.

58 Article 4, *Detailed Measures on Foreign Representative Offices*.

59 Article 4, *Detailed Measures on Foreign Representative Offices*.

60 Article 8, *Detailed Measures on Foreign Representative Offices*. 

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6.3.5 Branch of Foreign Enterprise

A branch of a foreign enterprise was not formally defined until the 2004 amendment of the *Company Law*.\(^{61}\) Prior to that, a branch of a foreign company could be registered according to the *Administrative Measures on the Registration of Enterprises of Foreign Countries (Regions) Engaging in Production and Operational Activities within China*\(^{62}\) which provided for three forms of foreign enterprises: i) mining enterprises; ii) foreign banks; and iii) other foreign enterprises involving in production and operational activities.\(^{63}\) The amendment on *Company Law* in 2004, for the first time, added provisions to define the legal status of a branch of a foreign enterprise and to stipulate that the implementation procedure for branches of foreign companies should be promulgated by the State Council\(^{64}\). However, no such regulations have yet been issued. Under the *Company Law*, the branch of a foreign enterprise is not a separate legal person under Chinese law and the parent company is responsible for its debts and liabilities. A branch cannot be registered as a WFOE and is not authorised under the 2004 *Commercial FIE Measures* to engage in retail, service or franchise business (see Chapter 6.4).

6.3.6 Merger and Acquisition

To set up a FIE in China from scratch has it advantages and disadvantages. The major advantage is that the foreign investor can shape the enterprise as it wants and starts it without any liabilities or potential claims. However, it can also be time, money and energy consuming, especially taking into account the need to recruit and

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\(^{61}\) Articles 199-205, 2004 *Company Law*.

\(^{62}\) Promulgated by the SAIC on 11 August 1992.

\(^{63}\) Articles 3 & 8, *Administrative Measures on the Registration of Enterprises of Foreign Countries (Regions) Engaging in Production and Operational Activities within China*.

\(^{64}\) Article 200, 2004 *Company Law*; Article 193, 2006 *Company Law*. 
train skilled staff. There were provisions in the *Equity JV Implementation Regulation*, the *Company Law*, and other regulations, such as the *Circular on Issues Relevant to the Transfer of State-owned Shares and Legal Person Shares in Listed Companies to Foreign Investors* governing the merger and acquisition of Chinese companies by foreign investors. It was not until 2003, that foreign investment through mergers or acquisitions was clarified by the *Provisional Measures on Acquisition of Domestic Enterprises by Foreign Investors*. The current revised version the *Measures on Acquisition of Domestic Enterprises by Foreign Investors* issued by the MOFCOM - specifies that the merger and acquisition has to be in compliance with FIE laws in relating to sector restrictions. Provisions in the *Company Law* dealing with the merger and acquisition have general application to foreign enterprises including foreign franchisors.

### 6.3.7 Advantages and Disadvantages of Alternative Foreign Investment Vehicles

It was generally believed that the Chinese government favoured JVs over WFOEs, at least in the earlier stages of opening up, as it lacks supervision over the operational activities of WFOEs once they have been approved, while foreign investors favoured WFOEs as the law allows them full control of the enterprise. Until 1997, Equity JVs accounted for the majority of FIEs in each year since China introduced the Open Door policy. In 1997, for the first time, among the number of newly approved FIEs, WFOEs (45 percent) exceeded Equity JVs (43 percent) while Cooperative JVs made

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66 Article 23 *Equity JV Implementation Regulation*.
67 Article 35, 36, and 143 -158 of *Company Law*.
68 Effective on 1 November 2002.
69 Issued by the MOFTEC on 12 January 2003 and take effect on 12 April 2003. Revised on 8 August 2006 and 22 June 2009.
70 Article 4, *Measures on Acquisition of Domestic Enterprises by Foreign Investors*. See further discussion in Chapter 6 below.
up the remainder (12 percent). In terms of the amount of the investment, the significance of WFOEs has also increased since 1997. The following figure shows the distribution of FDI by entry modes.

**Figure 8 Distribution of FDI in China by Entry Mode**

FDI in China by Entry Mode 1979-2007 (US$)

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<tr>
<td>WFOE</td>
<td>22%</td>
<td>36%</td>
<td>36%</td>
<td>39%</td>
<td>47%</td>
<td>50%</td>
<td>60%</td>
<td>62%</td>
<td>66%</td>
<td>59%</td>
<td>67%</td>
<td>78%</td>
</tr>
<tr>
<td>Contractual JV</td>
<td>43%</td>
<td>39%</td>
<td>39%</td>
<td>36%</td>
<td>35%</td>
<td>28%</td>
<td>29%</td>
<td>27%</td>
<td>3%</td>
<td>4%</td>
<td>2%</td>
<td>0%</td>
</tr>
<tr>
<td>Equity JV</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>Other</td>
<td>51%</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
</tr>
</tbody>
</table>

**joint venture v WFOE**

On opening up, the joint venture was the only available vehicle for foreign investors. Even when a WFOE became available in 1986, the Chinese government continued to give preferential treatment to joint ventures. Obtaining approval for a WFOE from the local administration authority was complicated and difficult without a Chinese partner with connections. However, as the authorities become increasingly familiar with foreign investment and its benefits, and under WTO influence, the formerly restrictive approval requirements for WFOEs have been loosened and the approval procedures simplified. Local authorities have indeed encouraged WFOEs as a

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quicker instrument than joint ventures to bring economic development to their area.  

A joint venture has the advantage of having a Chinese partner(s) familiar with the procedures of dealing with bureaucrats and may have personal connections, guangxi, -which is important for the success of a business in China. The Chinese partner may be a State-Owned Enterprise (SOE) that receives governmental assistance in both the supply of raw materials and allocation of import or export quotas. Establishing Equity JVs with a SOE enables the foreign investors to receive governmental assistance which may not otherwise be available. Furthermore, the foreign investor can “take advantage of the Chinese partners’ existing business contacts, product market, distribution network and established business relationship to increase the likelihood of success.”  

The major commercial disadvantages of a joint venture include: i) the time taken to negotiate a joint venture contract; ii) the foreign investor not having full control over management and decision making; iii) the potential for disputes arising between the parties in relation to management, strategy, valuations; iv) a foreign investor having to share its know-how with the Chinese partner(s). As Mark Schaub comments:

\[\text{When selecting the Chinese partner, the foreign investor should be clear about its criteria: whether it wishes to have a weak and compliant partner (but in such case why bother unless legally required?), or rather a strong but potentially difficult one.}\]  

For such reasons, the WFOE is an increasing preferred entry mode for foreign investors, particularly for “a medium-sized foreign company with little China experience [which] is unlikely to be successful as a JV partner … and will normally be more comfortable in the form of a WFOE”.

**Cooperative JV v Equity JV**

From a legal perspective, the principal feature that distinguishes a Cooperative JV

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74 Kui Hua Wang, op cit note 71 at 98.
75 Mark E. Schaub, op cit note 73 at 45.
76 Kui Hua Wang, op cit note 71 at 130.
77 Mark E. Schaub, op cit note 73 at 40.
from an Equity JV is the flexibility it offers particularly in relation to its internal arrangements such as the structuring of capital contributions, profit distribution and management. The foreign party can, for example, contribute 100 percent of the registered capital, with the Chinese partner making contributions other than an equity contribution. A Cooperative JV does not have to be structured as a company with separate legal personality. The participants of a Cooperative JV have the flexibility to share profit on an agreed basis, and not necessarily in proportion to capital contributions. The flexibility a Cooperative JV offers has made it a popular vehicle for small and short-term investment projects since it was introduced, but the percentage of Cooperative JVs has declined since the mid 1990s.  

Table 6: Comparison of FDI Vehicles

<table>
<thead>
<tr>
<th>Equity JV</th>
<th>WFOE</th>
<th>Cooperative JV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Separate Chinese Legal Person</td>
<td>Separate Chinese Legal Person</td>
<td>Separate Chinese Legal Person or Joint Venture Enterprise</td>
</tr>
<tr>
<td>Limited liability</td>
<td>Limited liability</td>
<td>Limited liability if company; or personal liability of participants</td>
</tr>
</tbody>
</table>

From a commercial perspective, the greater differences are between a joint venture (whether Cooperative JV or Equity JV) and WFOE. The most important difference relates to the corresponding advantages and disadvantages of the joint venture having a local partner. A local partner can provide valuable financial, human and other resources, including guangxi. But potential conflicts over management style and other issues can undermine the control of the foreign party over the enterprise.

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79 Xinhua News Agency, 'China approves nearly 10,000 foreign invested enterprises', Beijing, 30 July 1997; Kui Hua Wang op cit note 71 at 118.
6.4 MARKET ENTRY

A prerequisite to FDI operations by a foreign investment enterprise (FIE) is an approval and registration process. Obtaining approval from the Ministry of Commerce (MOFCOM), or one of its local branches, to establish the business is a requirement for FIEs which must be satisfied before the enterprise can be registered as business and licensed by the State Administration for Industry and Commerce (SAIC) or its local offices. Documentation required for MOFCOM approval and SAIC registration include specification of the scope of business. The liberalisation of FDI did not of itself open the domestic service sector, or the franchise sector, to foreign enterprises. Participation by FIEs in particular business sectors, and using franchising as a method of business expansion, have been subject to approval in accordance with the Equity JV Law, the Cooperative JV Law, the WFOE Law, their Implementation Regulations and other ad hoc regulations impacting on particular market sectors. The market entry restrictions which foreign franchise systems have encountered - whether their expansion is through FIE owned and managed outlets or franchised outlets - are discussed below.

6.4.1 Foreign Investment Guidelines

Entry into specific industry sectors was regulated by the Interim Measures on Guiding Foreign Investment Direction first promulgated in 1995, which were replaced by the Regulation for Guiding Foreign Investment Direction promulgated in 2002. The Regulation for Guiding Foreign Investment Direction applies to the projects of China-foreign Equity JVs, China-foreign Cooperative JVs and WFOEs

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80 Article 11, Equity JV Law; Articles 12 & 14, Wholly Foreign-Owned Enterprise Law; Article 12, Cooperative Joint Ventures Law.
81 The Interim Measures for Guiding Foreign Investment Direction was issued by the State Planning Commission, State Economic and Trade Commission and MOFTEC on 20 June 1995; revised and reissued by the State Council on 11 February 2002.
82 The Regulation for Guiding Foreign Investment Direction was promulgated by the State Council on 11 February 2002, came into force on 1 April 2002.
(Article 2). It classifies foreign investment projects into four catalogues: encouraged, permitted, restricted and prohibited.83

The encouraged catalogue includes projects involving the following elements (Article 5):

- projects that involve new agricultural technology, comprehensive development of agriculture, fundamental developments in industries in energy, transport and important raw materials;
- projects that involve advanced and new technology, or new equipment/new materials capable of improving product quality and efficiency, or projects which produce new equipment/new materials where there is a shortage of supply in China;
- projects that satisfy market demand and are capable of upgrading product quality, opening up new markets, or increasing the capacity of products in international competition;
- projects that involve new technology and/or new equipment that is capable of saving energy and raw materials as well as comprehensive utilisation of natural resources;
- projects that are capable of taking advantage of human and natural resources in Central and Western regions and are in compliance with the State industry policies; and
- any other projects as provided by laws and administrative regulations.

The restricted catalogue includes projects involving the following elements (Article 6):

- projects that involve outdated technology;
- projects that are not beneficial for the saving of resources and improvement of the biological environment;
- projects that involve exploration or exploitation of specific mines, the exploitation of which is protected by the State;
- projects that involve industries which are subject to the state policy of gradual opening-up; and
- any other projects as provided by laws and administrative regulations.

The prohibited catalogue includes projects involving the following elements (Article 7):

83 Article 4, Regulation for Guiding Foreign Investment Direction.
• projects that endanger national security or harm the public interest;
• projects that pollute or damage the environment, harm natural resources or pose threats to human health;
• projects that occupy large tracts of farm land and are harmful to the protection and development of land resources;
• projects that endanger the security of military installations and their effective use;
• projects that utilise production techniques or technology indigenous to China; and
• any other projects as provided by laws and administrative regulations.

Project which are not in the encouraged/restricted/prohibited catalogues are, by default, permitted. The Regulation for Guiding Foreign Investment Direction is a general guideline with basic principles. Most of restrictions set out are not greatly different from those which are restricted or prohibited in other countries, such as projects endangering national security or polluting the environment. The most significant difference is that enshrined in Article 6.4 and 6.5 of the restricted catalogue - "projects that involve industries which are subject to the state policy of gradual opening-up" and "projects as provided by law and administrative regulations". This has restricted foreign activities in many industry sectors. The 'state policy of gradual opening-up' is indicated in an implementation catalogue - the Catalogue for Guiding of Foreign Investment Industries - which details specific sectors of 'encouraged catalogue', 'restricted catalogue' and 'prohibited catalogue'.

China’s WTO commitments included special exemptions to allow China to gradually open its service markets and China negotiated successfully for certain sectors to be

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84 Similar provision content in Article 6 of replaced 1995 Interim Measures on Guiding Foreign Investment Direction:

85 The Catalogue for Guiding of Foreign Investment Industries was first issued by SPC, SETC and MOFTEC on 20 June 1995, revised and reissued by SPC, SETC and MOFTEC on 31 December 1997, amended and reissued by SPC, SETC and MOFTEC on 11 March and took effect on 1 April 2002; further amendment made by the SDPC and MOFCOM, issued on 30 November 2004, which took effect from 1 January 2005; the current Catalogue for Guiding of Foreign Investment Industries was issued by the SDPC and MOFCOM on 31 October 2007, took effect on 1 December 2007.
opened within one to eight years of China's accession. The *Catalogue for Guiding of Foreign Investment Industries* was amended during China's WTO negotiations and further amended to incorporate China's commitments on market entry. The current 2007 *Catalogue for Guiding Foreign Investment Industries* contains 351 sectors in the 'encouraged catalogue', 87 sectors in the 'restricted catalogue' and 40 sectors in the 'prohibited catalogue'.

From a Western perspective, it is very unclear what the 'restricted catalogue' means. Ambiguity is a continuing problem in Chinese legislation (as discussed in Chapter 4). Generally speaking, restrictions include restrictions on ownership restrictions (ratio of foreign investment); and higher levels of approval which may be required. It leaves great discretion to government agencies. In certain areas, such as in *Special Economic Zones* established early in the Opening Up era to encourage foreign trade and investment, foreign business was more liberally sanctioned. Other ad hoc initiatives to encourage investment in particular regions were also implemented – such as the *Catalogue of Priority Industries for Foreign Investment in the Central and Western Regions* which relaxed certain conditions and restrictions for foreign investment pursuant to the Central-Western Region Catalogue in order to promote the Chinese government's 'Great Western Development'.

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86 Most service sectors are open to foreign investment with little restrictions within three years of China's accession. See Part II - Schedule of Specific Commitments on Services, List of Article II MFN Exemptions Report of the Working Party on the Accession of China, (WT/ACC/CHN/49/Add.2, 1 October 2001 in the Schedule of Specific Commitment on Services, the Report of the Working Party on the Accession of China (WT/ACC/CHN/49).
87 WFOE is not allowed for certain sectors or 51 percent ownership by Chinese partner(s).
88 Article 12, Regulation on Guiding Foreign Investment Direction.
89 On 15 July 1979 the CPC Central Committee and the State Council jointly approved the reports submitted by Guangdong and Fujian provinces to set up four special export zones. They were renamed Special Economic Zones after the Standing Committee of the Fifth National People’s Congress approved the *Regulation on the Special Economic Zones in Guangdong Province* on 26 August 1980. The Standing Committee of the Fifth National People’s Congress delegated legislative power, on 26 November 1981, to the Guangdong and Fujian Provincial People’s Congress and their Standing Committees to draft economic regulations according to the SEZs’ condition and need in accordance with the national laws, regulations and rules. The concept of SEZs has been extended to other cities.
90 The *Catalogue of Priority Industries for Foreign Investment in the Central and Western Regions* was jointly issued by the SETC and SDPC and the MOFTEC with the approval of the State Council on 6 June 2000; revised on by the SETC and SDPC and the MOFCOM on 23 July 2004.
Franchising as a method of business expansion was not mentioned in the 1995 and 1997 *Catalogue for Guiding of Foreign Investment Industries*, but has been listed since 2002 (in the 2002 *Catalogue for Guiding of Foreign Investment Industries*) as restricted under the heading 'Wholesaling and Retailing Trade Industries'. The implications for the franchise sector are discussed below and in Chapter 7. Most restricted projects under the “provided by law and administrative regulation” provisions are in service sectors and are also discussed below.

6.4.2 Restrictions on Foreign Invested Enterprises in the Commercial Sector

China’s Open Door policy was designed to attract foreign investments in hi-tech industries and export oriented industries. Service sectors were not within these priority catalogues and were subject to further restrictions.

China first opened its retail sector in the *Official Reply to Utilizing Foreign Investment in Commercial Retail* in 1992. This State Council policy allowed, on a trial basis, “one or two” FIEs (through Equity JV or Cooperative JV) to be established in Beijing, Shanghai, Tianjin, Guangzhou, Dalian and Qingdao, and the SEZs to engage in commercial retail. It provided that commercial FIEs had to be approved by the State Council and could not engage in wholesaling or operate

\[\text{Franchising is listed in 2002, 2004, 2007 *Catalogue for the Guidance of Foreign Investment Industries*. Article 6.1 under the 'restricted catalogue' of the currently 2007 *Catalogue for the Guidance of Foreign Investment Industries*.}\]

\[\text{Article 6.5, *Regulation on Guiding Foreign Investment Direction*.}\]

\[\text{There has been a common confusion on what is a commercial sector or a foreign invested commercial enterprise, which has also been translated as 'merchandising enterprise'. Article 3 of 2004 *Commercial FIE Measures* (which discussed below) defines a commercial FIE as FIE engaging in commission agents service, wholesaling, retailing and franchising which include the same sectors as in term 'distribution services' under WTO agreement (for example as defined in *Part II –Schedule of Specific Commitments on Services, List of Article II MFN Exemptions Report of the Working Party on the Accession of China* (WT/ACC/CHN/49/Add.2)).}\]

\[\text{The 'Restricted catalogue' in the *Catalogue for the Guidance of Foreign Investment Industries* include ‘any other projects prescribed by the laws and administrative regulations’ (Article 6.5).}\]

\[\text{The *Official Reply to Utilizing Foreign Investment in Commercial Retail* was issued by State Council in Guohan (1992) No. 82. It was issued to government agencies, not released to general public at that time.}\]

\[\text{Engaging in commercial retailing through WFOE was not permitted.}\]
through commission agents. Chinese partner(s) were required to hold at least 51 percent equity interest in the joint venture. That was the first trial initiated by the Chinese government to allow FIEs to engage in commercial retailing. 97 FIEs engaging in the commercial sector were governed by policy and were approved by the State Council on a case by case basis until the *Measures Concerning Pilot Projects for Foreign Investment in the Commercial Sector (1999 Interim Commercial FIE Measures)* 98 expanded the geographic areas open to FIEs to all provincial capitals and municipalities directly under the central government. These *Measures* also specified that FIEs could expand through direct owned chain-stores *but not through franchise chains.* 99 The experiment of gradually opening service sectors to foreign investments brought China not only foreign investment, but also advanced marketing and management skills and was demonstrably successful in achieving these objectives. Significant restrictions nevertheless existed at that time in relation to ownership and structure (only Equity JVs and Cooperative JVs with majority Chinese ownership were allowed) and geographic location (only major cities were opened to foreign investors). Limitations, and complex approval procedures, imposed on FIEs remained until WTO-induced reforms compelled China to remove the various measures prohibited under the *Trade Related Investment Measures* (TRIMS) 100 (which it achieved by the 2004 *Commercial FIE Measures* discussed below).

### 6.4.3 Restrictions on Franchising

Part 2 of the *Catalogue for Guiding of Foreign Investment Industries* dealing with

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97 For further discussion, see Hai Huang (the then Head of Department of Law and Policy of the then Ministry of Internal Trade), 'Opinions on Opening of Chinese Commercial Sector to Foreign Investment' (1996) *09 Economic and Trade* 49-52.

98 The *Measures Concerning Pilot Projects for Foreign Investment in the Commercial Sector* were issued by the State Economy and Trade Commission and the MOFTEC on 25 June 1999 on the approval of the State Council.

99 Article 7, *Measures Concerning Pilot Projects for Foreign Investment in the Commercial Sector*. Municipalities directly under the central government in China are Beijing, Tianjin, Shanghai and Chongqing.

100 The *Agreement on Trade-Related Investment Measures* ("TRIMS Agreement") is one of the Multilateral Agreements on Trade in Goods, prohibits trade-related investment measures, such as local content requirements, that are inconsistent with basic provisions of GATT 1994.
*restricted* foreign investment industries, included franchising under the heading “Wholesale and Retail Trade Industries”\(^\text{101}\) thus subjecting *retail* franchising to an onerous approval regime while leaving uncertain the status of *service* franchising. Approvals were originally granted only to joint ventures and were subject to geographic restrictions. But it was nevertheless in the nature of a developing legal and regulatory system replete with approval processes and bureaucratic discretion at local levels that there were exceptions to the general rules. Commercial expediency often prevailed. Foreign business was more liberally sanctioned in the SEZs established early in the opening up era to encourage foreign trade and investment in a controlled manager. The franchise sector was further liberalised, despite high market entry thresholds and complex bureaucratic approval mechanisms, often unevenly applied, under *Measures for the Trial Establishment of Foreign Invested Commercial Enterprises* in 1999. Under the protocol governing its membership of the WTO in 2001 China agreed to open franchising to foreign franchisors in wholesale, retail, services and franchise sectors, with certain restrictions, by the end of 2004\(^\text{102}\). Pursuant to these commitments, in June 2004 the *Measures for the Administration of Foreign Investment in Commercial Enterprises* which repealed previous *Measures* and liberalised the operations of commercial FIEs came into effect.

### 6.4.4 Liberalisation of Foreign Invested Enterprises in the Commercial Sector

China’s WTO commitments to franchise operations included the removal of restrictions on geographical location, number, equity ratio and form of establishment for foreign investment by no later than 11 December 2004. China’s WTO

\(^{101}\) The *Catalogue of Restricted Foreign Investment Industries in the Catalogue for the Guidance of Foreign Investment Industries* was first issued in 1995 and revised in 2002, 2004 and 2007. Article 6, Part 2, of Current *Catalogue of Restricted Foreign Investment Industries* was issued by the National Development and Reform Commission and the MOFCOM on 31 October 2007 and took effect on 1 December 2007.

\(^{102}\) Part II - Schedule of Specific Commitment on Services, the Report of the Working Party on the Accession of China (WT/ACC/CHN/49/Add.2), WTO, 1 October 2001.
commitments in the area of distribution services have now been met by the Measures for the Administration of Foreign Investment in the Commercial Sector (2004 Commercial FIE Measures)\(^\text{103}\) which were issued on 16 April 2004 to replace the 1999 Interim FIE Measures, and to allow foreign franchisors to franchise through FIEs in China.\(^\text{104}\) The 2004 Commercial FIE Measures which took effect on 1 June 2004 open foreign investment in commercial sectors to foreign companies, enterprises and other economic organisations, and individuals engaging in commission agent services, wholesaling, retailing and franchising through a foreign investment enterprise in China. Such operations must be through a “commercial enterprise with foreign investment” (commercial FIE) – either an equity joint venture or cooperative joint venture or, from 11 December 2004, a wholly foreign owned enterprise (Articles 1-3, The Commercial FIE Measures)\(^\text{105}\). The Commercial FIE Measures remove many of the restrictive requirements for establishing commercial foreign investment enterprises. Although franchising remains, surprisingly, in the Catalogue of Restricted Foreign Investment Industries\(^\text{106}\) the practical effect of the Commercial FIE Measures is to legitimise foreign investment in franchise sector entry for FIE in the form of joint ventures and WFOEs.

The Commercial FIE Measures remove the high threshold requirements for establishing a commercial FIE. The commercial FIE must comply with the relevant

\(^\text{103}\) The Commercial FIE Measures were promulgated by MOFCOM on 16 April 2004, took effect on 1 June 2004.

\(^\text{104}\) Article 3, 2004 Commercial FIE Measures.

\(^\text{105}\) The restriction on a foreign company engaging in franchising activity was the key to the decision in Han Mei Yan v. Beijing Yinqi Bayi Yinqi Jianmei Limited. The plaintiff franchisee entered into a franchise agreement with the defendant which had been incorporated on February 2003 as a wholly foreign-owned enterprise. When certain payments were not made, the franchisor defendant terminated the contract for non-payment. The Chaoyang District People’s Court held that because before December 11, 2004 China did not permit foreign invested entities to be engaged in franchising the franchisor had traded illegally. The franchise agreement was held invalid with repayment of the money paid the franchisee ordered. This decision has been upheld by the Beijing Second Intermediate Court, Beijing, Yinqi Bayi Yinqi Jianmei Limited v Han Meiyan, (2005) Erzhongminzhongzi No. 14880., available at http://law.chinalawinfo.com/newlaw2002/slc/SLC.asp?Db=fnhl&Gid=117458327, accessed at December, 2006.

\(^\text{106}\) The current Catalogue of Restricted Foreign Investment Industries which took effect on 1 January 2005 did not change the “restricted” category of franchising in relation to wholesale and retail trade industries.
provisions on registered capital and total investment for foreign investment enterprises. The minimum registered capital is now as prescribed in the *Company Law* (RMB 30,000 – about US$ 5000 – although higher registered capital may be required for certain sectors, not particularly relevant to franchising). Its term of operation, in general, shall not exceed 30 years (Article 7). In addition Article 6 provides that:

The Foreign Investor in a foreign-invested commercial enterprise shall possess high prestige and shall not have violated the laws, administrative regulations and related rules of China. The establishment of foreign-invested commercial enterprises by Foreign Investors that possess relatively powerful economic strength, advanced commercial management experience and marketing technology, and an extensive international sales network is encouraged.

The *Commercial FIE Measures* prescribe conditions for opening shops (Article 8) but all geographic restrictions on the location of retail outlets have been removed from 11 December 2004 (Article 22). The *Measures* prescribe an examination and approval process for and a commercial FIE and its shops under the control of the central Ministry of Commerce although provision is made for examination and approval at the provincial level in certain situations (Articles 8,10,12,13). Franchisors benefit from the provision for the application, examination, feasibility study, report, approval and establishment in respect of the commercial FIE to be “carried out in one step” (Article 10) although following approval the commercial FIE must carry out registration procedures with the Administration for Industry and Commerce within one month (Article 11). Among the documentation required are copies of trademark or trade name licence contracts, technology transfer contracts, management contracts and service contracts concluded by the commercial FIE (Article 13).
Deng Xiaoping was not only pragmatic. He was also realistic in his appreciation of the challenge of establishing an adequate legal system to support economic reform and the Open Door policy:

*There is a lot of legislative work to do, and we do not have enough trained people. Therefore, legal provisions will inevitably be rough to start with, then be gradually improved upon...*

There was virtually no law governing foreign investment before 1978. Within months of launching the Open Door policy, China promulgated the *Equity JV Law* which provided the first legal structure for foreign investment and represented a significant development in China's re-engagement with the global community as well as providing the first opportunity for Western business to explore China's huge market. Alternative FDI vehicles were introduced later – the WFOE in 1986 and the Cooperative JV in 1988. Foreign investment in China's franchise sector nevertheless remained restricted until the 2004 *Commercial FIE Measures* pursuant to WTO accession commitments opened franchising to the Equity JV, Cooperative JV and WFOE. Today the Commercial FIE franchisor faces few regulatory impediments but the validity of cross-border franchising without a Commercial FIE remains legally uncertain as discussed in Chapter 7.

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CHAPTER SEVEN
FRANCHISE SECTOR REGULATION AND
THE FOREIGN FRANCHISOR

7.1 INTRODUCTION
Within a decade of the introduction of Deng Xiaoping’s ‘Open Door’ policy and the associated economic reforms, franchising was introduced to China, in the late 1980s, by the US franchising fast food pioneers KFC and McDonald’s. However, it was the implementation a decade later of the 1997 *Interim Franchise Measures* which was the major catalyst for sector development through prescribing a rudimentary regulatory environment for the development of franchising. Ironically, despite KFC and McDonald’s introducing the franchising concept to China, their expansion has been until very recently through company owned and managed outlets rather than through franchised outlets, a strategy due in part to the application of the 1997 *Interim Franchise Measures* to foreign franchisors being unclear.¹ Significantly, the President of McDonald’s Chinese operations stated in 2002 that “McDonald’s will begin franchising only after relevant regulations and laws are defined in China.”² It was not until 2005 that some clarification was provided by the 2005 *Franchise Measures*, issued by the Ministry of Commerce on the last day of 2004, which contained provisions on foreign franchisors and which for the first time officially regulated foreign invested franchising companies. A decade after the introduction of the 1997 *Interim Franchise Measures*, the State Council issued a *Regulation on the Administration of Commercial Franchises* having effect from 1 May 2007 which, unlike the 2005 *Franchise Measures*, subjects domestic and foreign invested franchisors to a uniform regulatory regime.

¹ The expansion of KFC and McDonald’s through company owned and managed rather than franchised outlets and the legal and commercial factors relevant to this strategy are discussed in Chapter 9.
² Peter Tan, President of McDonald’s China Development Co, cited by Dai Yan, ‘International Chain of Firms to Expand: McDonald’s Mulls over Franchise System after KFC’, *China Daily*, 8 July 2002.
This chapter reviews the development of franchise-specific regulation in China. It first addresses the policy issues associated with franchise regulation from an international perspective before outlining the development of China's franchise laws. It notes that this development has been driven by WTO accession commitments and analyses whether China's law reform initiatives in relation to franchising have been in full compliance with its WTO commitments. This chapter also critically evaluates the 2007 Franchise Regulation from the perspective of the foreign franchisor and assesses its impact on the future development of franchising in China.

7.2 REGULATING FRANCHISING

7.2.1 Franchise Sector Regulation

The development of franchising has, inevitably, led to increasing attention being devoted to regulatory issues. A viable franchise sector requires well developed commercial laws to support its healthy development – particularly contract and intellectual property laws – and effective dispute resolution and enforcement machinery. However, as Terry has commented, “Whether an effective legal environment requires a regulatory regime dedicated to the franchise sector is of course a much more controversial issue”:

The business format franchise model is a unique and proven method for exploiting the synergy created by marrying the entrepreneurial spirit and commitment of the franchisee with the proven business systems and management expertise of the franchisor. This may be threatened by regulation. However, franchisees are damaged, and franchising is diminished, by the inappropriate practices of those who trade off the reputation of franchising without the ability to deliver on its promise. The quest for an appropriate form of regulation which protects the interest of both parties in a manner that does not curb the entrepreneurial nature of franchising, or threaten its development, is

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The world quickly embraced the US concept of business format franchising which developed in the US in the 1950s but has been less enthusiastic in embracing the US regulatory model for franchising. Until the early 1990s only the US and the Canadian province of Alberta had introduced dedicated franchise-specific laws, but as noted at 7.2.4 below there is today a clear and increasing trend to specific franchise regulation. The frequently cited objections – of political interference, of compliance costs, of regulatory restrictions slowing the development of entrepreneurship in the franchise sector – are argued less stridently today as the realities of the franchisor/franchisee relationship and the associated problems become better appreciated. The support for franchise-specific legislation lies with the desire to “take care of problems that have arisen to redress the balance between the parties to an agreement where the necessary balance either does not exit or has been distorted, and of course to make sure that abuses either do not occur or, where they have occurred, that they do no not occur again.”

7.2.2 The Franchisor-franchisee Relationship

There is a growing body of literature on the special nature of the franchisor/franchisee relationship and the contract which enshrines it. There is increasing recognition that franchising is a relational contract which a New Zealand appellate judge recently described as follows:

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7 See generally Andrew Terry, ‘Franchising Relational Contracts and the Vibe’ (2005) 33 Australia Business Law Review, 289, which reviews the literature on the special nature of the franchisor/franchisee relationship.
In essence, relational contracts recognise the existence of a business relationship between the parties and the need to maintain that relationship; the difficulty of reducing important terms to well defined obligations; the impossibility of foretelling all the events which may impinge upon the contract; the need to adjust the relationship over time to provide for unforeseen factors or contingencies which cannot readily be provided for in advance; the commitment, likely to be extensive, which one party must make to the other, including significant investment; and that they are in an economic sense likely to be incomplete in failing to allocate, or allocate optimally, the risk between the parties in the event of certain future contingencies...

Consequently, a relational contract is one which involves not merely in exchange but a relationship between the contractual parties. The parties are not “strangers” in the accepted sense and much of their interaction takes place “off the contract” requiring a deliberate measure of communication, co-operation, and predictable performance based on mutual trust and confidence. Expectations of loyalty and interdependence mark the formation of the contract and become the basis for the rational economic planning of the parties.  

Elizabeth Spencer has noted that -

Relational contracts are defined by features of incompleteness and longevity. Relational contracts must be flexible, sometimes to the point of being vague. There is often a high level of discretion accorded to the parties, and such contracts therefore rely heavily on reciprocity and on trust that develops over time between the contracting parties.

Franchising exists, in Gillian Hadfield’s words, in a world of “contractual incompleteness and relational complexity” which challenges franchise regulators. The extra legal norms which explain relational contracting in the context of contracting equals are nevertheless not as compelling in the context of the typical business format franchising relationship which is a standard formal contract

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8 Thomas J, dissenting in *Bobux Marketing Ltd v Raynor Marketing Ltd* [2002] 1 NZLR 506 at 316.


characterised by both a power imbalance and an information imbalance. It is the confluence of the *relational* and the *standard form* nature of franchise agreements which challenges regulators.

The relational contract model is built on Macaulay's empirical studies in US in the 1960s, which suggested that:

People engaged in business often find that they do not need contract planning and contract law because of relational sanctions ... Even discrete transactions take place within a setting of continuing relationships and interdependence. The value of these relationships means that all involved must work to satisfy each other.

Macaulay's research suggested that "significant ongoing business relationships are regulated by the parties according to what is fair and reasonable, or commercially necessary, at particular points in time rather than by reference to rights and duties arising under a contract [as] all involved must ultimately work to satisfy each other."

Goldwasser and Ciro explain that underlying such a strategy are the clear economic benefits to be gained from suppressing or ignoring many disputes in the interests of keeping an otherwise profitable business relationship alive. Commercial parties in such relationships realise that, ultimately, the marginal cost of insisting on strict legal rights often exceeds the marginal benefits. In other words, profit maximisation and long-term economic self-interest considerations must play a significant role.

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alongside friendship reputation, interdependence, morality and altruistic desires.\textsuperscript{15}

While franchising is a classic relational contract, its standard form nature and the information and power imbalance which invariably characterizes it, mean that relational solutions are not always compelling. While most franchisors strive for good business relationships with much of the interaction with franchisees utilising relational tools and "a particular balance of co-operation and coercion, communication and strategy",\textsuperscript{16} this is not always the case. The recent report of the Australian Parliamentary Joint Committee on Corporations and Financial Services, \textit{Opportunity not Opportunism: improving conduct in Australian franchising} was particularly concerned with the consequences of the reality of the "asymmetrical" distribution of power within a franchise agreement:

The franchising model is necessarily predicated on strict franchisor control over the use of their brand, allowing them to impose strict terms and conditions on the way franchisees operate their franchise business. Because the franchisor's model needs to be implemented uniformly across the franchise network, franchise agreements are typically underpinned by standard form contracts drafted by the franchisor. These are presented to franchisees on a 'take it or leave it' basis: the franchisee can either agree to establish a franchising relationship on the franchisor's terms or not proceed at all.

In practice, franchisors are able to dictate business operations and procedures to franchisees, and are able to change these at will. Standard form contracts specify the beginning of a franchising relationship, but—as allowed for in the contracts—the operations manual and other communications or directions from the franchisor form the basis of daily operations. Franchisors can impose rigorous obligations on the way the franchisee operates, which are subject to change at the discretion of the franchisor. These obligations may be strictly enforced: failure by the franchisee to meet their obligations, as interpreted by the franchisor, can trigger termination of the contract. This control allows franchisors to prevent franchisees from exploiting their intellectual property to the detriment of the overall franchise network but can also lead to the potential for abuse of power.

\textsuperscript{15} Ibid.
\textsuperscript{16} Per Thomas J in \textit{Bobux Marketing Ltd v Raynor Marketing Ltd} op cit note 8.
On the other hand, standard form contracts provide little or no scope for franchisees to impose stringent obligations on franchisors or apply their own discretion to open-ended terms of the agreement. Despite their investment in the business and their dependence on the use of the franchise model to derive returns from this investment, franchisees can exert little or no leverage when seeking to impose their interpretation of the franchisor's obligations on the agreement.

Franchisors are therefore in a position to exercise far greater power than franchisees when enforcing the terms of open-ended, variable agreements. From the franchisee's position of relative weakness, they must hope that the franchisor will not exercise their discretion opportunistically. In good franchising relationships the franchisor nurtures and assists franchisees to maximize profit royalties and achieve growth of their brand. Such is the cooperative and interdependent way the majority of franchising relationships are conducted. However, the imbalance of power within the relationship means that scope exists for rogue franchisors to use their control opportunistically for financial gain at the expense of franchisees.\(^\text{17}\)

In the circumstances outlined by the Joint Committee, the relational nature of the franchise agreement, in combination with its standard form nature and accompanying information and power imbalance, can frustrate rather than support good business practice. Because traditional classical contract law has not been sympathetic to the proposition that in relation to agreements of an ongoing, interdependent, cooperative nature the parties should be accorded "reasonable security for the protection of justified expectations"\(^\text{18}\) specific regulation is increasingly being relied upon. The solution recommended by the Joint Committee was the introduction of a new provision in Australia regulatory instrument, the Franchising Code of Conduct,\(^\text{19}\) providing that "franchisors, franchisees and prospective franchisees shall act in good faith in relation to all aspects of a franchise


\(^{19}\) The *Franchising Code of Conduct* is prescribed under Part IVB of the *Trade Practices Act 1974* (Cth) as a mandatory industry code.
7.2.3 Policy Issues in Franchise Regulation

A frequently cited statement on the role of regulation in the franchising context is that of the Council of Small Business Organisations in Australia:

Entrepreneurship and business creation in a free enterprise society such as ours necessarily includes an element of risk and it should certainly not be the role of Government to remove risk. Nevertheless in the particular circumstances if franchising there are elements quite different to normal business development because of the control of the franchisor which can be an overriding risk for other than purely business or commercial reasons. Those special additional risks arising in part because of the balance of power in the franchising relationship should be minimised while leaving the commercial risks and decisions to be handled by the parties concerned.21

Those countries which have accepted that the “special additional risks arising in part because of the balance of power in the franchising relationship” need to be addressed have adopted a variety of regulatory strategies.

prior disclosure

Prior disclosure is the most widely accepted regulatory strategy and is employed to redress the information imbalance inherent in the franchising relationship by providing prospective franchisees with access to full and reliable information for the making of an informed investment decision. Terry suggests that the case for legislation remedying the information imbalance by mandating prior disclosure is widely accepted today.22 Lewis Rudnick, writing in the context of the complex US regulatory system, comments that there is no meaningful franchisor constituency for eliminating pre-sale disclosure and that ‘there is a consensus among franchisors that

20 Op cit note 17 at para 860.
21 Submission on a draft of a later abandoned 1986 proposal to enact dedicated franchising legislation for Australia cited and discussed by Andrew Terry, ‘Policy Issues in Franchise Regulation’ (1991) 6 Journal of International Franchising and Distribution Law 77 at 82.
22 Andrew Terry, op cit note 4 at 62.
comprehensive disclosure of information to prospective franchise buyers improves
the franchisee recruitment process and is generally good for franchising'.\textsuperscript{23} Prior
disclosure is, Terry argues, "the key to franchising reform".\textsuperscript{24} There can be little
argument with the philosophy expressed over two decades ago by one of the earliest
government reports in Australia which recommended franchising regulation:

No law can, or should act to prevent the holding or seeking of high
aspirations, however unlikely to be satisfied. However, it has been a
long standing philosophy of free enterprise government that it is a
legitimate role of government to provide, or cause by law to be
provided, an accurate informational framework within which
individual aspirations are formulated....\textsuperscript{25}

Pre-franchise disclosure legislation was not regarded as a restriction on business but
as a "common sense and firm basis for doing business within the peculiarly close
relationship of a franchise and in accordance with normal business practice".\textsuperscript{26} There
is of course room for considerable debate as to whether or not particular matters
need to be disclosed and the degree of detail which may turn ‘not so much on the
relevance of the information to a franchisee but whether the costs of providing the
information can be justified’.\textsuperscript{27}

To legislate to remedy the information imbalance by mandating prior disclosure is
widely accepted and supported by UNIDROIT’s \textit{Model Franchise Disclosure Law}\textsuperscript{28}. The
discussion on the ‘balance the power between franchisor and franchisee’
initiated by UNIDROIT in 1993 leading to the adoption and publication of the
\textit{Model Franchise Disclosure Law} in 2002, has been influential in the regulatory
debate. The \textit{Model Franchise Disclosure Law} suggests the minimum content of

31(6) \textit{Franchising World}, 24-27.
\textsuperscript{24} Andrew Terry, op cit note 21 at 82.
\textsuperscript{25} Trade Practices Consultative Committee, Parliament of Australia, \textit{Small Business and the Trade
Practices Act} (1979)[11.32], Canberra.
\textsuperscript{26} Ibid.
\textsuperscript{27} Office of Small Business, ‘Final Exposure Draft of the Franchising Code of Conduct’ (1998)
Canberra, [18].
\textsuperscript{28} UNIDROIT (International Institute for the Unification of Private Law), \textit{Model Franchise
Disclosure Law}, is available at www.unidroit.org/english/franchising/modellaw. For generally
discussion, see Lena Peters op cit note 6.
disclosure and states that any waiver by a franchisee of a right given by the *Model Law* is void. While the *Model Law* provides a precedent likely to be of great interest to legislators throughout the world when franchising legislation on their agenda, it is limited to prior disclosure and does not address registration or other aspects of the franchise relationship.

**alternative dispute resolution**

The 1997 Australian Fair Trading Report recorded that small business has difficulty in accessing justice, and commented that "there was no point in having unenforceable or non-exercisable rights and a legal system that was not affordable or accessible". In a limited number of jurisdictions, including Australia, mediation may be required as a prerequisite to litigation or arbitration.

**registration**

Registration is a regulatory strategy directed at improving regulatory compliance which has the side-effect of facilitating data collection and industry statistics. With the exception of 14 US states that require registration, registration is generally a strategy applied in developing rather than developed countries.

**standards of conduct**

Regulatory initiatives designed to redress the power imbalance in the franchising relationship are controversial and have much less support than prior disclosure laws. Addressing the power imbalance raises sensitive and difficult questions of fairness, of the appropriate allocation of risks in entrepreneurial activities and of the appropriate limits on the rights of the franchisor to structure the franchise relationship. The majority of the regulated regimes nevertheless regulate, to some


30 The registration states are California, Hawaii, Indiana; Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Oregon does not require registration, but it mandates disclosure and certain record-keeping requirements.

31 Lewis G. Rudnick, op cit note 23.
extent conduct within the franchisor/franchisee relationship. As noted above, the focus of the recent Australian Government franchising report was that the “inherent and necessary imbalance of power in franchise agreements in favour of the franchisor [abuse of which] can lead to opportunistic practices”. It can be argued that it is “the function of the disclosure statement to warn potential franchisees not to enter into agreements that they regard as imposing unduly onerous obligations”, but there is increasing recognition internationally that the power imbalance needs to be specifically addressed.

7.2.4 Franchise Regulation Internationally

The first franchise-specific regulation in the world was introduced by the State of California in 1970 and was modeled on securities law. It was followed by US federal prior disclosure legislation in 1979. Although franchising as a business strategy has been widely practiced in many developed countries since 1970s, only the Province of Alberta in Canada and Japan had introduced franchise-specific regulation by 1990. Today, the majority of countries still rely on the underlying commercial laws of general application to regulate the franchise sector, supplemented in many cases by voluntary self-regulatory codes of practice. The last decade has nevertheless seen a move to the introduction of dedicated and specific franchise regulation. Today, over 30 countries, including China, have established a

32 See generally Andrew Terry and Yun Zhang, op cit note 11.
33 Elizabeth Spencer, op cit note 9.
34 Andrew Terry, op cit note 4.
38 Ibid; Andrew Terry, op cit note 5.
specific regulatory regime to regulate franchising operations to some certain extent and the trend to regulation is undoubtedly "gathering momentum".\(^{39}\)

Despite the trend to specific franchise regulation, there is, nevertheless, no uniformity in either the regulatory strategies embraced or, within a particular strategy, the nature and extent and scope of the regulation. There are a variety of combinations and permutations in the regulatory mix internationally: \(^{40}\)

<table>
<thead>
<tr>
<th>The regulatory models</th>
<th>Jurisdictions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disclosure</td>
<td>Belgium, Brazil, France, Japan, Sweden, Taiwan</td>
</tr>
<tr>
<td>Disclosure &amp; Conduct</td>
<td>Albania, Canada, (Alberta, New Brunswick, Ontario, Prince Edward Island), Georgia, Italy, Romania</td>
</tr>
<tr>
<td>Disclosure &amp; Registration</td>
<td>Indonesia, Mexico, Spain</td>
</tr>
<tr>
<td>Disclosure, Registration &amp; Conduct</td>
<td>China, Kazakhstan, Macau, Malaysia, Moldova, Vietnam</td>
</tr>
<tr>
<td>Disclosure, Registration, Conduct &amp; Dispute Resolution</td>
<td>Korea</td>
</tr>
<tr>
<td>Disclosure, Conduct &amp; Dispute Resolution</td>
<td>Australia</td>
</tr>
<tr>
<td>Registration</td>
<td>Croatia, Barbados</td>
</tr>
<tr>
<td>Registration &amp; Conduct</td>
<td>Belarus, Kyrgyzstan, Lithuania, Russia, Saudi Arabia</td>
</tr>
<tr>
<td>Conduct</td>
<td>Estonia, Ukraine</td>
</tr>
</tbody>
</table>

The US presents a particularly complex regulatory model with federal prior disclosure laws supplemented by registration requirements in 14 states with conduct regulation imposed both federally (in relation to the automobile and petroleum distribution sectors) and by most states to deal with specific problems in various sectors as well as certain general issues (albeit not on a uniform basis). \(^{41}\) UNIDROIT’s *Model Franchise Disclosure Law* has been influential in accelerating the adoption of disclosure laws and shaping their content.\(^{42}\)

In developed countries, the justification for regulation is to address unfair practices

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\(^{39}\) Lena Peters op cit note 6.

\(^{40}\) For a detailed discussion see Andrew Terry op cit note 36. Chart is adapted from Terry.


\(^{42}\) See generally, Lena Peters op cit note 6.
in franchising which arise from the information and power imbalance inherent in the franchising relationship. In a developing country such as China, there may be more basic imperatives driving regulation. In the context of a system in which business activity which if not expressly authorised is, by implication, prohibited, a law which legitimises franchising as a method of business operation is a necessary first step.

7.3 THE DEVELOPMENT OF CHINA'S REGULATORY REGIME FOR FRANCHISING

China's short history of franchising regulation is one of increasing sophistication not only in the transition from industry Measures of uncertain legal effect to State Council legislation, but also in the content of the regulatory scheme which has developed from an industry rule operating essentially as a 'guide' to franchising to a comprehensive regulatory regime with many similarities to western models.

7.3.1 Regulation Prior to the 1997 Interim Franchise Measures

Franchising was practised in China prior to the 1997 Interim Franchise Measures establishing the first regulatory framework for its operation. KFC and McDonald's established operations in the late 1980s and early 1990s although their expansion at that time was through company owned and managed outlets other than through franchised outlets.\(^{43}\) By the mid 1990s, Western franchisors were increasingly entering China and domestic companies were starting to practise franchising as a method of expansion.\(^{44}\) However, there was a lack of understanding of the franchising concept and its development was handicapped by lack of formal legal recognition. To acknowledge the awareness of the practice of chain store and

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\(^{43}\) KFC opened its first franchised outlet in 1993 which remained its only franchised store until 1997.

\(^{44}\) The introduction and development of franchise sector in China is discussed in Chapter 8.
franchise operation, and to regulate the market, the then Ministry of Internal Trade (MOIT) issued the *Opinion on Regularizing the Operation and Management of Chain Stores*\(^{45}\) in March 1997. In this Circular, three forms of chain stores were recognised:

- **Direct operated chain** – a chain of stores owned, controlled and operated by a head office;
- **Voluntary chain** – individual stores trading under the supervision of a head office but maintaining separate legal personality and financial independence;
- **Franchise chain** – a store contacts with the head office to use franchising rights including trademark or trade name, technology, management skill to distribute goods and services developed by the head office which controls the operation.\(^{46}\)

The word 'franchise' (*te xu*) was officially used in this circular. It was first official recognition of franchising in China, and 'franchise chain' was described in terms which made it similar to the franchising concept in Western countries. Nevertheless, at that time the differences between franchised chains and company owned chains were unclear not only to the general public but also to government officials. There was confusion between franchise systems and chain stores. For many years the franchising concept was “merged” in the wider concept of the “chain” – a network of branded outlets owned, controlled and managed by the brand owner. The overlap is indeed evidenced in the name of the quasi-governmental body - CCFA - established in 1997 (which formerly existed as a division within the Ministry of Internal Trade) which oversees franchise development. Although it is generally known as the China Chain-store and Franchise Association (CCFA),\(^{47}\) the literal translation is China Chain-store Operation Association.

A “franchise” chain of course has many similarities to an “owned and managed”

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\(^{45}\) Issued by the then Ministry of Internal Trade on 27 March 1997, and taking effect immediately.

\(^{46}\) Article 4, *Opinion on Regularizing the Operation and Management of Chain Stores*. Translated by author. The ambiguity of this article is inherent in its drafting, presumably because of the lack of understanding of chain operation and franchising.

\(^{47}\) The China Chain Store and Franchise Association (CCFA) was approved and registered by the Ministry of Civil Affairs to “formulate trade regulations on franchising operations, to develop disciplines in the industry and to provide services to both franchisors and franchisees.” (Article 17, 1997 *Interim Franchise Measures*).
chain. The effective operation of both require brands, systems, controls, training and assistance but the vital distinguishing feature of franchising – the franchisor/franchisee independent contractor relationship as opposed to the owner/manager employment relationship - from which the unique synergies of franchising evolve are not recognised or acknowledged in regulating all “chains” in the same manner. It was not until the 1997 Interim Franchise Measures that franchising was officially recognised and regulated as a distinct method of business operation. Certain rules issued in relation to chain operations generally nevertheless continued to apply to franchising. Most regulations in China on chain operations at that period governed both franchised chains and regular chains in which the brand owner had a direct investment in the chain of retail establishments.

Under Chinese law at that time, two businesses could not be registered in the same area under the same name. Franchise operations brought to the fore the issue of several stores wanting to operate in the same district under the same name. The Circular Regarding Issues Relating to the Registration and Administration of Chain Stores was issued two months after the Opinion on Regularizing the Operation and Management of Chain Stores to address this. This Circular provided that two categories of chain operations could operate under the same name:

- stores wholly or partially invested and owned by head office and managed directly by the head office;
- stores partially invested by the head office or with no capital invested by the head office, which through contract with the head office, operate as a joint venture or obtain franchising right of using head office’s trademark, logo, operational skills and sell products of head office, operate together under the contract.

48 For example the Circular Regarding Issues Relating to the Registration and Administration of Chain Stores, discussed below, applied to both franchised chains and direct owned chains.

49 According to, Article 6, Measures on Administration of Business Name Registration issued by the SAIC on 22 July 1991.

50 The Circular Regarding Issues Relating to the Registration and Administration of Chain Stores was jointly issued by the State Administration for Industry and Commerce and the then Minister of Internal Trade on 30 May 1997; took effect immediately.

51 Article 2, Opinion on Regularizing the Operation and Management of Chain Stores.
It is clear that these categories of chain operation included both regular chains and franchising chains. As its title indicated, the Circular was issued to clarify issues in relation to registration. It stated that both company owned and franchised stores could be registered under the same name (Article 5) and specified the documentation needed for chain stores applying for registration which included the franchise contract (Article3). It further stated that stores “wholly or partially invested by head office” (company-owned stores) could be registered with the local Department of Administration for Industry and Commerce without following the normal procedures for licensing and other transferring requirements including the intellectual property rights (Article 6).

The late 1990s was the period when franchising started to emerge and develop. It was also the time when the Chinese government commenced transforming state-owned enterprises and introducing Western financing, accounting and management concepts. To clarify the issue relating to chain stores, the Provisional Measures on Issues Relating to the Financial Management of Enterprises’ Chain Operations were introduced. The Provisional Measures reinstated the provisions in the Opinion on Regularizing the Operation and Management of Chain Stores and specified that the Provisional Measures applied to direct operated chains, franchise chains and voluntary chains. Chapter 3 of the Provisional Measures, titled Financial Administration of Franchised Chains, contained several provisions relating to franchise operations. Article 16 stated that:

No more than 3 percent of the turnover as franchising fees relating to production and operation paid by franchisee to franchisor should be account as management cost (by franchisee). Franchising fees received by franchisor should be accounted as other operational income.

This provision was frequently misinterpreted in the west because of the ambiguity of

52 The Provisional Measures on Issues Relating to the Financial Management of Enterprises’ Chain Operations were issued by the Treasury on 29 September 1997; took effect immediately.

53 第十六条加盟店根据合同，按不高于销售额(营业额)3%的比例支付给特许者的与其生产经营有关的特许权使用费，计入管理费用。特许者收到加盟店交来的特许权使用费，计入其它业务收入。
the original language. An article published by Franchise Unlimited suggested it meant "domestic franchise fees are currently not allowed beyond 3 percent". However the original Chinese version suggests the franchise fee of no more than 3 percent of the turnover should be recorded as management cost. It did not limit the franchise fee to 3 percent of the turnover, and did not specify which category of fees in excess of 3 percent should be recorded for accounting purposes. The *Provisional Measures* were issued by the Treasury to standardise accounting management. It was not the Treasury's role to restrict the amount of franchising fees. This interpretation is supported by lawyers of the Legal Committee of the CCFA. The *Provisional Measures* have never been repealed, and so in theory, still have legal effect as a Ministerial Measure. However, they have had little impact in practice. One reason is that the two *Circulars* and the *Provisional Measures* did not include any consequences for non-compliance and merely stated the forms of chain stores and the methods for their registration and accounting management. Another reason is that the *Opinion on Regularizing the Operation and Management of Chain Stores* and the *Circular Regarding Issues Relating to the Registration and Administration of Chain Stores* were Ministry circulars, the legal effect of which was unclear. They could be cited by the court as governmental policy, but, theoretically, there were not law. Although they had *Regularising*, or *Administration*, in their titles, their contents merely served as a guideline for companies and their administrative organisation. However, such guidelines were important at that time for companies considering franchising as, without a Government guideline, registration would be impossible in practice.

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56 Discussion with lawyers of the Legal Committee of the CCFA, conducted by the researcher during the 2005 and 2006 International Franchise Forum in Shanghai.
57 The Constitution does not specify the scope of the judiciary’s authority to overturn remove invalid legislation or regulation. In practice, the department issued the legislation at the first place may promulgate or suggest to the State Council to promulgate a new regulation to replace the old one. *'Provisional'* measures and regulation is Chinese characteristic way of legislation to promptly response to the problems occurred.
7.3.2 The 1997 Interim Franchise Measures

In November 1997, the then Ministry of Internal Trade issued Measures for the Administration of Commercial Franchises (Trial Implementation) (hereinafter 1997 Interim Franchising Measures) which created the first regulatory framework for franchising in China. The 1997 Interim Franchising Measures were established to "standardise franchising activities, to protect the legal interests of the franchisor and the franchisee and to promote the development of chain operations" (Article 3). They applied to "all enterprises, individuals or other economic organisations participating in franchising (including catering and service industries) within the territory of the People’s Republic of China" (Article 3).

The 1997 Interim Franchise Measures was the first law in China governing franchising activity which separated franchising from direct chain operation. Franchise as a means of business was finally officially defined in Chinese law:

Franchise operations mean that the franchisor grants, in the form of a franchise contract, the use of the trademark (including service trademark), logo, products, patent right, proprietary technology, or mode of management, etc. owned by the franchisor, to the franchisee, and the franchisee, on its part, acting in accordance with the provisions of the contract and the uniform mode of business of the franchisor, conducts operating activities and pay appropriate fees to the franchisor.

This definition covered the essential features of the franchising concept as is generally understood: i) a franchising relationship is a contractual relationship; ii) the franchisor grants to the franchisee rights to use its intellectual property rights, including trademark and logo etc; iii) the franchisee pays fees to the franchisor; iv) the franchisee operates under the uniform mode of business developed by the franchisor.

58 The Measures for the Administration of Commercial Franchises (Trial Implementation) was issued by the then Ministry of Internal Trade (Xing-Zi 1997 No. 124) on 14 November 1997 and taking effect on that day.

59 Article 2, 1997 Interim Franchise Measures.
The 1997 *Interim Franchise Measures* classified franchising forms into *direct franchising* and *sub/regional franchising*. *Direct franchising* referred to franchising where the franchisor directly grants to the franchisee the right to establish and operate an outlet or outlets in accordance with the contract (and under which the franchisee may not transfer the franchise right to others); and *sub/regional franchising* referred to as franchising where the franchisor grants exclusive rights in a territory to a master franchisee to sub-franchise to other franchisees or to set up company owned outlets in the territory) (Article 5).

The 1997 *Interim Franchise Measures* were written more as a general guide to basic rights and obligations than as a detailed statement of such rights and obligations and contained no provisions dealing with their contravention. They contained a broad statement of the principles under which franchising should operate:

> Franchising business shall be conducted in adherence to the principles of voluntariness, fairness, compensation, good faith and standardisation.

In addition to this general principle, the 1997 *Interim Franchise Measures* also specifically addressed a number of issues:

**Qualifications of franchisor and franchisee**

The franchisor was required to be an independent legal entity with a registered trademark, trade name, product, patent, unique and transferable management skill or know-how, adequate operational resources, the capability provide long term

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60 See discussion in Chapter 7.5.2 below.

61 This is possibly typical of civil law systems but can be ambiguous to lawyers more familiar with common law system. Parties involved in a franchise contract dispute had to sue under the *Contract Law* (as discussed in Chapter 5) and use the *Interim Franchise Measures* as an interpretative device.

operational advice and supporting service and an "excellent business performance record for more than one year" (Article 6). It also required a franchisee to be either a legal person or natural person, and to possess the necessary business resources and capacity to managing the operation (Article 7).

**fundamental rights and duties of franchisors**
The fundamental rights of the franchisor were stated to be: the right to exercise supervision and to collect royalties and service charges, and the right to terminate the qualifications of the franchisee for franchise operations if the franchisee violated the franchise contract, infringe the lawful rights and interests of the franchisor or undermined the franchise system (Article 8). The fundamental duties of the franchisor were: to grant the franchisee the right, to provide education and training prior to opening of the business; to guide the franchisee in making good preparations for opening of the business, and to provide long-term management guidance, training and supplies as stipulated in the contract (Article 9).

**fundamental rights and duties of franchisees**
The fundamental rights of the franchisee were: to exercise the rights granted by the franchisor within the scope agreed in the contract, and to acquire the management technology, business secrets and training and guidance provided by the franchisor (Article 10). The fundamental duties of the franchisee were: to conduct business activities in strict compliance with the standards prescribed by the contract, to pay fees, to uphold the reputation and unity image of the chain system, and to accept guidance and supervision of the franchiser (Article 11).

**prior disclosure**
The *Measures* required written disclosure to be provided to the prospective franchisees at least ten days before the signing of the agreement (Article 12) of 'basic franchise information' including: name, basic information and performance of franchisor, the business circumstances of its franchisees, the estimated budget for the franchised store (which has been tested through practise), the methods for collection
of royalties and other charges, and the terms and conditions for the supply of goods (Article 12).

**franchise agreement**

Provisions required in the written franchise agreement included: the content, scope, term and region of franchise right granted, the rights and duties of the parties, training and guidance, fees and method of payment, confidentiality, liability for breach of contract, and term, modification, renewal and termination of the contract, (Article 13). Article 15 further specified that disputes shall be settled according to the procedures specified in the agreement.

**fees**

The *Measures* specified and defined fees which could be collected by a franchisor which included initial franchisee fee, royalties, security deposits and other fees as agreed in the franchise agreement (Article 14).

**filing and the role of Industry Associations**

The *Measures* stated that the role of the industry association, the China Chain Store and Franchise Association (CCFA), was to formulate rules and codes of conduct for franchise activities, to encourage self-discipline for the franchise sector, to provide services to franchisors and franchisees, and to promote development of the franchise sector (Article 17). Article 17 also required the franchisor to file the prior disclosure documentation with the CCFA. In 1997, the CCFA was approved and registered by the Ministry of Civil Affairs to “formulate trade regulations on franchising operations, to develop disciplines in the industry and to provide services to both franchisors and franchisees.”

Based on Article 17 of the 1997 *Interim Franchise Measures*, the CCFA issued a *Code for Administration of Filing of franchising enterprises (Trial Implementation)* on January 26, 2000. It provided that franchisors who had been engaged in franchising for more than one year and had at least one company owned outlet and three franchised outlets, could, on a voluntary basis, have

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63 Article 17, 1997 *Interim Franchise Measures*.
their franchise documents recorded. However, the *Code* was simply an industry code and voluntary filing was never properly practised.

From a Western perspective, the 1997 *Interim Franchise Measures* were not particularly sophisticated. They, in effect, described how franchising works rather than set out a comprehensive regulatory regime for franchising. However, they signalled government support for the franchising concept. At that time, among the general population, and even in the business community, the concept was not well known and the intricacies of the franchisor/franchisee relationship were not generally appreciated. Even the name was difficult in Chinese as there was not a word perfect match and the term "franchise" did not enter the language until the 1980s.

In the context of a system in which activity which is not expressly authorised is, by implication, prohibited, the *Measures*, despite being administrative rules of a general nature, had a significant role in the official recognition and, by implication, encouragement of franchising as a distinct method of business operation.

### 7.3.3 Problems with the 1997 *Interim Franchise Measures* and Reform Proposals

There was wide acknowledgement from both domestic and international franchise sectors, as well as officially at the government level within China, that the 1997

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Interim Franchise Measures required replacement by a more carefully developed regulatory regime. The Measures provided a guide to appropriate franchising conduct but did not solve many practical problems. The rapid growth of franchising in China was accompanied by problems that are familiar to all franchise sectors – that of the “scam-merchant” to use the colourful American expression as well as the under-prepared, inexperienced, and ill-advised franchisors and franchisees with little understanding of the subtleties and realities of the complex franchisor/franchisee relationship. Some traded off the promise of franchising without the capacity or will to deliver on it. Much franchising in China is not in the full business format mode. This has exacerbated the problem of bad practices in key areas such as training, support, supply, standards and so on. Guo Geping, Chairperson of the CCFA, speaking at the CCFA International Franchising Forum in 2004, addressed this issue directly:

Taking advantage of the poor legal environment, some franchisors conduct substandard businesses or even cheat franchisees of money while franchisees also delay payments to the franchisor or infringe the intellectual property rights of the franchisors. The construction of a sound legal environment will efficiently regulate the activities of both franchisors and franchisees, though we have been advocating self-discipline throughout the industry.\(^{67}\)

As a Ministerial rule, the 1997 Interim Franchise Measures did not have a strong legal effect. More importantly, due to China’s foreign investment control policy, domestic invested companies and foreign invested company were administered by different ministries. The regulatory body which issued the 1997 Interim Franchise Measures, the then Ministry of Internal Trade (MOIT), did not have authority to administer foreign invested companies which resulted in the 1997 Interim Franchise Measures’ application to foreign invested franchising companies being uncertain. In theory, the 1997 Interim Franchise Measures should have applied to foreign invested enterprises (FIEs) as FIEs are foreign by reason of the investment but domestic by

reason of the source of their legal personality. As discussed in Chapter 6, foreign invested companies needed approval on a case-by-case basis from the then Ministry of Foreign Trade and Economic Cooperation (MOFTEC) before being registered by the State Administration for Industry and Commerce (SAIC). The documentation needed for both approval and registration included the scope of business. With no law supporting FIEs engaging in franchising, seeking approval was not practicable. However, the reality was, as explained in Chapter 6, that approval was required. There was wide support in the Chinese franchise sector, and from foreign franchise systems operating in or proposing to enter China, for a new and more comprehensive regulatory regime.

Throughout 2002 it was suggested in the Chinese media, presumably with official approval, that a law, tentatively titled the *Commercial Franchising Regulation*, to replace the 1997 *Interim Franchise Measures* had been on the agenda of the State Council since 2001. A consultation draft of the proposed new regulation had been released for discussion as early as July of 2001. A report in the *China Daily* of 8 July 2002 records Men Xiaomei, vice-director of the Market Bureau under the State Economic and Trade Commission which was the responsible for drafting the regulation, stating that:

> China will unveil a new regulation on commercial franchises to boost the development of the country's new business model. The new regulation is aimed at ensuring franchise store runners carry out their

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68 The legal personality of FIEs is discussed in Chapter 6. Such review is supported by Paul Jones, a Canadian lawyer with comprehensive Chinese experience who is a co-author (coauthored with Zhiqiong June Wang, Andrew Terry and Yun Yao) of the report, 'Comparative Review of the Administrative and Promotional Mechanisms for The Franchise Sector', 2008 Report to the Ministry of Commerce, China and discussed with him in email correspondence and face to face meetings.

69 Franchising was not listed in the 1995 and 1997 *Catalogue for the Guidance of foreign Investment Industries*. As discussed in Chapter 6.


71 Unofficial release to the CCFA and relevant committees. The researcher participated in a meeting hosted by the CCFA to provide feedback in 2003. An article discussing the proposed law was written by Robert P. Zarkos, 'Related Article: Journey to the West, A Comparative Analysis of China's 2003 Proposed, WTO Compliant, Franchise Rules' (2004) 12 *Willamette Journal of International Law & Dispute Resolution* 315.
commitment to franchise brand owners and should ensure the quality of the stores.... The draft has been completed and will soon be submitted for review by the State Council. It is expected to be implemented before the end of this year after winning approval from the State Council.

Speaking at the CCFA International Franchising Conference in Shanghai in October 2004, Wang Xiaochuan, deputy director of the Department of Commercial Reform and Development within the Ministry of Commerce, stated that:

[China’s] booming franchising business has entered a rapid development stage [requiring] a professional law to regulate the industry.  

There was wide recognition within the State Council and the Ministry of Commerce that the development of franchising in China needed to be supported by a sophisticated national law rather than simply by Ministry Measures. Mr. Wang Xiaochuan and Ms. Yin Hong stated in several forums and meetings that a Franchise Regulation was on the priority list of the State Council. However, the State Council Regulation had a much longer gestation period, and did not emerge until 2007. The intervening period was nevertheless not one of regulatory inactivity. The establishment of the current Ministry of Commerce in March 2003, by merging the Ministry of Internal Trade and the Ministry of Foreign Trade and Economic Cooperation, made a unified regulatory regime for both domestic and foreign franchisors easier. But, with the proposed State Council’s new Franchise Regulation not being finalised, the MOFCOM in November 2004 released draft Provisional Measures on the Administration of Foreign-Invested Enterprises Engaged in Commercial Franchising (the 2004 Draft FIE Franchise Measures) to...


73 The Ministry of Commerce is responsible for both domestic and foreign invested enterprises. For general information: http://www.mofcom.gov.cn/mofcom/vange.shtml.

74 MOFCOM released, on its website for public opinion, draft Provisional Measures on the Administration of Foreign-Invested Enterprises Engaged in Commercial Franchising (2004 Provisional FIE Franchise Measures). The Chinese version of the 2004 Provisional FIE Franchise Measures and comments can be found on the Minister of Commerce website,
support the new liberalised regime for the participation of foreign invested enterprises in the commercial franchise sector. The draft measures were heavily based on the 1997 *Interim Franchise Measures*. The sub-text to the unexpected appearance of a new franchise regulation under the foreign-invested enterprises regime was that in order to meet WTO accession commitment obligations China was required to lift restrictions on foreign franchisors by 11 December 2004.

However, because of both defects in the draft\(^75\) and the dual regulatory regime it created for domestic and foreign franchisors (domestic franchisors under the 1997 *Interim Franchise Measures*, and foreign franchisors under the 2004 *Franchise Measures*) which is contrary to WTO “national treatment” principles the draft *FIE Franchise Measures* were abandoned.

On 31 December 2004, the Ministry of Commerce released *Measures for the Administration of Commercial Franchise Operations (2005 Franchise Measures)*\(^76\) after only a 12 day period consultation period. These *Measures*, which came into effect on 1 February 2005, repealed the 1997 *Interim Franchise Measures*.

### 7.3.4 The 2005 *Franchise Measures*

The 2005 *Franchise Measures* prescribed a regulatory regime for domestic and FIE franchisors under the same regulation. The 2005 *Franchise Measures* were formulated “for the purposes of regulating commercial franchise operations, protecting the legitimate interests of the parties involved, and promoting the healthy

\[^75\]For example, the draft *Provisional FIE Franchise Measures* was proposed to apply to franchising in “all service industries that engage in retail, culture and sports, catering, hotel and lease by foreign-invested enterprises in the territory of China” (Article 4). The service industries are never defined in law which could create legal uncertainty for franchisors in “non-service” sectors.

\[^76\]The *Measures for the Administration of Commercial Franchises (the 2005 Franchise Measures)* was issued by the MOFCOM on 31 December 2004, in effect on 1 February 2005.

\[^77\]A ‘commercial franchise’ is: “an arrangement whereby a franchisor, through an agreement with a franchisee, grants the franchisee the right to use business operating resources including trademarks, trade names, business models, etc., which the franchisor has the right to grant others to use; and the franchisee shall operate under the uniform franchise system and pay franchise fees to the franchisor in accordance with the agreement” (Article 2).
and orderly development of commercial franchising” (Article 1). Both direct and sub/regional franchising were covered (Article 4).\(^78\) Franchise operations were to be conducted under the laws and regulations of the People’s Republic of China, and pursuant to the principles “of voluntariness, fair dealing, honesty, and credibility” (Article 5). Legitimate rights and interests of consumers were not to be impaired through franchising and a franchisor could not through franchising cause market monopoly or impede fair competition (Article 5). The 2005 Franchise Measures were closely modelled on the repealed 1997 Interim Franchise Measures. They contained chapters on qualifications of the franchisor, rights and obligations of the parties, content and term of franchise agreement, information disclosure, advertising, supervision and administration, legal responsibility, and foreign invested enterprises.\(^79\)

**Qualifications of the Parties**

The 2005 Franchise Measures prescribed the necessary qualifications of both franchisee (Article 8) and franchisor (Article 7). A franchisee was to be an enterprise or other economic entity established in accordance with the law and with necessary capital, premises and personnel to operate the franchise. A franchisor had to satisfy more comprehensive prerequisites:

- it shall be an enterprise or other economic entity established in accordance with law and regulations;
- it shall have the right to license to others business resources such as trademarks, trade names and business models etc;

\(^78\) A franchisor may grant a franchise directly to a franchisee, to directly establish and operate a franchised until but who cannot further grant a franchise to a third party; or was grant the exclusive rights to a franchise within a certain territory to a franchisee, who in turn can further grant the franchise to other prospective franchisees, or establish and operate franchised units by itself (Article 4).

\(^79\) The 2005 Franchise Measures required foreign invested enterprises engaged in commercial activities through franchising to apply to the original approval authority for approval to “engage in commercial activities by franchising” which required submitting documentation including the business licence, FIE approval certificate, proof of Article 7 qualifications to be a franchisor, prior disclosure information, the standard franchise agreement and the Franchise Operations Manual. Foreign invested enterprises engaged in franchise operations prior to 1 February 2004 were required to file a report of their franchise operations to the original registration authority to legitimise their activity, but to continue franchising they were required, within an unspecified time frame, to apply for approval in the same manner as a commencing FIE franchisor.
• it shall have the ability to provide franchisees with long term operational guidance and training services;
• it shall have at least two direct sale stores (or stores owned by its subsidiary or holding company) in operation for more than one year within China;
• for a franchise which requires the franchisor to supply goods, it shall have a supply system which is stable and can guarantee quality of goods as well as have the ability to provide related services;
• it shall have good reputation, and have no record of perpetrating fraud through franchising.

On contravention of these provisions the commerce regulatory authority was empowered for issue orders to rectify, and may impose fines of less than RMB30,000. For “serious violations” the franchisor’s business licence could be cancelled (Article 38).

disclosure

The 2005 Franchise Measures required the franchisor to provide a prospective franchisee with a copy of the franchise agreement and a written disclosure document including “the relevant actual and basic information of the franchise” at least 20 days before executing the franchise agreement (Articles 17, 18). The disclosure document had to include (Article 19).80

- the franchisor’s name, address, registered capital, scope of business, number of years engaging in franchising, audited financial statements, and information regarding tax payments
- number, locations, and operational results of its franchisees; initial investment in a franchised unit; and the proportion of the former franchisees whose franchises are terminated to the total number of franchisees
- information regarding the registration, usage, and litigation in relation to the

80 In the original Chinese, several of the categories of required disclosure used the character ‘等’. It has different meanings which may alter the meaning of the list. ‘等’ when used at the end of a list of items, can be interpreted as “and so on”, or, as ‘the end of list of items’ (for further explanation, see Chinese Dictionary, Commercial Press). In the Measures, it is possibly correct to interpret it as “and so on” which is an acceptable civil law drafting method. It is important to note that an overall duty to disclose material information is required under the general commercial law which is discussed in Chapter 5. For discussion, see Paul Jones, ‘The Regulation of Franchising in China and the Development of a Civil Law Legal System’ (2006) 2 (1) Chinese Law & Policy Review, 78. The 2007 Franchise Regulation removed ‘等’, and instead, uses terms with a broader meaning, such as ‘basic information’. 

trademarks; information regarding business operating resources like trade names and the operational model

- the type, amount, and payment method of the franchising fees, as well as the collection and refund of the deposits
- litigation in which the franchisor was or is involved for the last five years
- goods or services the franchisor can supply to the franchisees, and any accompanying restrictions and conditions
- proof of capacity to provide the franchisee with training and guidance, as well as the current situation regarding training and guidance provided to the franchisees
- basic information on the principal officers of the franchisor, including whether they were subject to any criminal penalties, and whether they were personally responsible for the bankruptcy of any companies; and
- other disclosures requested by the franchisee.

The Measures also imposed disclosure obligations on the franchisee who, at the request of the franchisor, must accurately disclose information regarding the franchisee’s operational capabilities, including proof of its legal status, credit history and ownership (Article 20).

Both franchisors and franchisees were also subject to continuing disclosure obligations. During the course of the franchise operation, franchisors and franchisees shall “timely disclose relevant information” (Article 17). The franchisee must, in accordance with provisions of the franchise agreement and at the request of the franchisor, make “timely disclosure of actual information including operational results” (Article 20). Failure to disclose information as required had serious consequences. Commerce regulatory authorities were empowered to impose orders to rectify, and/or impose fines of less than RMB30,000. For serious violations the business licence could be cancelled (Article 39).

**rights and obligations of the parties**

The 2005 Franchise Measures set out basic rights and obligations of both franchisor and franchisee, which in all cases, were supplemented by “other [rights and obligations] pursuant to the franchise agreement” (Articles 9-12).
The franchisor’s specified rights were to supervise the franchisee to ensure uniformity and consistency, to terminate a franchisee who “breaches the franchise agreement, violates the legitimate rights and interests of the franchisor and harms the franchise system”, and to collect franchise fees and a deposit (Article 9). The franchisor’s specified obligations were to make timely disclosure as prescribed, to provide a franchisee with signage, manuals, guidance, training and other services in relation to the development of the franchise business, to provide goods as specified in the agreement, to promote and advertise the system and, most controversially, to “be liable for the quality of goods supplied by designated suppliers” (Article 10).

The franchisee’s specified rights were to receive the right to use the franchisor’s resources such as trademarks, operational model, training and guidance, to receive timely supply of goods in accordance with the franchise agreement, and to receive support in system wide promotions conducted by the franchisor (Article 11). The franchisee’s obligations included compliance with the agreement, payment of fees, protection of the uniformity of the system, not transferring the franchise without the franchisor’s permission, timely disclosure of required information to the franchisor, acceptance of franchisor, guidance and supervision and the retention of confidentiality of the franchisor’s trade records (Article 12).

**content of the franchise agreement**

The 2005 *Franchise Measures* (in Article 13) provided that “the content of the franchise agreement is to be determined by parties” but should “normally” include listed particular items (which were predictable and not controversial):

- names and addresses of the parties
- the scope, term, territory and exclusivity of the licensed franchise rights;
- the type, amount, payment method of the franchise fee, and the collection of refund of the deposit;
- confidentiality;
- quality control and responsibilities in relation to goods and services of the franchise;

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• training and guidance;
• the use of trade names;
• the use of intellectual property such as trademarks;
• consumer complaints;
• promotion and advertising;
• amendment and termination of the franchise agreement;
• liabilities regarding breach of contract;
• dispute resolution;
• other provisions agreed to by the parties.

The 2005 Franchise Measures envisaged the usual franchise fees – initial, continuing and “other” agreed fees – in addition to a “deposit” by the franchisee to the franchisor “to ensure performance of franchise agreement by the franchisee, which shall then be refunded to the franchisee upon expiration of the agreement” (Article 14). In a provision unusual from a western perspective the 2005 Franchise Measure provided that “the parties to the franchise shall determine the franchise fee and deposit in accordance to principles of fairness and reasonableness” (Article 15).

The only other aspect of the agreement specifically addressed relates to the term which “shall be of at least 3 years generally” (Article 15). Renewal was dealt with in a uniquely Chinese manner. On expiry of the agreement the parties shall “consult and ascertain the terms for the renewal of the franchise agreement in accordance to principles of fairness and reasonableness” (Article 15).

**advertising and promotion**

In advertising, promoting or offering a franchise the franchisor was prohibited from making misleading representations (Article 23) or exaggerating the profitability or other benefits of the franchise (Article 26). Breach of these provisions was punishable under the general law (Article 40).

**administration**

The Ministry of Commerce was responsible for interpreting the 2005 Franchise
Measures (Article 4) and for overseeing and regulating franchise operations within China, with commerce regulatory authorities of various levels responsible for supervising and administering franchise operations within their respective jurisdictions (Article 6). Franchise trade organisations were required to adopt codes of ethics for the industry, conduct self-regulation, provide services to franchise parties, and promote the development of the industry (Article 28).

There was an annual reporting requirement. Every January a franchisor was required to file a report with both the commerce regulatory authority of its locality and that of the franchisee’s locality, disclosing the information regarding the franchise agreements signed in the preceding year (Article 29). For FIE franchisors engaged in franchising the report must also be filed with the original registration authority (Article 34).

7.3.5 Major Changes Introduced by the 2005 Franchise Measures in Relation to Foreign Franchisors

*a quasi-unified regime*

From an international perspective the greatest significance of the 2005 Franchise Measures was that, for the first time, both foreign invested and domestic invested franchisors were subject to the same regulatory regime for franchise operations. The 2005 Franchise Measures nevertheless subjected foreign invested franchisors to a special approval regime, arguably in breach of WTO accession commitments. Chapter 7 was titled “Special provisions for foreign invested enterprise” and subjected foreign franchisors to an application and approval system which did not apply to domestic franchisors. Article 33 provided that foreign invested enterprises that engage in commercial activities by franchising shall apply to the original approval authority for approval to “engage in commercial activities by franchising.”

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81 The approval authority was required to approve or disapprove the application in writing within 30 days after the receipt of all application documentations and. Within one month after the
submitting documentation including

- application letter and board resolution;
- photocopies of the business license and FIE approval certificate;
- amendment of the contract or the articles of incorporation (articles of incorporation only if it is a WFOE);
- enterprises only need to submit amendments to the articles of incorporation;
- materials proving the requirements of Article 7 (proof of qualifications to be a franchisor);
- materials reflecting the requirements of Article 19 (prior disclosure information);
- sample of franchise agreement; and
- franchise business operation manual.

Apart from being discriminatory, the registration requirement for foreign franchisors was a cause for concern as the documents required to be filed for approval included commercially sensitive information continued in the operational manual.

**the “2+1” requirement**

Apart from the special provisions for foreign invested franchisors the most significant difference, and one which was widely criticised, was the requirement that prior to franchising a franchisor must have operated two directly owned stores for at least one year in China (Article 7.4). This ‘two stores plus one year’ ("2+1") requirement was presumably intended to stop inexperienced businesses trading off the reputation of franchising. However, it created an obstacle for experienced foreign franchisors seeking to expand in China. The “2+1” requirement would not only slow down the expansion of foreign franchisors, but could also compel a franchisor to have company owned stores, which is not a strategy that all business format franchisors have adopted, (for example Century 21).

receipt of the approval certificate, FIEs were required to apply to the industry and commerce administrative authority to amend their original business registrations. Franchisors engaged in franchising in China prior to 1 February 2004, were provided with an "amnesty" through filing a report of their franchise operations to the original registration authority. However, to continue franchising they were required within a specified time frame to apply for approval in the same manner as a commencing FIE franchisor (Article 36).
**direct and master franchising**

A residual concern for foreign franchisors was the validity of both *direct franchising* (from an offshore franchisor directly to a Chinese franchisee) and *master franchising* (from an offshore franchisor to a wholly Chinese enterprise which acquires the rights to sub-franchise within China or a defined territory within China). Under the 2005 *Franchise Measures*, direct franchising was apparently foreclosed to foreign franchisors as the Article 7(4) requirement, that the franchisor had at least two company owned outlets in operation in China for more than one year, could not be satisfied unless they first operated company-owned stores in China. Master franchising, which internationally is the most common method of international expansion,\(^{82}\) was a more serious concern. Its legality under the 2005 *Franchise Measures* was questionable. Article 3 of the *Measures* provided that they apply to franchise operations conducted within China. Article 35 provided that "in establishing FIEs engaging in commercial activities by franchising, foreign investors shall comply with the laws, regulations and rules on foreign investments, in addition to these Measures." It follows that foreign franchisors had to comply with the 2004 *Commercial FIE Measures* which opened the Chinese franchise sector to foreign franchisors operating through a Chinese-foreign joint venture or a WFOE. A foreign franchisor could of course grant sub-franchising rights to a joint venture or WFOE satisfying the FIE laws but master franchising to a wholly domestic Chinese enterprise was not only not covered but may indeed be prohibited if, by granting a master franchise in China, a foreign franchisor was engaging in franchise operations within China. If a master franchise agreement has, as is invariably the case, provisions relating to image and standards, operating systems, product quality control, location control, trademark use, opening assistance, in-country training and support, particularly if enforced by site inspections, it can be argued that the foreign franchisor is engaging in franchise operations in China. Given that master franchising is the most common method of cross-border franchising its legality


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needed to be clarified. In any event, the Measures required clarification in relation to the respective relationships between franchisor, sub-franchisor and franchisee.

franchisor liability

Another provision of concern to both foreign and domestic franchisors was Article 10 which imposed liability on franchisor for the quality of goods supplied to franchisees by designated suppliers. Article 10.4 stated that a franchisor was obligated to:

... supply goods to a franchisee pursuant to the terms of the franchise agreement; provided that, except for monopolized goods and those goods that have to be supplied by the franchisor or its designated suppliers to ensure the quality of the franchise operations, the franchisor cannot force a franchisee to accept the franchisor as its supplier of goods; however, the franchisor can stipulate the standards of quality for the goods, or provide a list of suppliers from which a franchisee can choose;...

Article 10.5 provided that when a supplier appointed by a franchisor is used by the franchisee, the franchisor is liable for the goods supplied by its designated supplier. The extending of the liability of the franchisor to the obligations of a third party supplier caused serious concern in the franchise sector and was deleted in the later Franchise Regulation in 2007.

other

Although many obligations imposed under the 2005 Franchise Measures were, from a western perspective, broad, vague and uncertain, the 2005 Franchise Measures were a significant development in the short history of franchising in China. The significance of a definitive legal framework for franchising was clearly expressed by an experienced consultant:

A crucial problem for franchising is that for years the Chinese Ministry of Commerce has been unceremoniously dragging its feet on passage of a Commercial Franchise Trade Regulation. With no enforceable rule in place, franchisors are reluctant to take the risks of franchising in China and are being forced to become partners in joint ventures with their Chinese franchisee investors. Such uncertainty is
clearly not the milieu in which franchisors normally covet to do business.”

While the broad generality of many of the obligations as well as certain specific provisions were a concern, both Chinese domestic enterprises and FIE franchisors welcomed the introduction of a viable regulatory regime for franchising in China and a more settled point of reference for conducting franchise operations. Particularly welcome was the recognition of “freedom of contract” through the Article 13 provision that “the content of the franchise agreement is to be determined by the parties”.

Franchisor and franchisee rights and obligations were in all cases subject to “other provisions stipulated in the contract” and the prescribed content of the franchise agreement was supplemented by “other provisions agreed to by the parties”. A more strict and complete framework for the information disclosure system introduced by the 2005 Measures, was believed to play a positive role in helping franchisors demonstrate their image. Also, welcomed by foreign franchisors was the emphasis the Measures accorded to intellectual property. The Measures prohibited the franchisee and its employees, during the course of and subsequent for termination, from disclosing the franchisor’s trade secrets (Article 21) and imposed confidentiality obligations on prospective franchisees in respect of trade secrets acquired through the prior disclosure exercise (Article 22). More generally, franchisors were prohibited from imitating a third party’s trademarks, scenes and lines in commercials, or any other signage to identify themselves in any misleading, deceiving or confusing way (Article 25).

84 Articles 17-22, Chapter 4, 2005 Franchise Measures.
86 The Measures require that prior to engaging in franchise operation, a franchisor shall register the trademark licensing agreement in accordance with the Trade-mark Law of the People’s Republic of China and its implementation rules (Article 31).
7.4 THE 2007 FRANCHISE REGULATION

7.4.1 Introduction

The 2005 Franchise Measures were short-lived as expected. The long awaited Commercial Franchise Regulation, promulgated by the State Council to replace the 2005 Franchise Measures, was introduced in 2007, a decade after introduction of the first franchise "law", the 1997 Interim Franchise Measures.

On 6 February 2007 the State Council released a Regulation on the Administration of Commercial Franchises (the 2007 Franchise Regulation) to take effect from 1 May 2007. The Regulation is formulated with the aims of 'regulating commercial franchising activities, promoting the healthy and orderly development of commercial franchising and safeguarding market order' (Article 1). Within days of the release of the Regulation, the official website of the Central People's Government of the PRC published Questions and Answers Regarding China's New Franchise Regulation presented by members of the State Council Legislative Affairs Office and the Ministry of Commerce. This commentary notes that the Regulation was based on international experience tempered by China's circumstances and that it balanced freedom of contract with the need for administrative guidance for the healthy development of the sector. The challenges facing the Chinese franchise sector are frankly acknowledged:

Because the essential element in a franchise system is the benefit of its intangible assets, and a franchisor may often have many franchisees, the franchisor and the franchisee have asymmetrical information and significant risks may be hidden. This inequality

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87 The Franchise Regulation was approved in principle by the State Council on 31 January 2007 and signed by the Premier on 6 February 2007, issued by Decree No 485 of the State Council, took effect on 1 May 2007. A number of English translations of the Regulation have been prepared, including one by the MOFCOM. In this paper, the translation of Paul Jones and Jennifer Bu (to which the researcher contributed) is used. It is attached as appendix I, and can be accessed at http://www.jonesco-law.ca.

makes it easy to conduct illegal or criminal activities in the name of franchising. In addition the market economy in our country has still not matured and the public understanding of franchising is not sufficiently developed, and rapid development of franchising has created some significant problems. For example some franchisors are not qualified to be franchisors, and do not have uniform standards. The market order is chaotic. Franchisors' and especially franchisees' legal rights are not effectively protected and sometimes illegal or criminal activities are conducted in the name of franchising.\(^8^9\)

The Commentary notes that the key to regulating franchising is to 'normalise the franchisor’s conduct':

The Regulation has mainly stipulated some necessary rules, measures and requirements that are basic to the normalisation and administration of franchising standards and activities, and some explicit legal liabilities to ensure the implementation of these standards. The Regulation has only emphasised the essential elements of the standards and left the parties to resolve other issues through contractual agreement as part of their legal relationship. At the same time the Regulation stipulated measures and requirements primarily to regulate the conduct of franchisors.\(^9^0\)

The long awaited 2007 Franchise Regulation has been welcomed by the international franchise community as, for the first time both domestic and foreign invested franchisors are subject to the same law without differential treatment.\(^9^1\)

Partly for this reason, the 2007 Franchise Regulation is much shorter than the 2005 Franchise Measures.\(^9^2\) It comprises five chapters. Chapter 1, ‘General Provisions’, states the aim of the Regulation, defines ‘franchise’, affirms a principle of good faith (which is a part of the obligation under the General Principles of the Civil Law and the Contract Law, as discussed in Chapter 5), and outlines the administrative arrangements for the supervision of franchising. Chapter 2, ‘Franchising Activities’,

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\(^8^9\) Ibid.
\(^9^0\) Ibid.
\(^9^1\) Although the 2007 Franchise Regulation has no special provisions on FIEs, they remain subject to other laws such as the Joint Venture Law and the WFOE Law which include approval requirements.
\(^9^2\) The 2007 Franchise Regulation has 34 provisions formed by 3345 Chinese characters. The 2005 Franchise Measures have 42 provisions formed by 4539 Chinese characters, including six provisions governing FIEs.
prescribes the qualifications for a franchisor and the registration/filing process, specifies terms of franchise contracts and addresses other relationship obligations. Chapter 3, ‘Information Disclosure’, sets up a prior disclosure regime and specifies 12 categories of information which franchisors must provide 30 days before signing the agreement. Chapter 4, ‘Legal Liabilities’, provides for administrative sanctions which may be imposed on franchisors who violate the Regulation, and includes a provision governing officials of the relevant commercial department who abuse their powers. Chapter 5, ‘Supplementary Provisions’, sets out general guidelines for the roles of industry associations and provides for the licensing of intellectual property to be in accordance with relevant laws. As provided for in the Regulation, the Ministry of Commerce has also issued two implementation measures which took effect on the same day as the Regulation: Measures for the Administration of Registration Commercial Franchises (Franchise Registration Measures)\(^\text{93}\) and Measures for the Administration of Information Disclosure of Commercial Franchises (Information Disclosure Measures)\(^\text{94}\).

### 7.4.2 Jurisdiction

The Regulation applies to ‘commercial franchising activities conducted within the territory of the People's Republic of China’ (Article 2). Unfortunately it does not clarify whether cross-border franchising directly from overseas into China by way of master franchising or area development constitutes ‘engaging in franchising in China’.

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\(^{93}\) The Measures for the Administration of Registration Commercial Franchises was issued by Decree No 15 of the MOFCOM on 30 April, took effect on 1 May 2007.

\(^{94}\) The Administration of Information Disclosure of Commercial Franchises was issued by Decree No 16 of MOFCOM on 30 April, took effect on 1 May 2007.
7.4.3 Definition

A franchise is defined in relatively familiar terms as: ‘...an arrangement whereby an enterprise (hereafter referred to as a “franchisor”) through an agreement grants other operators (hereafter referred to as the “franchisees”) the right to use its business operating resources, including registered trademarks, logos, patents, and proprietary technologies; whereby the franchisee conducts business under a uniform mode of operation; and whereby the franchisee pays franchise fees according to the agreement.’ (Article 3). It comprises three elements: (i) a contract relationship whereby franchisor grants the right to franchisee to use its resources such as trademarks, (ii) the franchisee operating under the unified business model of the franchisor, and (iii) the franchisee paying fees to the franchisor. Unlike the 1997 Interim Franchise Measures the 2007 Regulation does not expressly mention sub or regional franchising by a franchisor (described in the 1997 Interim Franchise Measures as the franchisor granting to a franchisee the right in a given region to grant franchises or itself set up and conduct a franchise network within the region).

7.4.4 Qualifications

The 2007 Franchise Regulation requires franchisors to have a mature business model, the ability to provide long term business guidance, technical support, business training and in particular to have operated two direct owned stores in the business to be franchised for more than one year (Article 7). The ‘2 + 1’ requirement in the 2007 Franchise Regulation differs in two ways from the ‘2 + 1’ requirement in the 2005 Franchise Measures. The earlier Measures required the franchisor to have ‘at least two direct sale stores (or stores owned by its subsidiary or holding company) in operation for more than one year within China’. The 2007 Regulation is silent on whether the outlets need to be ‘within China’ and on whether they can be operated by the franchisor’s affiliates. On a literal interpretation the requirement of store operation in China is relaxed so that overseas operations qualify. However, a literal
interpretation also suggests that the outlets cannot be operated by affiliates although this is a common practice amongst franchisors. While the Franchise Registration Measures (Article 5) clarify that overseas' outlets satisfy the '2+1' requirement, they do not clarify the issue of operation by affiliates.

Uncertainty also exists in relation to the provision that 'no entities or individuals other than an enterprise may engage in franchising activities as a franchisor' (Article 3). It is sensible to interpret this requirement as limiting franchisors to registered businesses including sole traders, companies, and contractual joint ventures thus excluding schools, government departments and even military divisions which in the past have engaged in business.

7.4.5 Prior Disclosure

The items of prior disclosure by the franchisor required by the 2007 Franchise Regulation are based on the previous 2005 Franchise Measures with some modifications. The 2007 Regulation nevertheless introduces a more comprehensive disclosure regime with prior disclosure required to be made in accordance with a Decree of the Ministry of Commerce, Measures for Administration on Information Disclosure of Commercial Franchises, effective on 1 May 2007. The Regulation provides for information to be provided under 12 headings (Article 22) which with more specific detail being provided in the Information Disclosure Measures:

- the franchisor's name, place of business, legal representative, registered capital, the scope of its franchise business and basic information about its franchise activities;
- basic information about the franchisor's registered trademarks, business logos, patents, proprietary technology and operational or business format model;
- 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);
- the costs and the terms and conditions for the products, services and equipment provided by the franchisor;
• detailed content, delivery methods and implementation plan regarding the continuous services to be provided to the franchisee, including operating guidance, technical support, training and other services;
• detailed method of guidance and supervision regarding the franchisees' operations;
• the investment budget for a franchise location;
• the number and location of existing franchise outlets within the territory of China, their distribution by region, and an assessment of their business performance;
• summaries of the financial statements and audit reports, audited by an accounting firm, for the most recent 2 years;
• franchise related lawsuits and arbitrated matters for the last five years and their status;
• whether the franchisor or its management legal representative have been convicted of serious illegal operations;
• other information specified by the Commerce Department of the State Council.

The prescribed information, and a model franchise agreement, must be provided to the franchisee at least 30 days before the agreement is executed (Article 21).\footnote{The 'contract' to be submitted for filing under Article 8 is a model contract. Article 21 in relation to provision of the contract to the franchisee uses a different Chinese word and has led to uncertainty as to whether the actual contract to be signed or a model contract must be submitted. The 
\textit{Implementing Measures for Commercial Franchise Information Disclosure} clarifies that a "model contract" must be provided to the franchisee.} The 2007 \textit{Franchise Regulation} in addition requires ongoing disclosure by the franchisor for material changes after the initial disclosure (Article 23).

\textbf{7.4.6 The Franchise Contract}

The 2007 \textit{Franchise Regulation} (Article 11) requires a written franchise agreement containing certain provisions, including:

- the franchisor's and the franchisee's basic information;
- content and the term of the franchising agreement;
- the types of franchise fees, the amounts to be paid and the method of
payment;
• specific provisions regarding the standards of operation for the franchised
business, the technical support to be provided by the franchisor and the
training services to be provided and how these will be delivered;
• the standards for the quality of the products or services and quality
 guarantees, and how these will be monitored and maintained;
• how the promotion and advertising of the products or services will be
 conducted;
• provisions regarding the protection of consumer rights and interests by the
franchisee and franchisor, and allocation of responsibilities and liabilities for
compensation;
• provisions regarding amendment, cancellation and termination of the
franchise agreement;
• default provisions and liability;
• dispute settlement mechanisms;
• other provisions which the franchisor and franchisee have agreed upon.

The Regulation requires the minimum term of the contract to be three years ‘unless
otherwise agreed upon by the franchisee’ (Article 13) and also requires the franchise
agreement to contain a ‘cooling off’ period under which a franchisee may
unilaterally terminate the contract ‘within a certain time after the franchise contract
has been signed’ (Article 12). The length of the ‘cooling off’ period is not specified
and is a matter for the contract.

7.4.7 Relationship/Conduct issues

The 2007 Franchise Regulation, like its predecessors, includes a general standard
obliging both franchisors and franchisees to act ‘in compliance with the principles of
free will, fair dealing, honesty and good faith’ (Article 4). The Regulation departs
from the model of the previous Measures which, in separate articles, list basic rights
and obligations of both franchisors and franchisees. Specific issues are nevertheless
addressed. The franchisor is required to provide a franchise operations manual to the
franchisee, and provide continuing operational guidance, technical support, business
training and other services to the franchisee in accordance with the franchise agreement (Article 14). Fees for promotion and marketing of the franchise system must be applied in accordance with the terms of the franchise agreement and promotional and marketing expenses must be promptly disclosed to franchisees (Article 17). A franchisee is prohibited from revealing or permitting other persons to access the franchisors' 'commercial secrets' (Article 18). A franchisee does not have the right to transfer the franchise to a third person without the consent of the franchisor (Article 18).

7.4.8 Registration/Filing

The 2007 Franchise Regulation removes the approval requirement for foreign franchisors contained in the 2005 Franchise Measures, and subjects both domestic and foreign franchisors to mandatory 'filing' requirements. The Chinese word used, 'bei an', may be translated as either 'registration' or 'filing' and both terms appear in various translations.\(^6\) In fact, little turns on the terminology. The process, whether called registration or filing, is far removed from the 'approval' requirement of the 2005 Franchise Measures for foreign franchisors which also appeared in earlier drafts of the Regulation.\(^7\) The 2007 Franchise Regulation simply requires (Article 8) the submission of the following documents to the provincial level Department of Commerce (if business activity is within one province), or to the Ministry of Commerce (if engaging in cross-provincial franchising) for archival filing within 15 days after sale of its first franchise:

- a copy of its business licence or a copy of its enterprise registration certificate;
- a standard form of franchise agreement;

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\(^6\) Whether the word 'bei an' in Chinese in the 2007 Franchise Regulation should be translated as 'registration' or 'filing/recording' has caused confusion and different translations have been made. However, 'bei an' in the Implementation Measures has been translated into 'filing/recording' almost universally.

\(^7\) Article 33, 2005 Franchise Measures.
• the franchise operating manual;
• its marketing plan;
• a written undertaking that the franchisor complies with the requirements for franchisors as set out in Article 7 of this Regulation and other relevant evidence of compliance;
• other documents and materials prescribed by the commercial administrative department of the State Council.  

If the product or service offered by the franchise system requires approval, the franchisor must also submit the relevant approval document (Article 8).

The relevant government authority shall file (ie record) and notify the franchisor within 10 days of receipt of the required documentation or give a further seven days for the franchisor to submit additional documents if the first submission is incomplete. Recognising existing franchise activity in China, the 2007 Franchise Regulation requires existing franchisors to file the documents by 1 May 2008 (Article 33).

Despite the “light touch” registration requirement which is essentially a ‘filing’ and not an ‘approval’ regime, concern may nevertheless be held as to the extent of the filing required. The documents required to be filed include a model franchise contract, the franchise operations manual and a marketing plan. These are commercially sensitive documents which franchisors with concerns as to the confidentiality of documentation within the administering bureaucracy may be reluctant to provide. Perhaps to pre-empt such concern, the Ministry of Commerce Decree, Measures for Administration of Filing the Record of Commercial Franchises simply requires in relation to the Operations Manual the table of contents to be submitted with the number of pages of each chapter and the total noted (Article 5).

98 The 2007 Franchise Regulation does not refer to the ‘Ministry of Commerce’ or the name of its local office. Rather it refers to “the administrative authority for commercial activity under the State Council” or “the commercial departments of the governments of provinces, autonomous regions, and municipalities”. This terminology is used because although the MOFCOM was formed in 2003 by merging the Ministry of Internal Trade and the Ministry of Foreign Trade and Economic Cooperation, its provincial departments are called either Economic and Trade Commission or Department of Foreign Trade and Economic Cooperation due to the historical reasons.
Surprisingly the franchisor’s disclosure document and the audited financial statements which must be provided to franchisees are not required to be submitted.

Franchisors must also make annual report of franchise contracts signed during the previous year in the first quarter of every year (Article 19).

7.4.9 Advertising and Promotion

The 2007 Franchise Regulation confirms that a franchisor engaging in misleading and deceptive conduct may be liable to penalties under the Advertising Law (Article 27). In addition, the Regulation itself provides for heavy penalties to be imposed on franchisors who resort to fraud or misleading content in promotion, or who include information on profit that any franchisee has gained from engaging in the franchise (Article 17(2)). Fines, corrective advertising and publication of the offender’s name may be ordered by the administrative authority.

7.4.10 Administration

The Ministry of Commerce is responsible for the supervision and administration of franchising activities nationally. The commercial departments of the governments of provinces, autonomous regions, and municipalities administer franchising activities in their respective territories (Article 5). Employees of commercial departments who abuse their power may be criminally or administratively liable (Article 30). The role of industry associations, such as the China Chain Store and Franchise Association, is also officially recognized in the Regulation. Guided by the MOFCOM, they may establish franchising codes of conduct to strengthen self-regulation, and provide relevant services to franchisors and franchisees (Article 32).
7.4.11 Administrative Sanctions

The 2007 Franchise Regulation has introduced a series of administrative penalties, in particular, fines, for non-compliance. Sanctions apply to unqualified franchisors (Article 24), and failure to disclose or file information and failure to comply with Article 17 on misleading advertising (Article 27).

7.5 FROM THE 1997 INTERIM FRANCHISE MEASURES TO THE 2007 FRANCHISE REGULATION: A DECADE OF DEVELOPMENT

7.5.1 The Long March to the Franchise Regulation

The franchise sector in China has come a long way in the decade from 1997 to 2007. The sector has grown rapidly as franchising has become an increasingly popular expansion strategy for both domestic and foreign enterprises. This growth has been driven by introduction of laws to facilitate, promote and regulate this development. Despite their limitations, the 1997 Interim Franchise Measures were a necessary starting point in the development for franchising. They were Ministry measures in the nature of industry rules rather than a law of the National People’s Congress or a regulation of the State Council. They contained no provisions addressing the consequences of their contravention and were in effect simply a description of franchising. Their significance nevertheless far transcended their limitations. They represented the first official recognition of franchising and were the catalyst for the adoption of franchising by domestic Chinese enterprises. They were interim measures (or, as often translated, “measures for trial implementation”), which acknowledged that it was anticipated that they would be replaced by a more carefully developed law. However, it was not until the 2005 that the Franchising

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99 Early in 1997, the then Ministry of Internal Trade released an Opinion on Regularising the Operation and Management of Chain Stores which provided three forms of chain stores: direct managed chains, voluntary chains, franchise chains. The ‘franchise chain’ was similar to business format franchising in most countries (discussed at 7.3.1). Franchising was not formally defined and recognised by law until the introduction of the 1997 Interim Franchise Measures.
Measures removed *Interim* from the title of the franchise-specific law in China and subjected foreign and domestic invested franchising enterprises to regulation under the same law. Because of the burdensome approval requirements on foreign invested, but not domestic, franchisors in the 2005 *Franchising Measures*, they were heavily criticised, but the move to a more certain regulatory regime which included foreign invested franchisors was well received.

China’s long march to a modern unified regulation regime ended a decade after the first official recognition of the franchising concept with the introduction of the 2007 *Franchise Regulation*. It provides a solid foundation for future development through its status as a law of the State Council and its unified regime for domestic and foreign franchisors.

The development of China’s regulatory regime for franchising from the 1997 *Interim Measures* to the 2007 *Regulation* is summarized in the following table:
<table>
<thead>
<tr>
<th></th>
<th>1997 Franchise Measures</th>
<th>2005 Franchise Measures</th>
<th>2007 Franchise Regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Purpose</strong></td>
<td>• standardise franchise operations</td>
<td>• standardise franchise operations</td>
<td>• regulate commercial franchises</td>
</tr>
<tr>
<td></td>
<td>• protect legal rights and interests</td>
<td>• protect legal rights and interests</td>
<td>• promote healthy and orderly development of franchising</td>
</tr>
<tr>
<td></td>
<td>and parties</td>
<td>and parties</td>
<td>• maintain market order</td>
</tr>
<tr>
<td></td>
<td>• promote growth of chain business</td>
<td>• promote growth of chain business</td>
<td></td>
</tr>
<tr>
<td><strong>Legislative Authority</strong></td>
<td>Ministry of Internal Trade</td>
<td>Ministry of Commerce</td>
<td>State Council</td>
</tr>
<tr>
<td><strong>Application</strong></td>
<td>Domestic invested only</td>
<td>Domestic and foreign invested enterprises</td>
<td>Domestic and foreign invested enterprises</td>
</tr>
<tr>
<td></td>
<td></td>
<td>but with special requirements for FIEs</td>
<td></td>
</tr>
<tr>
<td><strong>Definition</strong></td>
<td>• the use of the trademark, business name,</td>
<td>• the use of business operating resources</td>
<td>• use of registered trademark, enterprise mark, patent, know-how or any other business resource;</td>
</tr>
<tr>
<td></td>
<td>products, patent right, proprietary technology,</td>
<td>including trademarks, trade names, operational models etc, which</td>
<td>• conduct of business operations under the uniform business model as stipulated by the contract;</td>
</tr>
<tr>
<td></td>
<td>or mode of management, etc. owned by the</td>
<td>the franchisor has the right to grant others</td>
<td>• payment of fees</td>
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<tr>
<td></td>
<td>franchisor;</td>
<td>to use;</td>
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<tr>
<td></td>
<td>• acting in accordance with the provisions</td>
<td>• operation under the uniform franchise</td>
<td></td>
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<tr>
<td></td>
<td>of the contract and the uniform mode of</td>
<td>system;</td>
<td></td>
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<tr>
<td></td>
<td>business of the franchisor;</td>
<td>• payment of fees</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• payment of fees</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Master/area franchising</strong></td>
<td>Master franchising and area development</td>
<td>Master franchising and area development</td>
<td>Not referred to</td>
</tr>
<tr>
<td></td>
<td>defined</td>
<td>acknowledged</td>
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</tbody>
</table>

Table 8: Comparison of Franchise Regulations
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<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td>• legal person;</td>
<td>• registered business</td>
<td>• registered business with mature business model;</td>
</tr>
<tr>
<td></td>
<td>• more than one year's operation;</td>
<td>• right to licence business resources &amp; IP</td>
<td>• the ability to provide long-term support and service;</td>
</tr>
<tr>
<td></td>
<td>• registered trademark and other businesses resources;</td>
<td>• ability to provide goods and services</td>
<td>• 2 stores operation for 1 year</td>
</tr>
<tr>
<td></td>
<td>• ability to provide ongoing support</td>
<td>• trademark etc, supply system, capacity to supply long-term support</td>
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<td></td>
<td></td>
<td>• good reputation;</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>• 2 stores operation in China for 1 year</td>
<td></td>
</tr>
<tr>
<td>Rights of franchisor</td>
<td>• to supervise the operating activities of the franchisee in order to ensure uniformity</td>
<td>• to supervise the franchisees operations in accordance with the franchise agreement</td>
<td>Not specified</td>
</tr>
<tr>
<td></td>
<td>of the franchise system and consistency of product and service quality;</td>
<td>so as to ensure the Uniformity of the franchise system, as well as the consistency of</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• to collect royalties and service charges from the franchisee;</td>
<td>the quality of the products and services;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• to terminate if the franchisee violated the franchise contract,</td>
<td>• to terminate the franchise in accordance with the franchise agreement for breach of</td>
<td></td>
</tr>
<tr>
<td></td>
<td>infringes upon the lawful rights and interests of the franchiser or undermines the</td>
<td>contract, infringing the legitimate rights and interests of the franchisor, or damages</td>
<td></td>
</tr>
<tr>
<td></td>
<td>franchise system.</td>
<td>caused by the franchisee to the franchise system;</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>• to collect franchise fees and deposit;</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• other rights pursuant to the franchise agreement.</td>
<td></td>
</tr>
<tr>
<td>Obligations of franchisor</td>
<td>1997 Franchise Measures</td>
<td>2005 Franchise Measures</td>
<td>2007 Franchise Regulation</td>
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<tr>
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</tr>
<tr>
<td></td>
<td>• grant right to use business symbols and operations manual;</td>
<td>• disclose information;</td>
<td>• provide operations manual, training and service;</td>
</tr>
<tr>
<td></td>
<td>• provide training, management guidance and long-term service;</td>
<td>• grant the franchise right and provide business symbols and operation manual;</td>
<td>• use the advertising levy according to contract and report to franchisee;</td>
</tr>
<tr>
<td></td>
<td>• prior opening assistance</td>
<td>• provide training and service;</td>
<td>• quality and standard of products and services franchise system complies with relevant laws</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• supply goods specified in contract</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>• joint and several liability with designated suppliers</td>
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<td></td>
<td></td>
<td>• promote and advertise according to the agreement;</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>• other obligations under contract</td>
<td></td>
</tr>
<tr>
<td>Rights of franchisee</td>
<td>• exercise contract rights;</td>
<td>• use the franchisor’s trademark and other business resources;</td>
<td>Not specified</td>
</tr>
<tr>
<td></td>
<td>• acquire the operational technology and trade secrets from franchisor;</td>
<td>• receive training, goods (as agreed in contract); support for promotion;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• receive training and guidance</td>
<td>• other rights specified in the contract</td>
<td></td>
</tr>
<tr>
<td>Obligations of franchisee</td>
<td>• conduct business in compliance with contract standards;</td>
<td>• comply with contract and pay fees and deposits;</td>
<td>No transfer without franchisor’s consent</td>
</tr>
<tr>
<td></td>
<td>• pay fees;</td>
<td>• protect the uniformity of the franchise system;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• uphold the reputation and image of the franchise system;</td>
<td>• not to transfer without franchisor’s permission;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• accept guidance and supervision</td>
<td>• report operational and financial status to franchisor;</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• accept guidance and supervision;</td>
<td></td>
</tr>
<tr>
<td><strong>Mandatory Content of Franchise Contract</strong></td>
<td><strong>1997 Franchise Measures</strong></td>
<td><strong>2005 Franchise Measures</strong></td>
<td><strong>2007 Franchise Regulation</strong></td>
</tr>
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<td>------------------------------------------</td>
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<td>-------------------------------</td>
</tr>
<tr>
<td></td>
<td>scope, term and territory;</td>
<td>basic information of parties;</td>
<td>basic information of the parties;</td>
</tr>
<tr>
<td></td>
<td>rights and duties of both parties;</td>
<td>scope, term and territory permitted;</td>
<td>content and duration of the franchise;</td>
</tr>
<tr>
<td></td>
<td>training and guidance;</td>
<td>type, amount payment method of the franchisee fee, and the collection of refund of the deposit;</td>
<td>type, amount and payment method for the franchising fees;</td>
</tr>
<tr>
<td></td>
<td>fees and method of payment;</td>
<td>confidentiality clause;</td>
<td>content and methods for providing business guidance, technical support, business training and other services;</td>
</tr>
<tr>
<td></td>
<td>confidentiality clause;</td>
<td>quality control;</td>
<td>quality, standards for the product or service and guaranty measures;</td>
</tr>
<tr>
<td></td>
<td>liability for breach of contract;</td>
<td>training and guidance;</td>
<td>promotion, advertising and publicity;</td>
</tr>
<tr>
<td></td>
<td>term, modification, renewal, termination of the contract and dispute resolutions</td>
<td>use of trade names, trade marks and other IPs;</td>
<td>protection of consumers' rights and interests and the assumption of compensation liabilities in the franchise;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>consumer complaints;</td>
<td>amendment, rescission and termination of the franchise contract;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>promotion and advertising;</td>
<td>liability for breach of the contract;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>amendment and termination of franchise agreement;</td>
<td>dispute resolution methods</td>
</tr>
<tr>
<td></td>
<td></td>
<td>liabilities on breach;</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>dispute resolution</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Term of contract</strong></th>
<th><strong>1997 Franchise Measures</strong></th>
<th><strong>2005 Franchise Measures</strong></th>
<th><strong>2007 Franchise Regulation</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Not specified</td>
<td>Not less than 3 years</td>
<td>Not less than 3 years unless franchisee agrees</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Prior disclosure</strong></th>
<th><strong>1997 Franchise Measures</strong></th>
<th><strong>2005 Franchise Measures</strong></th>
<th><strong>2007 Franchise Regulation</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>10 days before signing</td>
<td>20 days before signing; with model contract</td>
<td>30 days before signing; with model contract</td>
<td></td>
</tr>
<tr>
<td>Prior disclosure format</td>
<td>1997 Franchise Measures</td>
<td>2005 Franchise Measures</td>
<td>2007 Franchise Regulation</td>
</tr>
<tr>
<td>-------------------------</td>
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<td>---------------------------</td>
</tr>
</tbody>
</table>
| Mandatory content of prior disclosure | • name and basic facts of franchisor’s enterprise, business performance, business circumstances of franchisees;  
• investment budget;  
• methods for collection of royalties and various charges  
• terms and restrictions for supply of articles and goods | • basic information of the franchisor, years engaged in franchising, content of financial statement and taxation status;  
• information on existing franchisees and the proportion of the franchisees who have terminated agreements;  
• information on trademarks and business resources;  
• litigation in the last five years;  
• type of goods and services supplied to franchisee and conditions and restrictions;  
• proof of capacity to provide the franchisee with guidance and training;  
• whether franchisor’s legal representative and other principal officers have criminal record or personal liability in relation to the bankruptcy of companies | • basic information of the franchisor and in respect of the franchised operations;  
• the basic information re IP and business model of the franchisor;  
• type, amount of franchising fees and payment method;  
• prices and requirements for providing the franchisee with products, services and equipment;  
• specific content of business guidance, technical support, business training and other services to be continuously provided to the franchisee as well as the method of providing and implementing;  
• guidance and supervision of the business activities of the franchisee;  
• investment budget for the franchise outlet;  
• quantity, distribution and business evaluation of franchisees currently existing within the territory of China;  
• financial statements and audit reports for the last two years;  
• franchise-related lawsuits and arbitrations for the last five years; whether franchisor or its legal representative have any record of illegal business operations; |
<table>
<thead>
<tr>
<th></th>
<th>1997 Franchise Measures</th>
<th>2005 Franchise Measures</th>
<th>2007 Franchise Regulation</th>
</tr>
</thead>
</table>
| Franchise disclosure                  | Not specified           | • initial information about business capabilities;  
|                                      |                         | • continuing information re operational results if required by contract |
|                                      |                         | Not specified           |
| General Standards Conduct            | Franchise operations to be conducted in accordance with principles of free will, fair dealing, honesty, good faith, standardisation | Franchise operations to be conducted in accordance with principles of free will, fair dealing, honesty, good faith | Franchise operations to be conducted in accordance with principles of free will, fair dealing, honesty, good faith |
| Other specific conduct/relationship issues | • franchisee shall not transfer the franchise to a third person without the consent of the franchisor  
|                                      | • franchisee shall keep franchisor's trade secrets | • franchisor shall disclose expenses for promotion and marketing to franchisees;  
|                                      |                                     | • franchisee is prohibited from revealing or permitting other persons to access the franchisors' "commercial secrets"  
|                                      |                                     | • franchisee shall not transfer the franchise to a third person without the consent of the franchisor |
| Cooling off period                   | No                       | No                      | Within time specified in contract |
| Approval / registration / filing      | Voluntary filing with CCFA | Prior approval required for foreign franchisor before engaging in franchise.  
|                                      |                         | Mandatory annual filing of information re franchise contracts signed in previous year by both foreign and domestic franchisors | • mandatory filing within 15 days after first franchise contract on provision of prescribed format information  
|                                      |                         |                         | • copy of the business license or enterprise registration certificate  
|                                      |                         |                         | • model franchise contract  
<p>|                                      |                         |                         | • franchise operations manual |</p>
<table>
<thead>
<tr>
<th></th>
<th>1997 Franchise Measures</th>
<th>2005 Franchise Measures</th>
<th>2007 Franchise Regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Updating report</td>
<td>Not specified</td>
<td>Mandatory annual report of franchise contracts signed in previous year.</td>
<td>Annual report of franchise contracts signed in previous year.</td>
</tr>
<tr>
<td>IP protection</td>
<td>No special requirements</td>
<td>• maintain confidential prior, during and after the course of the contract; • cease use of franchisor's IP on termination of the contract</td>
<td>Maintain franchisor's trade secrets</td>
</tr>
<tr>
<td>Promotion and advertising</td>
<td>Not specified</td>
<td>Misleading or deceptive information prohibited</td>
<td>• misleading or deceptive information prohibited; • advertising not to contain information about franchisee • profits from their franchise activities</td>
</tr>
<tr>
<td>Administration</td>
<td>• MOIT: supervise and administer franchise activity; • CCFA: filing and formulating code of conduct to strengthen self-discipline</td>
<td>• MOFCOM and its local offices: supervise and administer franchise activity; • CCFA and other industry associations: formulate code of conduct and strengthen self-discipline</td>
<td>• MOFCOM and its local offices: supervise and administer franchise activity; • CCFA and other industry associations: formulate code of conduct and strengthen self-discipline</td>
</tr>
<tr>
<td>Administrative Sanctions</td>
<td>Not specified</td>
<td>Administrative punishment for franchisor &amp; franchisee not meeting qualifications and disclosure requirements and for misleading advertising</td>
<td>• administrative punishment for franchisor not meeting the qualification • disclosure, filing, updating requirements • liability of administrative officials abusing power</td>
</tr>
</tbody>
</table>
This section provides a critical assessment of the 2007 Franchise Regulation as a regulatory instrument for franchising in China. Issues which relate specifically to foreign franchisors are separately addressed at 7.6.

Although over 30 countries or regions have dedicated and specific franchise regulations or laws, in most cases the regulation is 'minimalist' and unsophisticated and far removed from a comprehensive 'code' of conduct for franchising. Of the 13 Asia-Pacific nations/regions with franchise specific regulation only five of the regulatory schemes can be regarded as comprehensive. China's 2007 Franchise Regulation is a comprehensive regulatory instrument and a significant development in the regulation for franchising in China. It is an authoritative law at the State Council level and subjects both domestic and foreign invested franchisors to a uniform regulatory regime. The Regulation is formulated with the aims of 'regulating commercial franchising activities, promoting the healthy and orderly development of commercial franchising and safeguarding market order' (Article 1). It prescribes a comprehensive prior disclosure regime and a "light touch" registration system. It enshrines a general principle of good faith, specifies terms of franchise contacts and addresses other specific relationship obligations. Contemporaneous Government commentary noted that it was based on international experience tempered by China's circumstances and that it balanced freedom of contact with the need for administrative guidance for the healthy development of the sector.

Foreign franchisors have welcomed the 2007 Franchise Regulation which has relaxed '2+1' requirement, and substituted a registration regime for the former approval regime (discussed further at 7.6.5 below). It also prescribes a more

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100 See discussion in Andrew Terry, op cit note 5.
102 Australia, China, Indonesia, Japan, Kazakhstan, Korea, Kyrgyzstan, Macau SAR, Malaysia, Russia, Saudi Arabia, Taiwan and Vietnam. Andrew Terry, op cit note 5.
103 As discussed in Chapter 7.4 above.
comprehensive disclosure requirement, and removed the potential liability of a franchisor for the quality of the goods provided by designated suppliers, which was an unpopular provision in the 2005 *Franchise Measures*. There are nevertheless some residual problems with the 2007 *Franchise Regulation*.

**definition**

A "franchise" is defined by the 2007 *Franchise Regulation* in descriptive terms without listing situations when a business expansion should be considered as franchise and thus governed by the *Regulation*. To avoid the disclosure and registration requirement, some enterprises in China claim they are not franchising but licensing in order to avoid complying with the requirements of the 2007 *Franchise Regulation*. The lack of sophistication in the drafting of the 2007 *Franchise Regulation* has led to uncertainty in interpretation and application. It has been suggested by the representative of MOFCOM that whether a contract is a franchise contract should not be decided by the title of the contract, but rather by the contents. However, no guideline has been laid down. Indeed, a number of companies which prior to the 2005 claimed to be franchising companies now claim to be simply licensors. Kodak, for example, grew its ‘Kodak Express’ chain through franchising and its then legal consultant, Xiaogang Ma, become a member of the Legal Advisory Committee of the CCFA. Kodak now no longer promotes its business as franchising, and has not registered with MOFCOM.

The definition of ‘franchise’ is of course a major issue in any regulation scheme for franchising. There is no satisfactory definition of franchise universally accepted and

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105 As discussed at Chapter 7.5.2 below.

106 Yin Hong, online live blog of a meeting hosted by Beijing Chaoyang District Court on discussion on issues in relation to litigation on franchising. Published on the China Court Online, can be accessed at:

107 Kodak’s franchising was well known in China. See generally Michele Lee op cit note 65.
there is a large body of commentary on what should be, or has been, considered a franchise. The 2007 Franchise Regulation nevertheless conforms to common international precedents in incorporating elements of distinguishing marks, system and payment.

A definition drafted in the wide descriptive terms of Article 3 of the 2007 Franchise Regulation nevertheless leads to problems of interpretations and application to particular circumstances. Australia’s experience can again be used by way of example. Clause 4 of the Franchising Code of Conduct incorporates the same elements, albeit in significantly more detail, but also clarifies the status of certain relationships by expressly providing that they are, or are not, franchising agreement for the purpose of the Code:

4. Meaning of franchise agreement
(1) A franchise agreement is an agreement:

(a) that takes the form, in whole or part, of any of the following
   (i) a written agreement;
   (ii) an oral agreement;
   (iii) an implied agreement; and

(b) in which a person (the franchisor) grants to another person (the franchisee) the right to carry on the business of offering, supplying or distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor; and

(c) under which the operation of the business will be substantially or

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materially associated with a trade mark, advertising or a commercial symbol:

(i) owned, used or licensed by the franchisor or an associate of the franchisor; or

(ii) specified by the franchisor or an associate of the franchisor; and

(d) under which, before starting business or continuing the business, the franchisee must pay or agree to pay to the franchisor or an associate of the franchisor an amount including, for example;

(i) an initial capital investment fee; or

(ii) a payment for goods or services; or

(iii) a fee based on a percentage of gross or net income whether or not called a royalty or franchise service fee; or

(iv) a training fee or training school fee;

1. but excluding:

(v) payment for goods and services at or below their usual wholesale price; or

(vi) repayment by the franchisee of a loan from the franchisor; or

(vii) payment of the usual wholesale price for goods taken on consignment; or

(viii) payment of market value for purchase or lease of real property, fixtures, equipment or supplies needed to start business or to continue business under the franchise agreement.

(2) For subclause (1), each of the following is taken to be a franchise agreement:

(a) transfer, renewal or extension of a franchise agreement;

(b) a motor vehicle dealership agreement.

(3) However, any of the following does not in itself constitute a franchise agreement:

(a) an employer and employee relationship;

(b) a partnership relationship;

(c) a landlord and tenant relationship;

(d) a mortgagor and mortgagee relationship;

(e) a lender and borrower relationship;

(f) the relationship between the members of a cooperative that is registered, incorporated or formed under any of the following laws:

(i) Co-operatives Act 1992 of New South Wales;

(ii) Co-operatives Act 1996 of Victoria;

(iii) Cooperatives Act 1997 of Queensland;

(iv) Co-operatives and Provident Societies Act 1903 of Western Australia;

(v) Co-operatives Act 1997 of South Australia;

(vi) Co-operatives Industrial Societies Act 1928 of Tasmania;

(vii) Co-operatives Societies Act 1939 of the Australian Capital
Despite the fact that in the Australian drafting the definition is more specific than in China, issues continue to arise in relating to whether licensing and distribution arrangements constitute a ‘franchise agreement’ under the Code.\(^\text{109}\)

It can be argued that the key for defining franchising is the recognition that the franchise’s investment is largely dependent on the actions of the franchisor. The uncertainty in the application of both the Australian and the Chinese definition would be greatly minimized if the definition was drafted in terms recognising the franchisee’s dependence on the franchisor and the franchisor’s control over the franchisee.\(^\text{110}\) Indeed in determining that there was no a case for franchise specific regulation of this time, the New Zealand government expressly referred to the difficulty defining ‘franchise’ as one of the factors leading to this conclusion.\(^\text{111}\)

**qualifications for franchising: the ‘2+1’ requirement**

The 2007 *Franchise Regulation* requires franchisors to have a mature business model, the ability to provide long term business guidance, technical support, business training and in particular to have operated two direct owned stores (‘2 + 1’ requirement) in the business to be franchised for more than one year (Article 7). The ‘2 + 1’ requirement has been criticised by both domestic and foreign franchisors. This requirement was presumably intended to stop inexperienced businesses trading off the reputation of franchising. However, neither the 2007 *Franchise Regulation* nor the 2007 *Franchise Registration Measures* have clarified whether directly operated stores owned by affiliates, which is not an uncommon practice, satisfy the

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\(^{109}\) See for example *ACCC v Kyloe Pty Ltd [2007]* FCA 522; *Capital Networks Pty Ltd v .au Domain Administration Ltd* [2004] FCA 808.


‘2 + 1’ requirement.

Furthermore, the ‘2 + 1’ requirement has been applied inconsistently by the courts. The Beijing Chaoyang District Court cited Article 7 (the ‘2 + 1’ requirement) of the 2007 Franchise Regulation in ruling a franchise agreement was null and void in *Wang Jing v. Beijing Sunlight Ruili Beauty Co. Ltd.* It stated that:

According to the Franchise Regulation, ‘to be engaged in franchising a franchisor shall have a mature business model, and shall be able to provide franchisees with continuous operational guidance, technical support, training and other services. For a franchisor to be engaged in franchising it must have at least 2 directly-operated company-owned stores and have operated them for at least 1 year.’ This provision is a mandatory qualification for a franchisor engaging in the franchising activity. A contract is void if the franchisor violated this requirement. In this case, Sunlight Ruili has franchised without any direct own and operated stores and has therefore violated the mandatory requirement. Thus, the contract between Sunlight Ruili and Wang Jing is void.

However, Beijing No. 1 Intermediate Court ruled in *Liu Yongxing v. Talent Cat (Beijing) International Brand Management Consultants Co., Ltd.:

The provisions of Article 7 of the Franchise Regulation on eligibility requirements for franchisors are administrative guidelines and not mandatory provisions, and thus a violation does not lead to the legal consequence that the contract is null and void.

The contradictory interpretations of the ‘2+1’ requirement have been noted by judges, scholars, lawyers, franchisors and franchisees. There are opposing views. One view is that it is only an administrative provision, the breach of which will lead to

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113 Ibid. Translated by author.

imposition of administrative penalties (fines) on the franchisor, but which will not invalidate the contract. The other view maintains that it is a substantive requirement which, if not met, invalidates the franchise agreement. To address issues arising in relation to the interpretation and application of the Franchise Regulation, a joint meeting attended by judges of several Beijing courts, a representative of MOFCOM, the Secretary General of the CCFA, a university professor, a lawyer, a franchise consultant and others, was held to discuss the different views. No consensus was reached at the meeting. Indeed a third interpretation was put forward. Liu Jixiang of the Beijing Higher People's Court suggested that the first part of Article 7, which requires a mature business model, is mandatory, but that the second paragraph containing the '2+1' requirement is merely an administrative guide. Although this meeting did not resolve the issue, the fact that the discussion was uploaded on a live blog is a welcome example of openness and transparency which will facilitate the government’s decision making. Furthermore, the representative of the MOFCOM suggested that relaxation of '2+1' requirement by including '2+1' by affiliates of franchisors is currently under consideration by the MOFCOM.

registration/filing system

The current registration/filing system (discussed in chapter 7.4.8) has been criticised by franchisors and scholars in China for its complexity. Article 3 of the Registration Measures provides that:

Where a franchisor engages in commercial franchise operations

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115 Paul Jones, unpublished newsletter of Johnes & Co distributed through email.
116 The meeting was held by Chaoyang District Court on 24 April 2009 in Beijing. It is available on live blog on China Court Online, which can be accessed at: http://www.chinacourt.org/zhibo/member/index.php?member_id=1000&zhibo_id=1097&domain=bigy.chinacourt.org, last accessed on 10 August 2009.
117 Ibid.
118 Hong Yin, op cit note 116.
119 The current registration system applies equally to both domestic and foreign invested franchise enterprises. The burden that registration system imposes on franchising enterprises is not an issue for major franchising enterprises, thus has not been criticised from foreign franchisors. For discussion on practical issues in China’s franchise registration/filing system for small franchising enterprises, see Jun Yao, 'Regulate Regulation: A study on Franchise Filing in China' (Paper presented at the 2nd China Global Franchise Summit, 9 November 2008, Zhuhai, Guangdong, China).
within the territorial scope of a province, autonomous region or municipality directly under the central government, the franchisor shall register with the Commerce Department of the respective province, autonomous region or municipality directly under the central government where it is located. Where a franchisor engages in commercial franchise operations across the territorial boundaries of a province, autonomous region or municipality under the central government, the franchisor shall register with the Commerce Department of the State Council.\footnote{Current Commerce Department of the State Council is the Ministry of Commerce ("MOFCOM"). See op cit note 73.}

Article 3 does not clarify whether a franchisor who expands operations to a second province must register both with the provincial commerce department as well as with MOFCOM. Two levels of registration increase the administrative burden on franchisors and are inconsistent given China’s unitary system of government and unnecessary given that the information is available on the same website.\footnote{Article 3 of the Franchise Registration Measures provides: “A national network shall be used for commercial franchise registrations. Franchisors who meet the requirements of the provisions of the Franchise Registration Measures shall register through the government website (www.mofcom.gov.cn)".}

The 2007 Registration Measures introduced electronic registration/filing through online submission. Online submission of the 12 catalogues of information has been divided into two parts: online filing and PDF format attachments. The online filing system is no doubt efficient for the government. But the absence of an alternative filing system, - and the need to convert paper documentation to PDF format – imposes a burden on franchisors, and particularly franchisors in relatively undeveloped areas. The complexity of online submission and the extensive information required mean that many franchisors have to pay consultants or the CCFA to help with their registration.\footnote{Most franchisors submit the registration through the CCFA.} Furthermore, the Registration Measures impose not only a annual updating obligation on the franchisor (Article 7), but also require the franchisor to update changes in relation to the information listed in the 12 catalogues in the Registration Measures within 30 days. The 12 catalogues include information such as the location of all of the franchisee stores within China,
marketing plan, table of contexts of the franchise operations manual (with the number of pages of each chapter etc)\textsuperscript{123} which are of importance to management, but not to administrative officials. Although the information required for registration is extensive, and in some cases, commercially sensitive,\textsuperscript{124} the information available online for public access is very basic.\textsuperscript{125} Domestic franchisors and scholars have expressed their concern that the compliance cost imposed by the Measures may slow the development of the growing franchise sector.\textsuperscript{126} On the other hand the move to a registration requirement is less burdensome than the previous approval system and is for this reason generally welcomed in the Western world.\textsuperscript{127} Ironically, the burdens of compliance fall more heavily on domestic franchisors, particularly those smaller enterprises in remote areas, than on foreign franchisors.

\textbf{Other}

The 2007 Franchise Regulation and its implementation Measures have removed the provisions of the 2005 Franchise Measures which prescribed various rights of franchisors and obligations of franchisees (as shown in the table above).\textsuperscript{128} These provisions in 2005 Franchise Measures were very general and invariably set out nothing different from the provisions that are commonly included in franchise contracts and were protected under contract law.\textsuperscript{129} The omission of those provisions in the 2007 Franchise Regulation may be interpreted as respect for freedom of contract (as suggested by the government commentary noted at 7.4.1). However, the Regulation nevertheless also serves a important role in educating the general public,

\begin{itemize}
\item \textsuperscript{123} Article 5, Franchise Registration Measures.
\item \textsuperscript{124} Such as marketing plan, take of content of franchise operation manual, required by Article 5 of Franchise Registration Measures.
\item \textsuperscript{125} Article 11 of the Franchise Registration Measures prescribed four types of information available online.
\item \textsuperscript{126} Jun Yao, opcitnote 119.
\item \textsuperscript{127} See for example, comments made by Janet Jie Tang, a partner in the Beijing office of international law firm, DLA Pipe, ‘Beijing makes red tape less of a burden for foreign franchisers’, Finical Times, 6 June 2007.
\item \textsuperscript{128} One of franchisee’s obligations, no transfer without franchisors’ consent, remains in the 2007 Franchise Regulation (Article18), but other obligation such as protect the uniformity of the franchise system, report operational and finical status to franchisor etc. was moved.
\item \textsuperscript{129} For discussion of relationship of the Franchise Regulation and other civil and commercial law, see Paul Jones, op cit not 80.
\end{itemize}
and the removal of those provisions, and the introduction of more detailed provisions imposing in relation to, *inter alia*, disclosure, registration, and advertising may have a negative effect through misleading the general public to believe that all problems arising in franchising are the fault of franchisors. Indeed in China, unethical practices by franchisees have not been uncommon in the past. From January 2005 to May 2006, 14 out of the 47 cases relating to franchising which went to trial in the Beijing Haidian District Court were related to non-compliance with a system standard by the franchisee.

The imperfect drafting and ambiguity which commonly exist in legal drafting in China can also be found in the *Franchise Regulation*. Article 13 states that: “The franchise agreement shall have a minimum term of three years. But it may be shorter if the franchisee agrees”. The purpose and legal effect of this provision are unclear.

**General assessment**

While criticisms may be made of particular aspects of China’s 2007 *Franchise Regulation* there is no criticism of the concept of regulation itself. While in some, and even perhaps most, national franchise sectors regulation may be regarded as an unwelcome, albeit increasingly common, intrusion into the free enterprise system, in China the introduction of a franchise law was a significant and necessary step. Philip Zeidman has commented that, “in the final analysis, it may well be that the sheer act of regulation – and, in the process, the recognition of franchising, the stripping away of its ‘second class’ status – is more important than the contents themselves”.


Philip Zeidman, “New Franchising Regulations Go into Effect in China” (March 2005) *Franchising World* 40. These comments were made in relation to the 2005 *Franchise Measures* but are applicable to 1997 *Interim Franchise Measures.*
Franchise Measures – at both government and industry level – that there was a need for a more comprehensive regulatory framework for franchising. The President of McDonald’s Chinese operations stated in 2002 that “McDonald’s will begin franchising only after relevant regulations and laws are defined in China.” With the introduction of the new 2007 State Council Franchise Regulation, the regulatory process which began a decade earlier has progressed significantly, but the contribution of the rudimentary 1997 Measures to the development of a strong franchise sector should not be underestimated.

Although it was true, and is possibly still true today, that China is a country where business activity is generally prohibited unless it is expressly authorised, the Chinese government, at least at the central level, has recognised that there were foreign invested enterprises engaging in franchise before introduction of the 2004 Commercial FIE Measures and the 2005 Franchise Measures, which expressly authorised the practice of franchising. The 2005 Franchise Measures provided that such foreign franchisors already engaging in franchising could continue franchising by filing with the original approval authority. That suggests that the Government understood that there were foreign franchisors who had expanded their business through franchising in China without the approval required by law and retrospectively authorised such operation.

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133 Peter Tan, President of McDonald’s China Development Co, cited in Dai Yan, ‘International Chain of Firms to Expand: McDonald’s Mulls over Franchise System after KFC’, China Daily, 8 July 2002.

134 The Regulation on the Administration of Commercial Franchises (the 2007 Franchise Regulation) was issued by the State Council of the People’s Republic of China on 6 February 2007, took effect on 1 May 2007.

135 The restriction on a foreign company engaging in franchising activity was the key to the decision in Han MeiYan v. Beijing Yinqi Bayi Yinqi Jianmei Limited, as discussed in 7.6.5 below.

136 The comments made by the ACBC on the 2005 Franchise Measures that “Franchisors such as McDonald’s will be subject to more rigorous laws under the new measures” was a misunderstanding of Chinese legal system. For the comments by the ACBC, see ‘New Franchise Measures’ in (February/March 2005) Australia China Connections 38.

137 Article 36, 2005 Franchise Measures.
7.6 THE FOREIGN FRANCHISOR AND THE CURRENT REGULATORY REGIME

7.6.1 Liberalisation and Unification

Running parallel to the evolution of the regulatory regime for the operation of franchised business in China from the 1997 *Interim Measures* to the 2007 *Franchise Regulation* have been two closely related developments of great significance to foreign franchisors - the *liberalisation* of market entry for foreign franchisors and the *unification* of the regulatory regime for domestic and foreign franchisors. Both developments have been driven by WTO accession commitments and have made foreign franchising in China both legal and practicably possible.

*market liberalisation*

In addition to the normal legal, commercial and cultural issues which challenge any franchise system in international expansion, the foreign franchisor proposing to enter China has faced additional regulatory obstacles. Market entry, participation in particular business sectors and even the use of franchising as a method of business operation and expansion, have all raised complex regulatory issues. Given China's long period of isolation it is hardly surprising that the priority of China's massive economic reform program has been to "assist China in reaching its goals of economic and technical modernisation rather than to assist foreigners in exploiting the Chinese domestic consumer markets".\(^{138}\) China has had a restrictive and highly complex foreign investment regime and participation in certain sectors has been strictly controlled. The success of prominent international franchise brands in China is proof that the regulatory and bureaucratic challenges can be overcome. However, the operations of these companies in China have been primarily through a chain network of owned and managed outlets with a local joint venture partner rather than through conventional franchising. For the new wave of foreign franchisors, WTO

reforms have driven significant liberalisation of foreign investment making business entry into formerly closed sectors including franchising much more viable and feasible.

An internationally expanding franchise system has a range of alternative entry vehicles. In the case of China, foreign participation in franchising by way of direct foreign investment through the establishment of an approved legal entity (cooperative or contractual joint venture, equity joint venture or wholly foreign owned enterprise) is today routine. However, franchising in China without establishing a legal entity in China (through master franchising, regional franchising, area development agreement or direct franchising) has not been expressly legitimised. The history, development and legitimacy of the two broad alternative categories raise different issues and are discussed separately below at 7.6.5 and 7.6.6.

**unification of the regulatory regime for domestic and foreign franchisors**

Until recently, the administration of domestic invested companies and the administration of foreign invested enterprises were the responsibility of different ministries. The regulatory body which issued and administered the 1997 *Interim Franchise Measures*, the then Ministry of Internal Trade, was, as its name suggests, responsible for domestic companies and had no authority in relation to foreign enterprises. The application of the 1997 *Interim Franchise Measures* to foreign invested franchising companies was therefore uncertain. The establishment of the current Ministry of Commerce in March 2003, by the merging the Ministry of Internal Trade and the Ministry of Foreign Trade and Economic Cooperation, made a unified regulatory regime for both domestic and foreign franchisors feasible. This regime was imperfectly implemented in the 2005 *Franchise Measures* which subjected both domestic and foreign franchisors to a unified regime but which nevertheless imposed additional registration requirements on foreign franchisors.

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139 Foreign invested companies needed approval on case by case basis from the then Ministry of Foreign Trade and Economic Cooperation, as discussed in Chapter 6 and Chapter 7.3.2.

140 As discussed in Chapter 7.3.2.
The 2007 *Franchise Regulation* finally removed all discriminatory treatment and set up a unified regulatory regime.

7.6.2 Legal and Regulatory Issues for Foreign Franchisors

The 2007 *Franchise Regulation* provides a solid foundation for future franchising development through its status as a regulation of the State Council and its unified regime for domestic and foreign franchisors. Foreign franchisors have welcomed the removal of requirement in the previous *Measures* which made franchisors jointly and severally liable for the products and services provided by their designated suppliers and the adoption of a registration requirement in the nature of ‘filing’ rather than ‘approval’ (see Chapter 7.3). Comfort will also be taken from the express recognition of the freedom of contract[^141] and the protection of the trade secrets of the franchisor[^142]. Given its very long gestation period the 2007 *Franchise Regulation* is perhaps an anti-climax. This indeed may be one of its strengths. It contains no real surprises and is a refinement rather than a re-engineering of the previous regime. The broadness and generality of many of the provisions of the 2007 *Franchise Regulation* will remain a source of concern and frustration to franchisors, particularly foreign franchisors familiar with a more detailed regulatory scheme as is usual in common law jurisdictions, as will the influence of local levels of government bureaucracy and possibly inconsistent interpretations in applying the law. While these issues are to some extent inherent in the Chinese legal system[^143], it is debateable whether a decade of regulatory activity has resulted in an improvement in the law to the extent that Deng Xiaoping may have contemplated.

There are nevertheless two particular issues in relation to which an undesirable degree of uncertainty remains – the operation and implications of the ‘2+1’

[^141]: Article 4, *Franchise Regulation*.
[^142]: Article 18, *Franchise Regulation*.
requirement and the legal status of direct franchising into China by way of master franchising and area development arrangements. These are discussed below (at 7.6.2.5)

7.6.2.1 Jurisdiction

The 2007 Franchise Regulation applies to ‘commercial franchising activities conducted within the territory of the People’s Republic of China’. The concept of “conducted within” China is not defined and some uncertainty arises as to the particular activities that will bring franchising within the jurisdictional net. Franchising activities conducted within China can be interpreted as applying to contracts negotiated and signed in China, or to franchised stores located in China. The problem arises when one party is not a Chinese enterprise and the direct or master franchise contract is signed outside China. This will arise when a Chinese franchisor contracts with a non-Chinese franchisee for stores located outside China; when a non-Chinese franchisor contracts with Chinese franchisee (outside China) for stores located inside China; and when a Chinese franchisor contracts with a Chinese franchisee for stores outside China.¹⁴⁴

In some jurisdictions, the issue of the application of the regulatory instrument has been clarified. In Australia for example the Franchising Code of Conduct as originally prescribed expressly provided that the Code did not apply to a franchise agreement if the franchisor was: (i) resident, domiciled or incorporated, outside

¹⁴⁴ Similar ambiguity also exists in the US law in relation to whether federal and state registration laws apply to international transitions, despite clarification has been sorted in certain states and the interpretation by the court. In the Nieman v Derlcean USA Franchise Co 178 F3d 1126 (Cir 1999), the court ruled that the FTC Act does not authorize the extraterritorial application of the Amended Franchise Rule to pure outbound transaction (from a domestic franchisor to foreign citizens operating in a non-US jurisdiction to open stores outside the US). The Amended Franchise Rule ¶436.2 clarifies that it applies only to sales of franchises that are to be located in the United Sates. For further discussion, see Rochelle B. Spandorf and Mark B. Forseth ‘Franchise Registration’ in Andrew C. Selden (ed) , Fundamentals of Franchising (3rd 2008) 125 at 135 American Bar Association; California Corporations Code ¶31018 (b) Business Franchise Guide, CCH ¶3050.22; Rochelle B. Spandorf, ‘Circuit Checks FTC Disclosure rule at US Border’ (Summer 1999) 3 Franchise Law 1.
Australia and (ii) grants only one franchise or master franchise to be operated in Australia. The 2006 Review of the Disclosure Provisions of the Franchising Code of Conduct (the Matthews Report)\textsuperscript{145} nevertheless noted sector concerns to the effect that an Australian master franchisee acquiring franchising rights in Australia from a foreign franchisor was in a similarly vulnerable position to a domestic unit franchisee acquiring a franchise from an Australian franchisor and should be protected by, \textit{inter alia}, prior disclosure laws. This recommendation was accepted by the government and an amendment to the Franchising Code of Conduct, effective March 2008, removed the previous exemption. A foreign franchisor entering Australia by master franchising is today subject to the Franchising Code of Conduct.

If it is important to protect an Australian master franchisee who is in a vulnerable position due to information imbalance, it is equally important to protect a Chinese master franchisee. The position of master franchising, which is currently uncertain should be clarified. The ambiguity existing in the 2007 Franchise Regulation in relation to foreign franchisors is further discussed in chapter 7.6.

7.6.2.2 Registration

Although the 2005 Franchise Measures subjected both foreign invested franchising enterprises and domestic invested franchising enterprises to the same law, Chapter 7 of the Measures, entitled ‘\textit{Special provisions on foreign invested enterprises},’ subjected FIE franchisors to a special approval regime. Article 33 required submission of commercially sensitive information including prior disclosure documentation, contract format and operation manuals to the administrative authority for approval. The 2007 Franchise Regulation has been welcomed by the international franchise community as, for the first time, both domestic and foreign

invested franchisors are subject to the same law without differential treatment.\textsuperscript{146} The registration/filing/recording requirements are the same for both domestic invested and foreign invested franchisors.

7.6.2.3 The ‘2+1’ Requirement

The most widely criticised aspect of the 2005 Franchise Measures from a foreign franchisor’s perspective other than the special approval provision was, as noted at Chapter 7.3 the requirement that prior to franchising a franchisor must have operated two direct owned stores for at least one year in China (Article 7.4). This ‘two stores plus one year’ (‘2+1’’) requirement created an obstacle for experienced foreign franchisors seeking to expand in China. The ‘2+1’ requirement would not only slow down the expansion of foreign franchisors, but could also compel a franchisor to have company owned stores which may not be common strategy of that company. Some franchisors, such as Century 21 and many hotel franchisors, traditionally do not have company owned stores. The relaxation of the ‘2+1’ requirement in the 2007 Franchise Regulation which omits any reference to the outlets being in China has been welcomed. The 2007 Regulation nevertheless does not clarify whether the two outlets can be operated by the franchisor’s affiliates. While the Franchise Registration Measures (Article 5) clarify that overseas’ outlets satisfy the ‘2+1’ requirement, they do not clarify the issue of operation by affiliates. A representative of MOFCOM has suggested that to qualify stores operated through franchisor’s affiliates as franchisors owned and operated stores for the purpose of the ‘2+1’ requirement is currently under consideration.\textsuperscript{147}

\textsuperscript{146} Although the 2007 Franchise Regulation has no special provisions on FIEs, they remain subject to other laws including Equity Joint Venture Law, Co-operative Joint Venture Law and WFOE Law which include approval requirements.

\textsuperscript{147} Hong Yin, op cit note 116.
7.6.2.4 Market Entry through a Foreign Invested Vehicle

An integral element of China’s reopening was the legislative machinery to attract international investment. Foreign investment in China has been possible since 1979 through an equity joint venture, since 1986 through a wholly foreign owned enterprise and since 1988 through a contractual or co-operative joint venture. The laws governing these foreign investment vehicles have been revised at various stages to liberalise formerly restrictive requirements driven by the desire to attract further foreign investment as well as to satisfy WTO obligations.

The liberalisation of direct foreign investment did not of itself open the domestic franchise sector to foreign franchisors. Entry into specific industry sectors was regulated by the 1995 Provisions on Guiding Foreign Investment Direction and Catalogue for the Guidance of Foreign Investment Industries. Franchising as a way of business expansion was not mentioned in the 1995 and 1997 Catalogue for the Guidance of Foreign Investment Industries, but has been listed since 2002 in the Catalogue for the Guidance of Foreign Investment Industries as “restricted” under the heading ‘Wholesaling and Retailing Trade Industries’. Not being listed in the Catalogue for the Guidance of Foreign Investment Industries before 2002 certainly did not mean that franchising could be practiced in China. In China, the “business scope” has to be specified before approval of the business licence. Without a law and policy expressly legitimatising franchising, its practise was difficult if not impossible except in the Special Economic Zones established early in the ‘opening up’ era to encourage foreign trade and investment in a controlled manner, where foreign business was more liberally controlled. It was nevertheless in the nature of a developing legal and regulatory system replete with approval processes and bureaucratic discretion at local levels that there were exceptions to the general rules.

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148 As discussed in Chapter 6.2.
149 As discussed in Chapter 6.2.
150 Franchise remained in the ‘Restricted Catalogue’ under the heading ‘Wholesaling and Retailing Trade Industries’ in the late 2004 and 2007 Catalogue for the Guidance of Foreign Investment Industries.
Although foreign invested enterprises were generally liberalised under the 1999 *Measures for the Trial Establishment of Foreign Invested Commercial Enterprises*, they were expressly prohibited for engaging in franchising.  The restriction on a foreign company engaging in franchising activity was the key to the decision in *Han MeiYan v. Beijing Yingqi Bayi Yingqi Jianmei Limited*. The plaintiff franchisee entered into a franchise agreement with the defendant which had been incorporated in February 2003 as a wholly foreign-owned enterprise. When certain payments were not made, the franchisor terminated the contract for non-payment. The Chaoyang District People’s Court held that,

> According to the *Regulation on Guiding Foreign Investment Direction* 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.

Thus, the franchisor had traded illegally. The franchise agreement was held invalid with repayment of the money paid by the franchisee ordered.

Under the protocol governing its membership of the WTO in 2001 China agreed to open franchising to foreign franchisors in wholesale, retail, services and franchise sectors, with certain restrictions, by the end of 2004. Pursuant to these

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151 Article 6, 1999 *Measures for the Trial Establishment of Foreign Invested Commercial Enterprises*, as discussed in Chapter 6.


153 *Han MeiYan v Beijing Yingqi Bayi Yingqi Jianmei Limited*, Beijing Chaoyang District Court, (2005) Chaominchuzi No 5967. Translated by Paul Jones, see also discussion in Paul Jones, op cit note 80.

154 See discussion, Paul Jones, op cit note 80.

155 China’s WTO commitments to franchise operations included the removal of restrictions on geographical location, number, equity ratio and form of establishment for foreign investment by no later than 11 December 2004. *Part II - Schedule of Specific Commitment on Services, the*
commitments, in June 2004 the Measures for the Administration of Foreign Investment in Commercial Enterprises (2004 Commercial FIE Measures) which repealed the previous Measures, came into effect. The 2004 Commercial FIE Measures remove many of the restrictive requirements for establishing commercial foreign investment enterprises. Although franchising remains, surprisingly, in the Catalogue of Restricted Foreign Investment Industries the practical effect of the Commercial FIE Measures is to legitimise participation in the franchise sector for FIEs by joint ventures from 1 June 2004 and by WFOEs from 11 December 2004.

The 2004 Commercial FIE Measures, which took effect on 1 June 2004, opened foreign investment in retail and franchising operations to foreign companies, enterprises and other economic organisations and individuals engaging in these activities through a foreign investment enterprise in China. Such operations must be through a “commercial enterprise with foreign investment” (a commercial FIE) – either a Sino-foreign equity or co-operative joint venture or, from 11 December 2004, a wholly foreign owned enterprise (Articles 1-3, 21). No other structure for foreign investment in the retailing and franchise sectors is permitted (Articles 19, 24).

A commercial FIE can itself franchise or may “authorise others to establish outlets by franchising” (Article 9) and in the latter case must comply with any separate state regulation on franchising (Article 19).

As a result of the 2004 Commercial FIE Measures participation in the franchise sector through a joint venture or WFOE is officially sanctioned. The structure adopted can be determined having regard to commercial considerations; most

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156 The current Catalogue of Restricted Foreign Investment Industries which took effect on 1 January 2005 does not change the “restricted” category of franchising in relation to wholesale and retail trade industries.

157 The Commercial FIE Measures also liberalise, in the same manner, commission agency services and wholesale operations.

158 The restriction on a foreign company engaging in franchising activity before the time indicated was the key to the decision in Han Mei Yan v. Beijing Yingyi Baiyi Yingyi Jianmei Limited as discussed above, op cit note 152.

159 “Franchising” is defined as the “grant of authority pursuant to contract for the use of a trademark, trade name, or business method etc in exchange for remuneration or franchising fees” (Article 3).
notably the advantage of having a local partner without whom business operation in China is extremely difficult, but which advantage is balanced by the complexity of negotiations with a potential business partner and concerns about the possible loss of control in a venture with such a party. The franchisor entering China through a foreign invested vehicle has to choose between the advantage of having a local partner who does not necessarily understand western business and franchising norms in the case of a joint venture; or the disadvantage of no local partner but the corresponding advantage of control in the case of WFOE. The regulatory impediments are nevertheless removed and the bureaucratic requirements reduced.

Although the 2004 *Commercial FIE Measures* clarify the issue of franchise sector entry for foreign investors through commercial FIEs and open the previously restricted distribution sector, foreign franchisors still faced additional complications from the then specific franchising regulation. The 2005 *Franchise Measures* introduced two provisions of particular importance to FIE franchisors. Although the 2005 *Franchise Measures* applied equally to domestic and foreign franchisors in respect of the regulation of the franchising relationship, foreign franchisors were subject to an application and approval system which did not apply to domestic franchisors. This requirement was of doubtful validity under WTO commitments and has been deleted from the new 2007 *Commercial Franchise Regulation* which subjects domestic and FIE franchisors to a uniform registration and reporting protocol. The second initiative in the 2005 *Franchise Measures* of particular interest to FIE franchisors was the requirement that, prior to franchising, the franchisor, or its holding or subsidiary entity, had itself operated at least two stores in China for more than a year (Article 7(4)). The 2007 *Franchise Regulation* has changed this provision to a requirement that for a franchisor to be engaged in franchising they must have “at least two directly operated company owned outlets that have been carrying on business for more than one year” (Article 7). The removal of the reference to “China” in relation to the two stores allows the FIE franchisor to establish its credential on the basis of its home operations.
7.6.2.5 Market Entry without a Foreign Investment Vehicle: the Legal Status of Cross Border Franchising by way of Master Franchising and Area Development Agreements

Undoubtedly the greatest frustration with the 2007 Franchise Regulation is that the opportunity was not taken to authoritatively clarify the legal status of direct cross border franchising into China by way master franchising and area development arrangements. While the 2004 FIE Measures have clarified the validity of foreign franchising in China through a joint venture or wholly foreign owned enterprise, they do not address other arrangements commonly used for international expansion. One impediment to direct master franchising/area development - the former ‘2+1’ requirement - has been removed by the 2007 Regulation and the associated Registration and Disclosure Measures. But, the failure of the 2007 Regulation to address master franchising/area development leaves residual uncertainty as to their status. It will be unfortunate if foreign enterprise (without physical presence in China) franchisors have to continue to use a non-franchise ‘hybrid’ model - ‘multiple contracts separately covering individual core essential covering individual core essential elements of franchising, such as trade mark use licensing, backed by distribution contracts with quality control requirements'160 - which may be open to legal challenge because of uncertainty as to the status of cross border franchising.

The 2004 Commercial FIE Measures expressly legitimise franchising in China by a commercial FIE but not by offshore foreign franchisors. While entry into the Chinese franchise sector has been clarified for commercial FIE franchisors a residual uncertainty prevails in relation to the validity of franchising in China without a commercial FIE. Direct franchising and area development franchising remain in a regulatory void. The 2005 Commercial Franchise Measures did not address this issue and the 2007 Franchise Regulation is similarly silent. Under the 2005 Franchise Measures the “two stores – one year” requirement had the effect of

preventing any form of direct franchising into China from overseas because the two stores had to be in China. The 2007 Franchise Regulation removes the express requirement that the two stores be in China thus removing this requirement as a bar to direct franchising but by not specifically addressing the legitimacy of franchising in China without a commercial FIE the uncertainty remains. Given the significance of master franchising – internationally the most common method of international expansion – the failure of the 2007 Franchise Regulation to deal with it is unfortunate.

A foreign franchisor can of course grant sub-franchising rights to a joint venture or WFOE satisfying the FIE laws but master franchising to a wholly domestic Chinese enterprise is not covered, and may indeed be prohibited if, by granting a master or area development franchise in China, a foreign franchisor is engaging in franchise operations within China. If a master franchise agreement has, as is invariably the case, provisions relating to image and standards, operating systems, product quality control, location control, trademark use, opening assistance, in-country training and support, particularly if enforced by site inspections, it can be argued that the foreign franchisor is engaging in franchise operations in China which, if not through a commercial FIE, contravenes the 2004 Commercial FIE Measures.

Duvall and Zheng suggest that Article 3 of the 2004 Commercial FIE Measures (which provides that “foreign companies … or individuals shall carry on [franchising activities] through foreign investment enterprises established within China”) “should not be read in isolation, but rather in the context of the overall structure of the Measures, in particular Article 2 [which] provides that foreign investors setting up commercial FIEs inside China must comply with the Commercial FIE Measures”. It is arguable that the 2004 Commercial FIE Measures regulate only the establishment and operation of all commercial FIEs in

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China, but do not exclude cross border franchising. The contrary view is argued by Susan Lavender who, in relation to the 2005 Franchise Measures argued that the requirement that a franchisor must be “established in accordance with law” was influential and that the franchisor must be an enterprise established under Chinese law:

The FIE Measures which first recognised the legality of franchising a foreign Franchise Model in the PRC, stipulated that foreign franchising activities ... are to be conducted by a commercial FIE. Consistent with this approach the Measures, in turn, only speak of FIEs in relation to foreign franchising. The logical conclusion is therefore that a franchisor established under the laws of a foreign jurisdiction is not permitted to franchise directly its Franchise Model from its offshore jurisdiction to a PRC domestic franchisee. Instead it must be a direct foreign investor in the PRC in order to pursue franchising within the jurisdiction through its FIE. 162

The concern of the legality of direct offshore franchising in China was expressed by other scholars and practitioners. 163 Lavender nevertheless acknowledges that it would seem unlikely for the Ministry of Commerce to resort to wholesale invalidation of existing offshore franchising arrangements, considering the radical disruption of major prosperous large-scale business operations which this would represent164. Indeed, China’s WTO accession commitments in relation to franchising specifically acknowledge cross-border franchising which may influence a more liberal stance to cross-border franchising by the authorities.

Frequently in China commercial expediency provides a solution to regulatory uncertainty. Prior to the development of the current regulatory framework under the

162 Susan Lavender, op cit note 160 at 57.
163 Wulff and Xu, op cit note 64 at 20.
164 Lavender also opines on how the offshore foreign franchisor could be penalised for non compliance with the Measures. Being offshore it is outside the jurisdiction of the PRC. “It is a foreign ghost rather than a domestic legal entity that can be called to answer for non-conformity with legal requirements”. The penalties imposed by the Measures are only applicable to PRC-based entities, being fines (and only a maximum of RMB 30,000) or revocation of business licence. Royalty payments flowing from the PRC franchisee to the offshore franchisor would appear to be the only tangible aspect of the franchising arrangements that could be controlled.
2007 Commercial Franchise Regulation foreign franchisors have frequently entered China through a non-franchise model comprising “the sum of most of the parts ... instead of the synthetic whole”. Lavender describes these as: “multiple contracts separately covering individual core essential elements of franchising, such as trademark use licensing, backed by distribution contracts with quality control requirements [which] omit reference to the synthesised concept of licensing of an operating model as a whole, since this element most conclusively categories the contractual arrangements as franchising rather than various anomalous forms of licensing combined with distribution”. Such structures replicate the advantages of the franchise model through a series of agreements covering the various elements. If the legal uncertainty as to the validity of master franchising continues the “non-franchise” model may continue to be used. The legality of the non-franchise model is nevertheless a concern and as it leaves open the possibility of being judicially or administratively determined to amount in fact to franchising as defined.

The 2004 Commercial FIE Measures constitute the main case against the legitimacy of cross-border franchising but, as Ministry Measures, are subordinate to the State Council 2007 Regulation on Commercial Franchises which applies to all “commercial franchising operations conducted within the boundaries” of China and suggest no distinction between direct investment and cross-border franchising. China’s WTO accession commitments includes, in relation to franchising, the removal of restrictions on geographical location, number, equity ratio and form of establishments for foreign investment by no later than 11 December 2004 and the commitment to impose no limitations as market access in relation to cross-border supply. Support for the legitimacy of cross-border franchising is provided by China’s WTO accession commitments.

165 Lavender, op cit note 160.
166 Ibid.
167 Part II - Schedule of Specific Commitment on Services, the Report of the Working Party on the Accession of China (WT/ACC/CHN/49/Add.2), WTO, 1 October 2001.
168 The liberation regarding on geographical location, number, equity ratio and form of establishments for foreign investment has given effect to by the 2004 Commercial FIE Measures.
Consistent with this interpretation the Ministry of Commerce has indicated informally that cross-border franchising is permitted but foreign franchisors would derive comfort from legislative classification or authoritative pronouncement. China’s WTO commitments clearly indicate that direct franchising is permitted. However, given the significance of master franchising – internationally the most common method of international expansion – the failure of the 2007 Franchise Regulation to expressly allow master franchising/area development is unfortunate.

7.7 CHAPTER SUMMARY

In China, as in other countries, the law has had a significant role in improving the environment for franchising by prescribing a regulatory regime for its orderly development which accommodates the interests of both franchisors and franchisees. In China however the law has had a more fundamental role in creating the environment in which franchising was possible.

The 1997 Interim Franchise Measures were, as noted earlier, an important starting point. They were significant through communicating the Government’s support for the franchising concept and encouragement of its adoption. They were nevertheless rudimentary and to a large extent a “description” of franchising rather than a regulation of it. As a Ministerial rule they had low legal effect and in applying only to domestic franchisors, they had no application to foreign franchisors. That there was official recognition that the 1997 Measures were simply the starting point is expressly acknowledged in their title Interim Franchise Measures for Trial Implementation. The pressure for a more sophisticated regulatory regime was driven both by WTO accession commitments which demanded market liberalisation and a unified domestic and foreign regime as well as from the Ministry of Commerce and the franchise sector itself which recognised that a more professional and more

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comprehensive specific franchise regulation at the State Council level (as opposed to regulation by Measures which are simply Ministry rules) was an urgent priority for the orderly growth of the franchise sector.\textsuperscript{170}

The next regulatory development was nevertheless not the expected State Council Franchise Regulation but a draft \textit{Provisional Measures on the Administration of Foreign-Invested Enterprises Engaged in Commercial Franchising} released by the Ministry of Commerce in November 2004. The Draft Measures were presumably introduced to support the new liberalised regime for the participation of foreign invested enterprises in the commercial franchise sector under the 2004 Commercial FIE Measures: in order to meet WTO accession commitment obligations China was required to lift restrictions on foreign franchisors by 11 December 2004. However, because of both defects in the draft\textsuperscript{171} and the dual regulatory regime it created for domestic and foreign franchisors (domestic franchisors under the 1997 \textit{Interim Franchise Measures}, and foreign franchisors under the 2004 \textit{Draft FIE Franchise Measures}) which is contrary to WTO “national treatment” principles the draft \textit{FIE Franchise Measures} were abandoned. On 31 December 2004, the Ministry of Commerce released Measures for the \textit{Administration of Commercial Franchise Operations} after only a 12 day period for comment. These Measures, which came into effect on 1 February 2005 repealed the 1997 \textit{Interim Franchise Measures}.

The 2005 \textit{Franchise Measures} prescribed a regulatory regime for domestic and FIE franchisors under the same regulation although, arguably in breach of WTO commitments, additional regulation obligations were imposed on foreign franchisors. On 6 February 2007 the State Council released the \textit{Regulation on the Administration}


\textsuperscript{171} For example, the \textit{Draft FIE Franchise Measures} applied to franchising in “all service industries that engage in retail, culture and sports, catering, hotel and lease by foreign-invested enterprises in the territory of China” (Article 4) which created legal uncertainty for franchisors in “non-service” sectors such as product distribution franchises.
of Commercial Franchises which took effect from 1 May 2007. The Franchise Regulation was welcomed internationally for removing the discriminatory approval requirements for foreign franchisors under the 2005 Franchise Measures and for subjecting foreign and domestic franchisors to the same law. Although the position of foreign franchisors is strengthened under the new unified regime some particular issues nevertheless remain unresolved including the status of direct cross-border franchising.
PART THREE
FOREIGN FRANCHISING COMPANIES IN CHINA

CHAPTER 8 THE DEVELOPMENT OF FRANCHISING IN CHINA

CHAPTER 9 THE IMPACT OF THE REGULATORY REGIME ON FOREIGN FRANCHISORS’ ENTRY AND EXPANSION STRATEGIES IN CHINA: THE KFC AND MCDONALD’S EXPERIENCE
CHAPTER EIGHT
THE DEVELOPMENT OF FRANCHISING IN CHINA

8.1 INTRODUCTION

Since the Open Door policy adopted by China in 1978 ended 30 years of isolation, introduced massive economic and legal reforms, encouraged foreign investment and resurrected private enterprise, China has become the world’s third largest and fastest growing economy.¹ With its rapid economic growth and its increasingly wealthy population of 1.3 billion, China is potentially the largest consumer market in the world. These factors, in combination with a stable political environment, have made China the world’s most popular destination for foreign direct investment (FDI).²

As in other countries, pioneering US franchise systems provided the catalyst for local franchising development. The term “franchising” was not part of the Chinese language when the US fast food pioneers KFC and McDonald’s entered China in the late 1980s — but the development of the franchise sector since then has been spectacular. Although foreign franchise systems initially faced significant regulatory and bureaucratic hurdles in establishing their systems,³ China’s recent history has been one of increasing market liberalisation, particularly pursuant to WTO accession commitments. In less than 20 years, China has become one of the most franchised countries in the world in terms of system numbers although the scale of operations is still very limited from both per capita and percentage of GDP perspectives.

Franchising accounts for only 3 percent of China's retail sales compared to 40 percent in US. Systems average 43 outlets compared to 540 outlets in the US. Although the entry of internationally prominent US franchise systems introduced the concept of franchising to China, their operations currently are, ironically, primarily through managed chain operations rather than through franchised operations.

This chapter reviews the history and the development of franchising in China and examines the major environmental factors in China which have influenced the expansion of foreign franchising firms into China. It also addresses the challenges and opportunities for franchisors, and in particular, for international franchise companies.

8.2 INTRODUCTION OF THE FRANCHISE CONCEPT TO CHINA

Franchising as a method of doing business is a US invention and was introduced to China in the same way as it was introduced to other countries - by the international expansion of US franchise enterprises, particularly the leading fast food systems. KFC was the first major US fast-food franchise company to enter China. In February 1986, after nearly three years of negotiations with government agencies, it entered into a joint venture contract with two state owned enterprises - Beijing Corporation of Production and Processing, and Beijing Travel and Tourism Corporation. On 12 November 1987, KFC opened its first outlet in Beijing. Its distinctive outlet and its distinctive product attracted massive consumer interest. The opening day of the 650 seat Beijing restaurant was a spectacular success breaking

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5 Ibid.
6 Discussed further in Chapter 8.4.1.
7 As discussed in Chapter 3.
9 Ibid, 48.
KFC world sales records. Today, KFC has over 2300 outlets in China.

McDonald’s was a later entrant into the Chinese market opening its first outlet in 1990. Although it adopted a similar strategy to KFC in establishing a joint venture with a state owned enterprise, it commenced its operations not in the national capital but in Shenzhen in the south of China, one of the first Special Economic Zones established by Deng Xiaoping to experiment with foreign investment. McDonald’s soon moved to Beijing and in April 1992 opened an outlet in Wangfujing (the major shopping street of Beijing). Its relocated Wangfujing outlet is still the largest in its 30,000 plus worldwide chain. Today, McDonald’s has more than 670 outlets in China.

Since then, other international franchise companies have commenced operations in China. Pizza Hut and hotel chains Marriott and Holiday Inn entered China in the early 1990s. Century 21 appointed its first master franchisee in 2000 and has expanded rapidly. It now has 1000 outlets with 10,000 brokers. Burger King, a much later entrant than its fast-food competitors, opened its first outlet in Shanghai in 2005 but plans to have a 1,000 restaurant chain within a decade. Today, 70 percent of the top twenty franchisors in terms of worldwide sales, and thirty six

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10 Ibid, 49.
12 McDonald’s entered into a joint venture contract with Beijing Corporation of Farming Industry and Commerce in November 1990. English and Xau, op cit note 8 at 45.
13 Special Economic Zones (SEZs) are development zones established by the Chinese Government to encourage foreign investment, with less restriction and more favorable tax rate as discussed in Chapter 2.
14 Ibid.
15 Ibid.
17 Steve DeSutter, President EMEA/Asia Pacific/Europe of Burger King, ‘Burger King’ (Speech delivered at CCFA 2005 International Franchising Forum, Shanghai, 7 September 2005).
18 The top 20 franchise systems by worldwide sales in 2004 (by Franchise Times, http://www.franchisetimes.com) were McDonald’s, 7-Eleven, Carlson Wagonlit Travel, Ace Hardware, KFC, Burger King, Pizza Hut, Wendy’s, Coldwell Banker Real Estate Corporation, Circle K Stores, Subway Restaurants, Blockbuster, Marriott Hotels, Resorts & Suites, Taco Bell, Holiday Inn, RadioShack, Century 21 Real Estate, Domino’s Pizza, Sheraton Hotels and Suites, Applebee’s Neighborhood Grill & Bar.
percent of the top 200 of the global franchising giants, have already entered China. A survey conducted by the China Chain-store and Franchise Association in 2004 records that franchising companies originally from the US accounted for 58 percent of the international franchisors in China.

### 8.3 ADOPTION OF FRANCHISING BY LOCAL ENTERPRISES

The success of the US fast food companies alerted the local business community to the unique advantages of the franchising concept and encouraged its adoption by local entrepreneurs. The first Chinese enterprise to franchise its operations is reputed to be Lining Corporation, a sportswear company established in 1990 by Li Ning – a sporting legend, who won three gold medals in gymnastics at the 1984 Olympics and who lit the flame at the 2008 Beijing Olympics. Li Ning expanded his business from 1993 through franchising, and soon created another legend by developing his system throughout the country.

Another early example was the Quanjude Group which was established in 1993 to take over Quanjude - the oldest and most famous Peking duck restaurant in China which first commenced operation in 1864. The Quanjude Group quickly adopted franchising to expand its operations, and it currently has 70 stores of which 58 are franchised. It is one of the few Chinese franchise companies that has franchised outside China with restaurants in the US and Japan and a proposal to open in

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19 The top 200 franchise systems by worldwide sales estimate by Franchise Times, can be found at http://www.franchisetimes.com.
21 Ibid.
24 Li, op cit note 22.
Lining has become the leading domestic sportswear company and has been a franchising role model for private enterprises. Quanjude has become a role model for anachronistic state owned enterprises diversifying, reviving and re-establishing their relevance. Encouraged by their successes, many other local enterprises have started to franchise. These successful domestic franchisors have led to the wider adoption of franchising by local enterprises which today service most consumer markets and, as in the West, increasingly business-to-business markets.

8.4 THE DEVELOPMENT OF THE FRANCHISE SECTOR IN CHINA

8.4.1 Rapid Growth of Franchise Sector

China Chain-store and Franchise Association statistics indicate rapid and substantial growth in the franchise sector, particularly since the introduction of the 1997 Interim Franchise Measures – from 37 systems in 1997 to 2600 in 2006. This would make China the most franchised country in the world in term of system numbers. Some caution is nevertheless necessary with the CCFA statistics. They are not independently audited and may be inflated by the inclusion of non-franchised chain operations and very basic product and trade name systems which are not usually included in franchising statistics.

The 2007 Franchise Regulation introduced a filing system which will lead to more accurate statistics. As at April 2009, 1175 enterprises had registered with the Ministry of Commerce or its provincial offices. Of the 1175 franchisors, 943 have

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29 Statistics estimated by the CCFA based on the survey conducted by the CCFA.
30 Lorelle Frazer, '2008 Franchising Australia', Survey prepared by the Asia-Pacific Centre for Franchising Excellence at the Griffith University, for example, does not capture franchising activities in motor vehicle and fuel retailing (see page 9).
31 As discussed in 7.4.8 below.
operations in more than one province and 232 operated within one province only.\(^\text{32}\)

This figure is possibly less than the totality of franchising operations in China. Due to the requirement of the 2007 *Franchise Regulation*, certain companies decided not to describe their businesses as ‘franchising’ and adopted the nomenclature of ‘licensing’.\(^\text{33}\) (Criticism of the vagueness of the definition which perhaps encourages this practice was made at Chapter 7.5)

Today, with almost 200,000 outlets, franchising has created 3 million jobs.\(^\text{34}\) The estimated rate of growth of the Chinese franchise sector in the decade from the since the introduction of the 1997 *Franchise Measures* to the introduction of 2007 *Franchise Regulation* is shown in the chart below and is based on the CCFA statistics.\(^\text{35}\)

**Figure 9: Number of Franchise Systems in China**

![Figure 9: Number of Franchise Systems in China](image)

Although China has recently emerged as one of the most franchised countries in the world in terms of system numbers, the economic impact of its franchise sector is still

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\(^\text{35}\) Geping Guo, ‘Status of China Franchise Chain Development’ (Speech delivered at 2005 CCFA Franchise Conference, Beijing, 20 April 2005). Numbers of Systems from 1997 to 1999 were estimated by the CCFA.
at an embryonic stage. There is massive potential for future growth as franchising business currently accounts for only 3 percent of China's total retail sales which is starkly behind the 40 percent of the United States.\(^{36}\)

Franchising as method of business operation in China today is used by both local and foreign companies to access a wide range of industry sectors. Businesses in diverse sectors have used franchising to expand their operations. Currently in Beijing there are 70 types of industries in chain store businesses of which over 40 have utilised franchising.\(^{37}\) Fast food restaurants and retail and household services are currently the three most popular areas for new franchise investment in China.\(^{38}\) But, due to the increased pressures in the workplace and the need for leisure activities there are increased demands on time, and home services are becoming increasingly popular and franchise systems have quickly responded to this niche. A 2004 CCFA survey indicates the following distribution of franchise systems in industry sectors:\(^{39}\)

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\(^{36}\) Geping Guo, ibid.

\(^{37}\) Ibid.


\(^{39}\) Geping Guo, op cit note 35.
Although franchise systems in China account for only a small percentage of retail sales, their sales growth has been extremely rapid. The sales growth of the franchise sector has averaged 40 percent over the last few years, far greater than the 10 percent annual growth rate for national consumer sales.  

However, the growth rates of various industries are different. Taking 2004, the most recent year for which comprehensive statistics are available, as an example:

\[\text{Restaurant 31.6\%}
\]
\[\text{Convenience store 8.6\%}
\]
\[\text{Education 6.9\%}
\]
\[\text{Real estate 3.1\%}
\]
\[\text{Clothing 5.8\%}
\]
\[\text{Pharmacy 2.5\%}
\]
\[\text{Household electric appliances 1.0\%}
\]
\[\text{Car Service 4.7\%}
\]
\[\text{Home decoration 8.1\%}
\]
\[\text{Beauty & fitness 6.6\%}
\]
\[\text{Bookstore 2.2\%}
\]
\[\text{Other 14.4\%}
\]
Table 9: Growth of Franchise sector by Industry Distribution

<table>
<thead>
<tr>
<th>Sectors</th>
<th>Average Growth of Outlets %</th>
<th>Average Growth of Turnover %</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Franchisors</td>
<td>Franchisees</td>
</tr>
<tr>
<td>1 Real Estate</td>
<td>75.48</td>
<td>79.06</td>
</tr>
<tr>
<td>2 Home Decoration</td>
<td>48.7</td>
<td>85.2</td>
</tr>
<tr>
<td>3 Education</td>
<td>31.2</td>
<td>41.8</td>
</tr>
<tr>
<td>4 Bookstores</td>
<td>8.51</td>
<td>7.43</td>
</tr>
<tr>
<td>5 Laundry</td>
<td>24.81</td>
<td>21.43</td>
</tr>
<tr>
<td>6 Chinese Restaurant</td>
<td>34.72</td>
<td>37.92</td>
</tr>
<tr>
<td>7 Clothing</td>
<td>18.07</td>
<td>15.54</td>
</tr>
<tr>
<td>Average</td>
<td>33.18</td>
<td>37.87</td>
</tr>
</tbody>
</table>

The introduction of international franchise brands and the emergence of local franchise enterprises have led to the development of increasing franchising expertise. Chinese franchising is increasingly characterized by growing maturity in the organization of the wider sector. The government promotes franchising in different ways, including supporting the CCFA in its exhibitions and data collection. The CCFA has hosted the National Franchise Conference and Expo in Beijing annually since 1999 and the International Franchise Forum and Expo in Shanghai annually since 2002. The CCFA also has played an important role in education and obtaining statistical data. Exhibitions held by national and provincial industry associations and private sector companies have increased to more than three per month on average, and these have grown each year in terms of franchise brands marketing their systems, potential investors and attendees. Academics have been attracted by the booming franchise sector as a significant research field. The Franchise Management School of Beijing Normal University in Zhuhai, the University of International Business and Economics and China University of Political Science and Law have played a

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leading role in sector research. These and other universities offer subjects in franchising and the Franchise Management School offers a dedicated four year business degree specializing in franchising, believed to be the first and only such initiative in the world. Books, magazines and websites devoted to franchise have increasingly appeared and the sector is now the subject of wide media and general interest.

However, although franchising has been enthusiastically embraced in China by enterprises looking to expand, by individuals wishing to enter business sectors using another’s proven system and by consumers, the development of franchising is uneven across China. Franchising is well developed in the major cities such as Guangzhou, Shenzhen, Beijing and Shanghai which have been most exposed to economic reform and western influences, but the vast majority of Chinese do not live in these major cities. The benefits of economic reforms have not been evenly shared across China and, to the majority of the Chinese population, franchising is still not well known. The chain store (including the franchise chain and the direct owned chain) and retail enterprises in the municipalities of Shanghai and Beijing and the provinces of Jiangsu and Guangdong account for almost 70 percent of total chain store and retail sales of the whole country.46

8.4.2 Problems Accompanying the Development of Franchising

The rapid growth of franchising in China has not been without problems. This is not an experience unique to China and most, probably all, franchise sectors in their early stages of development experience predictable growing pains. Many of these problems arise from a lack of understanding of franchising and the intricacies of the franchisor/franchisee relationship. Unethical practices are also common.

The high profile and success of foreign systems, such as KFC and McDonald’s, and

46 CCFA, op cit note 20.
local systems such as Lining and Quanjude, led many Chinese entrepreneurs to believe that franchising was a magic formula and a guarantee of business success. Enterprises traded off the proven success of franchising to promote their franchise systems and their consulting services. Slogans such as “to be the McDonald’s of China”, “the 10,000 stores project” and “boss making factory” were frequently used in late 1990s and early 2000s. Franchising as a business strategy was widely utilized in expanding industry sectors but was practised by many franchisors, franchisees and consultants without a comprehensive understanding of franchising or an appreciation of the factors on which its success had been built. As with its development in other countries, franchising was diminished by inappropriate practices, and by “scam merchants” who cheated investors using the good name of franchising. Negative comments in the media undermined people’s confidence in franchising.

The problems were summarized by Guo Geping, the Chairperson of the China Chain-store and Franchise Association, in her speech to the CCFA International Franchise Forum in 2004:

- franchisors may commence franchising without meeting the basic requirements such as having a registered trademark or sufficient experience or a proven system
- franchisors may not disclose information appropriately or sufficiently - information regarding the risk of operation may not be adequately disclosed, or the potential profit may be exaggerated
- franchisors may stop supplying ongoing support and services to franchisees after the franchise fees are collected, or engage in other fraudulent practices
- franchisors and franchisees may knowingly breach the franchise contract

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• franchisees may not pay franchise fees as specified or may infringe the franchisor's intellectual property.

The recent introduction of the 2007 Franchise Regulation is the official response to these problems. Within days of the release of the Regulation the official website of the Central People's Government of the PRC published an interview with an unnamed spokesperson from the Department of Law and Policy under the State Council and the Ministry of Commerce providing background information and commentary on the new Regulation. The official acknowledged that China has a "serious consumer fraud problem" through a franchisor promising more than it can deliver and concealing information necessary to the prospective franchisee to make an appropriate decision. It was conceded that this is a particularly important problem in China because its market economy is still not mature, and because there is a limited understanding among the public as to "what a franchise is". The Regulation was introduced to encourage the "healthy development of the sector".

Another reality of the Chinese franchise sector today is that many domestic systems are still at an early stage of development. Successful franchise systems develop from successful prototype business operations and pilot operations, from which the essential operational formats and management systems are tested, refined and documented. Franchising is the replication of a proven business concept through a proven business system. It has been the metamorphosis of franchising from unsophisticated product and trade name distribution arrangements to comprehensive business format franchising arrangements which has driven the growth and development of franchising throughout the world. The essence of contemporary business format franchising is the replication of proven systems incorporating comprehensive managerial and operational protocols. However, in China domestic franchising is generally at an early developmental stage. 30 percent of franchisors do

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50 Article 1, 2007 Franchise Regulation.
not have a franchise manual, and 20 percent have no operations manual.\textsuperscript{51} The term "franchise" is widely used to describe arrangements which are often simply unsophisticated distribution arrangements offering little in the way of operational formats, assistance and training.

Infrastructure necessary to support the sector is still at an early stage of development. While banking, accounting, marketing, insurance and legal services are increasingly available, supply line logistics, human resources and management expertise are developing more slowly and are current obstacles to orderly expansion. The foreign franchisor in China also faces problems arising from cultural traits such as a lack of respect for regulatory regimes for business and feudal ideas of "being the head of a chicken than the tail of a cow". Such characteristics aggravate the franchisor's management challenge and may threaten the unity of franchise systems and harm the entire franchise business.

The problems are exacerbated by the uneven development of commerce, and franchising, across China. Despite a national language there is great variety of dialects in addition to cultural, social and demographic differences. China's growing body of regulatory laws is applied at the regional and local level and the different administrative regimes have complicated the expansion of franchise systems into geographically dispersed regions. Outside the major cities most of the infrastructure issues, particularly logistics, are complicated.

\textbf{8.4.3 The Impact of Environmental Factors on Foreign Franchisors}

As discussed in Chapter Three, environmental factors of a host country - economic, demographic, geographical/cultural distance, and legal and political dimensions - have a significant impact on foreign franchisors in both choice of country, choice of

\begin{footnote}
\textsuperscript{51} CCFA, op cit note 20.
\end{footnote}
entry strategy and choice of expansion strategy. In order to understand the impact of environmental factors impacting on the attractiveness of China as a target country for foreign franchisors, data from the World Bank and the China National Bureau of Statistics have been used to analyse the relationship between environmental factors and the entry of international franchising firms. In research examining factors in choice of entry modes which focus on organisational factors through quantitative study, the author and other researchers obtained details of number of foreign franchising firms in China and the time of their entry. The data is used to understand the environmental factors as discussed below.

8.4.3.1 The Economic Dimension

In less than three decades since the initiation of reform and opening up, China’s economy has undergone a fundamental change from a planned economy to a market economy. Its economic development over the last 20 years has been extraordinary. Since 1978, China’s economic growth rate has been among the world’s highest, with an average annual growth of over 8 percent a year for over 20 years. The overall objective for economic construction proposed in 1978 - quadrupling the annual industrial and agricultural output value of the year 1980 by the end of the 20th century - was fulfilled ahead of schedule. China became the world’s third largest economy in terms of GDP in 2008.

The survey suggested that 85 percent of the survey participants rated economic

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54 Ibid. Data collected during that research is used in this Chapter to under the environmental factors.
55 Despite a slowing under the influence of the global financial crisis, China’s economic growth rate is expected to be the highest in the world in 2008.
growth as either ‘important’ or ‘most important’ in their evaluation of China as a host country. The economic growth in China from 1985-2005 has led to increasing numbers of international franchising firms expanding their business to China over this period. The GDP volume of China and the number of international franchising firms expanding to China are summarised in the following chart. It indicates that the growth in the number of international franchising firms in China has a very close relationship with China’s GDP growth.

Figure 11: GDP v International Franchisors in China

![Bar chart showing number of firms entering China market vs GDP from 1990 to 2005.](chart.png)

With a high GDP growth and a low birth rate (because of China’s one child policy), the per capita income in China now qualifies it as a Middle Income country. The higher disposable income of the Chinese citizenry (albeit very unevenly distributed) has provided real market potential. The retail and service sectors have experienced rapid growth which almost doubled from 1985 to 1990 (from RMB 430 billion to

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57 See discussion in Mingxia Zhu, Zhiqiong June Wang and Hong Rose Quan, op cit note 53.
RMB 830 billion). By 2006, the turnover of retail sector reached RMB 7641 billion. The following chart shows the growth of retail and consumer sector and the growth of number of foreign franchisors in China.

Figure 12: Retail Sector v International Franchisors in China

This research result is consistent with the finding that franchisors expand to countries where substantial market opportunities are believed to exist ("opportunity recognition"). It is also consistent with findings on exploiting potential markets by Hackett, Hoffman and Preble, and findings on perceived favourability of the external environment by Eroglu.

62 Donald W. Hackett, ibid.
8.4.3.2 The Demographic Dimension

China’s economic growth is mirrored in its demographic transition. Per capita incomes have increased and poverty has been reduced. It has been suggested that high population growth has a positive impact on international franchising firms’ expansion. China’s one child policy has led to population growth below 1 percent over the last ten years. However, when mortality and then fertility declines, countries have a period when most of the population is in the workforce age groups and dependency ratios are low. China’s economy has benefited from this “demographic window of opportunity”. The percentage of the population aged from 15 to 64 rose from 67 percent of China’s total population in 1990 to 72 percent in 2006. Over the same period, China has rapidly reduced illiteracy and increased numbers of university graduates. UNESCO (2005) estimates that 22 percent of the population in tertiary education age groups are enrolled in tertiary education. China’s adult literacy rate for those aged 15 and over is 91.6 percent. The following chart shows the number of graduates in China each year in relationship number of foreign franchising systems.

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65 As discussed in Chapter 2.
The increasing number of university graduates has provided a strong pool of management personnel. During the same period, the pool of potential franchisees has also increased. Chinese people have traditionally embraced entrepreneurship and franchising provides viable business opportunities. The economic reforms in China which have made franchising possible have resulted in some unwelcome and previously unknown consequences, such as a rising unemployment rate in the early 1990s. However, the existence of unemployment and the prevalence of entrepreneurship provide an ample supply of potential franchisees.

China's population today is far more urbanised than that of its neighbour India. China's urbanisation rate increased from 40 percent in 2006 to 45 percent in 2007\(^69\) compared with India's 29 percent in 2007. Demographic analysis suggests that China's urban manufacturing and construction boom, and thriving urban markets,

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are attracting villagers to the cities and towns. China has recorded urban population growth rates of 4.7 percent annually between 1995 - 2005. Today, China has 183 cities with a population of one million or more compared to India's 35. Urbanisation provides franchising firms with more opportunity for expansion. The following chart shows the growth of urban population and growth of foreign franchise firms in China.

**Figure 14: Urban Population v International Franchisors in China**

Number of Firms (cumulative) entering China Market vs Urban Population

It is suggested that female education and labour force participation are positive to franchise sector growth. Since the establishment of the PRC in 1949, the equal opportunity policy promoted by the government has played a positive role in women's status in the society. It is estimated that the adult literacy rate for women in China is 84 percent compared with only 53 percent in India. The female labour force participation rate of more than 40 percent is similar to most developed countries. The table below compares the demographic dimension in China, US and

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70 Ibid.
71 UNESCO data for China 2005 (1 percent sample survey).
Australia:

Table 10: A Comparison of Demographic Dimensions among China, US and Australia

<table>
<thead>
<tr>
<th>Demographic items</th>
<th>China</th>
<th>US</th>
<th>Australia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (Million)</td>
<td>1,304</td>
<td>296.5</td>
<td>20.32</td>
</tr>
<tr>
<td>Population Growth Rate (Annual %)</td>
<td>0.9</td>
<td>1.2</td>
<td>1.2</td>
</tr>
<tr>
<td>Population Density (Inhabitants/sq.km)</td>
<td>139</td>
<td>32</td>
<td>3</td>
</tr>
<tr>
<td>Urbanization (%)</td>
<td>40</td>
<td>80</td>
<td>92</td>
</tr>
<tr>
<td>Female Labour Force Participation Rate (%)</td>
<td>44.6</td>
<td>46.2</td>
<td>45.3</td>
</tr>
</tbody>
</table>

(Source: World Bank, World Development Indicators 2006)

International business expands into China partly because it provides economies of scale. The development of Chinese private companies and the growth of private capital provide a solid base. China's growing interest in Western concepts, and its rapidly growing middle class, have attracted multinationals entering China to supply its growing market, especially since those firms face mature markets at home. From the above table, it can be seen that China has a large population base for franchise sector development. The urbanisation rate in China is still much lower than the US and Australia, but Chinese government policy to increase urbanisation, and recent land right reforms, provides huge potential for future development.73

8.4.3.3 The Geographical/Cultural Distance Dimension

Geographical and cultural distances are invariably identified as important factors affecting franchisors' international expansion decisions. For this reason, US franchisors typically expand to Canada first and Australian franchisors typically expand to New Zealand first. Research shows that among the 130 international franchising firms in China, 61.5 percent come from Asian countries, 30.8 percent

73 The Property Right Law was enacted by the 5th Session of the 11th NPC on 16 March 2007, taking effect on 1 October 2007.
come from North America and 7.7 percent from Europe.74

Table 11: Frequency and Percentage of Home Country Group

<table>
<thead>
<tr>
<th>Regions</th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>40</td>
<td>30.8</td>
</tr>
<tr>
<td>Asia</td>
<td>80</td>
<td>61.5</td>
</tr>
<tr>
<td>Europe</td>
<td>10</td>
<td>7.7</td>
</tr>
<tr>
<td>Total</td>
<td>130</td>
<td>100.0</td>
</tr>
</tbody>
</table>

North America and Europe are, generally speaking, much more advanced in franchising development, and this result supports the conclusion that companies from Asia are motivated to franchise in China as a result of lesser cultural and geographic distance. This result is consistent with the findings of Fladmoe-Lindquist75 which indicate that the less the cultural and geographic distance between host country (China) and the home country, the more likely a franchisor is likely to enter the Chinese market. The current international franchising firms in China are mostly from Asia. If international franchising firms in North America and Europe can do more to meet the culture gap with China, they will have more marketing opportunities in the Chinese market. The cultural challenges for western franchisors in China is acknowledged by many franchisors in China and discussed further in Chapters 8.4.4 and 9.

8.4.3.4 The Political/ Legal Dimension

China’s WTO accession commitments, and obligations to open retail, services and franchise sectors to foreign competition, coupled with stronger intellectual property protection under the TRIPS Agreement and the introduction of an appropriate regulatory regime for the franchising, have had the greatest influence on the entry

74 Mingxia Zhu, Zhiqiong June Wang and Hong Rose Quan, op cit note 53.
and development of foreign franchising firms. Franchising is not possible without this underlying legal infrastructure.

Franchising specific regulation in China commenced with the 1997 *Interim Franchise Measures* – rudimentary industry rules the main significance of which is that they signalled government approval and authorisation of franchised distribution albeit only for domestic invested enterprises. The need at that time for an experimental, provisional law prevailed over the need for a more carefully constructed regulatory regime for the embryonic franchise sector at that time. The first franchising regulation officially governing foreign franchisors, *Measures for the Administration of Commercial Franchise Operations (2005 Franchise Measures)* was issued on 31 December 2004 by the Ministry of Commerce and came into effect on 1 February 2005. The 2005 *Franchise Measures* repealed the 1997 *Interim Franchise Measures* and subjected both domestic and foreign franchisors to a uniform regulatory regime. However, foreign invested franchisors were nevertheless subject to an approval process which wholly domestic franchisors were not subject to - a regime which was arguably in breach of WTO obligations. The introduction, a decade after the first franchising regulation, of the current 2007 *Franchise Regulation* provides a solid foundation for future development through its status as a law of the State Council and its unified regime for domestic and foreign franchisors. The 2007 *Franchise Regulation*, through prescribing an authoritative regulatory regime for franchising, will be influential in promoting the healthy and orderly development of foreign franchising firms.

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76 China was admitted to the WTO in November 2001, 15 years of trying and 51 years after withdrawing from the then international trade system which it denounced as a “capitalistic club”. The WTO chief at the time, Mike Moore of New Zealand, described China’s WTO accession as “one of the most significant events of the 21st century (The Australian, 24 September 2001).

77 The 1997 *Interim Franchise Measures* were issued by the then Ministry of Internal Trade (MOIT) which governed only domestic invested enterprises. Foreign invested enterprises were governed by the Ministry of Trade and Economic Cooperation (MOFTEC). In March 2003 MOIT and MOFTEC were merged to form the Ministry of Commerce which has responsibility for both domestic and foreign invested enterprises.

78 The *Measures for the Administration of Commercial Franchises* (the 2005 *Franchise Measures*) was issued by the Ministry of Commerce on 31 December 2004, in effect on 1 February 2005.

79 National Treatment is one of the principal WTO obligations.
development of commercial franchising' as well as 'safeguarding market order.'

In developed countries, the justification for franchise-specific regulation is to address unfair practices in franchising which arise from the information and power imbalance inherent in the franchising relationship. In a developing country such as China, there may be more basic imperatives driving regulation. In the context of a system in which business activity which if not expressly authorised is, by implication, prohibited, a law which legitimises franchising as a method of business operation is a necessary step. In the decade which China moved regulation in form of Ministry Rules under the 1997 Interim Franchising Measures to regulation in the form of a law of the State Council under the 2007 Franchising Regulation by the State Council which governing both foreign invested and domestic franchising firms under the same law, the franchise sector in China has experienced significant growth.

With increasing legal certainty, China has seen a corresponding increase in foreign franchisors establishing operations in China. The survey shows that only 23 percent of the foreign franchising firms entered China between 1985 to 1996. 16 percent of the firms entered China in 1997 when the first franchising regulating in China was released. Political uncertainty, law and regulations have been identified as the second and fourth important factors in entry mode choice in China respectively.

Most respondents suggested that the political and legal environment significantly influenced their decision to enter China.

KFC entered in China in 1987, but by the end of 1996, it had only 131 stores in China. Its expansion since 1997 has nevertheless been impressive. The following chart shows the increase in the number of KFC and McDonald’s stores in the decade.

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80 Article 1, 2007 Franchise Regulation.
81 Consistent with international regulatory initiatives it is essentially a prior disclosure regime to address the information imbalance inherent in franchising, although the power imbalance is addressed in relation to specific issues. See generally, Terry, Andrew, 'Policy Issues in Franchise Regulation' Journal of International (1991) 6 Franchising and Distribution Law 77.
82 Zhu, Wang and Quan, op cit note 53.
83 ibid.
84 ibid.
1997-2007. When the 1997 Interim Franchise Measures were introduced, KFC had only around 200 stores although it has been in China for 10 years. Its store numbers reached 1500 by the end of 2005.

**Figure 15: Number of Outlets (KFC v McDonald's)**

8.4.4 The Challenges and Opportunities for Foreign Franchisors in China

The particular challenge of inappropriate practices in a rapidly developing sector has seen a specific regulatory response. China was one of the first countries to adopt franchise-specific regulation to supplement the underlying commercial laws to address problems arising in franchise sector. As discussed in Chapter 7 the law clearly has an important role in China, as in other countries, to address the growing pains of a rapidly emerging franchise sector. However, it cannot solve all the problems. The massive legal reforms, the stable political environment and WTO accession have had a positive impact on foreign franchising firms entry in China. However, the influence of local levels of government bureaucracy, and administrative discretions inherent in comprehensive approval and licensing requirements, remain a concern and a frustration to foreign franchisors.87

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86 Data collected from KFC and McDonald's websites.
87 As discussed in Chapter 7.
Balancing localisation with standardisation is a challenge when a franchise system expands internationally. It is a particular challenge in China as the observation is frequently made that China is not "one market" from the consumer's and the franchisor's perspective. Most local franchising systems are not yet strong enough to be a real threat to established international franchisors because they lack the key elements for a successful franchising system, such as a recognised brand, a proven system and know-how, which are the innate advantages of established foreign franchisors. Foreign franchisors nevertheless face real challenges in that they are unfamiliar with the Chinese commercial environment, consumption psychology and industry conditions. Finding the right partner, and competent senior management, is both time consuming and difficult. Cultural issues require particular sensitivity for foreign franchisors. China is rapidly moving to a more familiar western business environment, but a 5000 year culture cannot be expected to change overnight. It is not only language – which in its spoken form has many dialects – but more entrenched cultural characteristics which challenge international franchisors. Prominent among these is the concept of "guanxi" – of the prime importance of personal connections, networks and relationships with business partners, government officials, media and trade associations which are forged through sustained cooperation, commitment and contact.

China's long history and unique culture pose significant challenges. Understanding the Chinese people and offering what they need and like are important. The culture in China differs dramatically from north to south and from east coast to west. As most franchising businesses are in the service and retail sectors, it would be a mistake to consider China as a single market. Culture, development, tradition and taste vary from city to city. In relation to foreign franchisors considering China entry, Paul Hallett has commented on the need for a "localization" across a range of

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• Local Market: language, culture, development and consumer taste vary from city to city in China;
• Local Competition: local competition can respond quickly to opportunities, so don’t underestimate it;
• Local Structure: corporate structure considerations are key in China;
• Local Finance: don’t underestimate the investment necessary to establish branch in China;
• Local Product: adaption to local taste is important;
• Local Supply: using local supplies can both support the local economy and improve cost-efficiency;
• Local Partner: choosing right partners;
• Local Ties: franchisor should not rely simply on the contract, as personal and network obligations are important.

The Chinese adopt the philosophy that “while nothing is easy, everything is possible”. Despite the challenges, companies which have adopted this attitude have achieved great success in China.\textsuperscript{90} KFC negotiated with government authorities for nearly three years and devoted another 20 months to developing its supply chains, training staff and refining its system before the first outlet opened in Beijing.\textsuperscript{91} The turnover of its 1,200 Chinese outlets in 2004 reached RMB12 billion (approximately US$ 1.5 billion)\textsuperscript{92}, which is almost one third of the total turnover of its US 5,524 outlets (US$4.9 billion in 2003)\textsuperscript{93}. YUM! Brands, which owns KFC and Pizza Hut in China, claims that “KFC makes almost as much money in China today as it makes in the US”.\textsuperscript{94} Kodak spent four years conducting seven rounds of negotiation in order to acquire the major Chinese film manufacturers. In 1998 it invested US$1.2 billion,

\textsuperscript{89} Paul Hallett op cit note 88.
\textsuperscript{90} Celia Fan, ‘When things are not going well in China’, \textit{Australia China Connections}, Dec 2005/Jan 2006, Volume 5 issue 6 at 12
\textsuperscript{91} Wilke English and Chin Xau, op cit note 8 at 47.
\textsuperscript{93} Yunsheng Huang, op cit note 55.
\textsuperscript{94} \url{http://www.globbrand.com/2005/05/08/20050508-144434-1.shtml} accessed on 11 October 2005.
\textsuperscript{94} David Novak, CEO of Yum! Brands, \textit{Fortune Magazine}, 4 October 2004, 46.
its largest overseas investment, and it has established a near monopoly position in the film-manufacturing sector in China. It has also expanded its Kodak Express network through franchising with the support of the Bank of China, and now has more than 8000 outlets in China.

With its rapid economic growth and “the world’s largest potential market, embracing 1.3 billion people including 412 million young consumers under twenty and with rapidly rising levels of disposable income in economically booming urban areas” China is an increasingly attractive franchise market for both local and foreign enterprises. The rapid spread of Western influence on the relatively young population has resulted in an increased demand for western-oriented lifestyle and higher quality products and services in China. Chinese have become increasingly brand conscious. In selecting products and services, the brand plays an important role in modern China. One of the most important advantages of franchising is that a new store can use an established brand in a new market. Protection and promoting trademark in China is essential. Building a brand’s reputation in Chinese consumer markets is needed even before entering into the Chinese Market. To protect the image of the brand, franchising requires not only adequate intellectual property protection but uniformity and standardisation. To balance standardization and localization is particularly challenging for Western firms in China. Increasing disposable income has made it possible for more consumers to source higher quality products and services. Chinese consumers are increasingly sophisticated and brand conscious. There is an increasing demand for standardized quality which franchise networks

95 http://wwwcn.kodak.com/CN/zh-cn/corp/KodakInChina/kodak_in_china.jhtml?type=5_2_2&id =0.2.4.6&lc=zh-cn, accessed on 2 August 2005.
can provide and an increasing preparedness to pay more for well-known brands. Post WTO market liberalisation reforms have facilitated foreign investment in the franchise sector and foreign franchisors are entering in increasing numbers.\(^{100}\)

Not surprisingly, the economic reforms which have made possible the development of franchising have not been without casualties. The reforms of past twenty years have resulted in some unwelcome and previously unknown consequences, including a rising unemployment rate,\(^{101}\) which has become a critical problem for the government and the public.\(^{102}\) It is in part because franchising is seen by the Chinese government as a strategy to solve these problems that its development has been encouraged by the government. The existence of unemployment and the prevalence of entrepreneurship provide an ample supply of potential franchisees.\(^{103}\) The development of Chinese private companies and the growth of private capital provide a solid base for franchising business. China has a great number of potential franchisees with strong sources of funding. Franchising compensates for their commercial inexperience by linking their investments to well-tested concepts and operation systems and comprehensive training and support.

Although China presents significant commercial, cultural and legal challenges for the foreign franchisor, the success of McDonald’s, KFC and other international brands has proven that such challenges can be overcome. The sheer volume of almost a quarter of the world's population is obviously significant in itself but access to this market by foreign franchise systems is now increasingly possible because of economic and regulatory reforms and liberalisation of market access, and

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\(^{100}\) China’s WTO commitments to franchise operations include removing restrictions on geographical location, number, equity ratio and form of establishment for foreign investment by no later than December 2004 (Schedule of Specific Commitment on Services, the Report of the Working Party on the Accession of China (WT/ACC/CHN/49). As discussed in Chapter 7, these obligations have largely been met through the 2007 Franchising Regulation.

\(^{101}\) The unemployment rate raised from 2.3 percent in 1991 to 3.1 percent in 1997 and 4.3 percent in 2003. National Bureau of Statistic of PRC, China Economic Statistics Report.


\(^{103}\) Mingxia Zhu, ibid at 27.
increasingly attractive through equally significant commercial and social factors. These factors, combined with the current under-development of the franchise model, suggest an exciting future for franchising in China.

8.5 CHAPTER SUMMARY

The Open Door policy and economic reforms made it possible for foreign franchisors to enter China and introduce the franchising concept to China. A range of economic, commercial, social, political and legal factors have influenced the rapid growth of the Chinese franchise sector over the last two decades. Over the last decade the franchise market in China has been growing at extraordinary speed, originally under the influence of foreign franchise systems but more recently through domestic enterprises adopting a franchising strategy. The rapid development of the Chinese franchise sector since then mirrors the rapid development of the Chinese economy generally. The research suggests that most theory on environmental factors, built mainly on the experiences of US franchising firms' expansion to the developed Western world, is applicable to China, an emerging economy.

Franchising was introduced to China two decades ago by American fast-food icon, KFC, but its rapid development nevertheless started from 1997 when the first franchising regulation was issued by the government and the CCFA was established which signaled government’s support for the concept. The rapid growth of franchise sector in China has nevertheless been accompanied by predictable problems including enterprises, domestic and foreign, franchising unproven concepts and immature systems, and improper conduct which persists despite the regulatory attempts to prevent it. With the development of franchising specific law to address the common issues in the franchisor/franchisee relationship and to regulate the franchise sector, and to clarify and open the domestic market to foreign franchisors, the Chinese franchise sector, with both domestic and foreign franchisors, is becoming stronger.
There is wide and increasing agreement with the comment of Jerry Wilkerson, the former president of the International Franchise Association, that China, the largest marketplace the world has ever known, "will be a magnificent place for franchising to flourish in the near future".\textsuperscript{104}

CHAPTER NINE

THE IMPACT OF THE REGULATORY REGIME ON FOREIGN FRANCHISORS’ ENTRY AND EXPANSION STRATEGIES IN CHINA: THE KFC AND MCDONALD’S EXPERIENCE

9.1 INTRODUCTION

In the late 1940s when Dick and Mac McDonald, Harlin Sanders, Howard Johnson and other franchising pioneers were refining their concepts which would within a few years revolutionise the distribution of goods and services, China was preparing for a quite different revolution. The establishment of the People’s Republic of China as a new communist country on 1 October 1949 was to have a profound effect not only on its citizens but also on global commerce. But it was not until the “open door” policies of Deng Xiaoping in 1979 ended three decades of isolation and re-engaged China with the outside world, that sweeping economic reforms created an environment in which franchising could be practised. However, the development of the franchise sector in China required further stimuli. The franchising concept was not well understood locally. Foreign franchise systems were yet to enter the Chinese market and introduce the concept. A legal framework for the operation of franchised business in China was yet to be established.

The development of the domestic franchise sector in China owes much to the pioneering US fast food systems. Their international expansion provided the stimulus for local development, as it did elsewhere around the world. It was the entry of KFC in 1987 and McDonald’s in 1990 that provided the catalyst for the development of the franchise sector in China. It is therefore ironic that both KFC and McDonald’s operate primarily in China not as traditional franchise systems, but as company owned chains.¹ Their standardised operations, albeit not franchised, nevertheless stimulated local entrepreneurs to embrace franchising as well as paving

¹ See Chapter 9.3.2 and 9.4.2 below.
the way for the entry of other international systems. Much of the credit for the rapid development of the Chinese franchise sector over the last decade is attributable to the leadership and example of these colonising franchising pioneers. This Chapter reviews the entry mode and expansion strategies of KFC and McDonald's - the two most dominant foreign franchise systems operating in China through a foreign investment vehicle - and the impact of the regulatory regime on them. Both systems, in common with many other major foreign franchisors who have entered China, have a different operational structure for their Chinese operations than in their home markets, and indeed in other international markets. In China, KFC and McDonald's - whose Chinese experience is the subject of the case study in this Chapter - operate primarily through owned and managed rather than franchised outlets.

This Chapter reviews the entry mode and expansion strategies of KFC and McDonald's, and analyses the influence of the local regulatory (market entry) and legal (franchise operations) environment on their choices of entry mode and expansion structure. Chapter 9.2 explains the qualitative study methodology adopted for this research. Chapter 9.3 and 9.4 analyse the impact of the regulatory and legal regimes on, respectively, KFC and McDonald's entry and expansion strategies. Chapter 9.5 summarises the findings of the qualitative research.

9.2 RESEARCH METHODOLOGY AND RESEARCH DESIGN

9.2.1 Case Study and Qualitative Research

Case studies are used to provide a comprehensive understanding of contemporary phenomena within a real-life context. They can provide a comprehensive understanding of issues under investigation and their findings tend to have a high

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validity for practitioners.\textsuperscript{3} They have been used for different types of research, including exploration, theory building, theory testing, theory extension and theory refinement.\textsuperscript{4}

The purpose of this research is to assess the impact of laws and regulations on foreign franchisors' entry and expansion strategy in China and to provide an in-depth understanding of the influencing factors behind it. The case study method was deemed to be an effective approach to understanding the reasons of firms' decision-making and their relationship with macro-environment.

Case studies may be either quantitative or qualitative.\textsuperscript{5} A review of the existing research in relation to entry mode choice indicates that most prior empirical studies have been based on quantitative surveys which have tested the relationship between influencing factors and entry modes by using quantitative hypotheses.\textsuperscript{6} By testing only the potential influences which have been hypothesised, the researcher risks making incorrect or inconsistent conclusions. Furthermore, not only is the sample quality for a survey difficult to control, but it is also difficult to get deeper insights into entry mode decision-making from such a survey. By contrast, qualitative research can facilitate a deeper exploration of influences and reveal influences of law on foreign franchisors' strategies beyond those which the researcher might have hypothesised.

Empirical research in law is a relatively new research method but it is increasingly

\textsuperscript{3} Chris Voss, Nikos Tsikriktsis and Mark Frohlich, ibid.
\textsuperscript{5} Voss, Tsikriktsis and Frohlich, op cit note 2.
popular. Traditional legal research methodologies have been based on primary and secondary sources of law, and have typically involved either vertical and horizontal comparisons, or critical analysis. Empirical legal research can explore how law works in the real world – the impact that law has on people, communities and societies, as well as the influence that various social, economic and political factors have on law and policy.

The limited legal research which has adopted an empirical approach has primarily addressed criminal and social issues has also been used for research in the field of commercial law. Commentators believe that the lack of empirical legal research is partly due to a tradition of postgraduate legal studies being doctrinally theoretical, as well as to the shortage of training and supervisors in empirical methods. Researchers have nevertheless recognised the importance of empirical legal research in understanding how mechanisms of regulatory control might be improved, how individuals and organisations respond and adapt to their legal environment and how the law can contribute to the overall well-being of society.

No empirical research on the franchising laws of China has been found. Previous research has analysed legal and political environmental factors as determinants for internationally expanding franchisors. However, the issue of the influence of the legal and political environment on the strategic decisions of foreign franchising firms entering China has yet to be analysed. To understand the regulatory impact on foreign franchisors in China, and gain deeper understanding of their concern in

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7 Empirical research on law matters first started in late 1950s. However, it was mainly used for very limited criminal law and justice in the past. It has become increasing popular in recent decade. The establishment of the Center for Empirical Research in the Law in the School of Law of Washington University in St. Louis in 2006 is an evidence of that. For general discussion, Dame H Genn, Martin Partinton, and Sally Wheeler, Law in the Real World: Improving Our Understanding of How Law Works (2006) The Nuffield Foundation, London, p1; it can be accessed at http://www.ucl.ac.uk.


10 Dame H Genn, Martin Partinton, and Sally Wheeler, op cit note 7.
relation to the regulatory environment, this research has adopted an empirical approach of qualitative study in addition to the traditional legal research methods.

Among the numerous qualitative research methods, the interview is the method most widely employed. Interviews can be relatively informal, and enable interactivity between researchers and informants. They allow researchers to collect reliable data that are relevant to the research questions and objectives. The most recognised categories of qualitative interview are structured interviews, semi-structured interviews and unstructured interviews. This research used semi-structured interviews. The structured interview technique does not give the researcher opportunities to probe deeply in discovering new clues, which can limit its possible findings. Unstructured interviews can solve this problem by giving interviewees the opportunity to talk freely, but such interviews can be complex and hard to control. Thus, the semi-structured interview was chosen as the research method for gaining insights from senior managers of the foreign invested franchising companies, – KFC and McDonald’s in this thesis.

In addition to interviews, publicly available data has also been used as background material.

9.2.2 Sample Selection and Case Study Design

9.2.2.1 Sample Selection

The qualitative research outlined in this chapter is based on the experience of KFC...
and McDonald's in relation to their entry mode and expansion strategies to better understand the extent to which China's regulatory regime has influenced their strategic decisions. KFC and McDonald's were selected as they are the most prominent foreign franchise systems operating in China through a foreign invested enterprise vehicle. It is widely recognized that the fast-food franchising industry is not only the inventor and pioneer of modern business format franchising in the US, but is also an ambassador for the franchising concept to China and world. Two of the largest US fast-food franchising firms – KFC and McDonald's - were chosen for this study. Over the past decade, these systems have continuously been on the Top 20 list of franchising systems based on worldwide sales revenue. They entered China at different times and their performance in China have been relatively different.

This research adopts a multiple-case study approach to gain insight into the decision-making of these major fast food firms in relation to their decisions regarding market entry into and expansion strategies in China. A multiple-case study method is supported by previous researchers as a desirable method when the research is descriptive, theory building or theory testing. In comparison with a single-case study, it offers a distinct advantage. It enables the researcher to relate differences in context to constants in process and outcome. At the same time, it allows cross case analysis. Multiple case studies also enable the researcher to avoid the findings being merely the result of idiosyncrasies of the research design.

Many scholars assert that franchising research should be conducted on an industry-by-industry basis. Industry characteristics can affect a firm's entry mode choice, because the control and capital required varies significantly between different industries.

When selecting only KFC and McDonald's for inclusion in the case study, it was

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16 According to Franchise Times, which can be accessed http://www.franchisetimes.com.
considered that small firms may choose their entry mode out of impulse without feasibility studies and legal consultation. For this reason, the author decided to choose large franchising firms. Large firms are able to adjust their strategy according to legal and commercial environment in the target country. They have less internal limitations, such as financial or personnel restrictions. By using cases on firms of a similar size, the organizational factors which may impact their entry mode decision tend to be similar; making it possible to concentrate more on the environmental factors.

9.2.2.2 Approaching the Participants and Ethical Concerns

Senior managers involved in the original choice of market entry mode were the most suitable participants for this study. Accessing targeted organisations and interview informants is often difficult, as not all targeted interviewees have sufficient motives or interests to be interviewed. Targeted interviewees, who were contacted through personal and professional contacts, were approached by phone or email. As their companies are identifiable in this thesis, appropriate authorisation was sought before each interview was conducted.

Ethical concerns arise at several stages in a research project. Issues include privacy, informed consent, and deception. This research followed the University of New South Wales Code of Ethics. The interviews were approved by the Human Research Ethics Committee of the University of New South Wales, under the recommendation of the Australian School of Business Human Research Ethics Advisory Panel (approval number: 07663, attached as Appendix V).

The researcher sent an information letter to all participants fully explaining the participant’s rights, the use of the data, the purpose of the research, and participants’ rights.

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privacy protection. A Participant Information Statement and Consent Form (Appendix VI) was signed by all interviewees. A copy of the signed form and Revocation of Consent Form (Appendix VII) were given to each participant. They were informed that withdrawing their consent to participate in the research at any stage would not jeopardise any treatment or relationship with the University. During the face-to-face interviews, the researcher was mindful of the ethical concerns highlighted by Saunders\textsuperscript{22} and Sekaran\textsuperscript{23} and avoided pressing the participants for a response.

9.2.2.3 Semi-Structured Interview

As noted above, a semi-structured interview approach was adopted to provide an opportunity for the researcher and the interviewees to interact. Ambiguity in the wording of questions can arise, no matter how carefully an interviewer has worded them. To reduce misunderstandings, pilot studies were conducted to test the interview design. During the pilot study, three interviews were undertaken. The three interviewees were a Chinese lawyer who had served as in-house counsel for a major foreign franchising company in China, a Canadian lawyer who had provided professional advice to an American franchising company on its international expansion, and the manager of a foreign franchising company in China. Their suggestions and comments were sought after each interview, and revisions were made accordingly.

Based on interview frameworks developed by Bryman and Ghauri and Gronhaug, the interview process involved four main steps (see figure 9.1):\textsuperscript{24} i) preparing the interview, ii) pre-interview, iii) main interview, iv) post interview. As indicated in figure 9.1, the researcher prepared for the interviews elaborately in advance. An

\textsuperscript{22} Saunders, Lewis, and Thornhill, ibid.
\textsuperscript{23} Uma Sekaran, Research Methods for Business: a Skill-building Approach (3\textsuperscript{rd} ed 2000) John Wiley & Sons, Inc..
interview guideline was drafted to include key questions. During the interviews, additional attention and time were given to key questions. Interviewees were invited to make additional comments at the end of the interview, and through follow up emails.

**Figure 16: The Interview Process**

<table>
<thead>
<tr>
<th>Preparing interview</th>
<th>Pre—interview</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Contact the interviewee</td>
<td>• plan the time</td>
</tr>
<tr>
<td>• Review (revise) interview questions</td>
<td>• dresses</td>
</tr>
<tr>
<td>• rehearse</td>
<td></td>
</tr>
</tbody>
</table>

Identify novel issues in relation to interview questions

<table>
<thead>
<tr>
<th>Post—interview</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Started small talk, introduce the purpose of the researches</td>
</tr>
<tr>
<td>• Time control</td>
</tr>
<tr>
<td>• Sensitive questions/terminology</td>
</tr>
<tr>
<td>• Avoid leading-directing</td>
</tr>
<tr>
<td>• Sent ‘thank-you’ letter</td>
</tr>
<tr>
<td>• Writing interview report</td>
</tr>
</tbody>
</table>

Source: Adapted from Ghauri and Gronhaug (2005) and Bryman (2004)

### 9.2.2.4 Data Collection and Analysis

Various sources of data are potentially available for use in the case study approach. These include observation, pre-existing documentary sources, meetings and interviews. This case study utilised both pre-existing documentary sources and semi-structured interviews.

The main reason to examine the publicly available documentary sources was to gain an overview of the two companies' history, development, strategy and performance. The documents used in this research include briefings, media reports, public speeches made by senior management, and various corporate documents registered

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with administrative authorities. These documents provided a background understanding of each interviewee's organisation prior to the interview. They enabled the researcher to better target questions. Inferences from those documents raised issues worth further investigation. They were also used to confirm information obtained from other sources. When information was contradictory, the researcher pursued the reasons behind any inconsistencies.

Each interview took approximately ninety minutes. Two of the interviews were tape recorded with the interviewees' consent. Each participant's views, reasoning behind strategic choices, and their personal interpretations were captured. The interviews were transcribed and interview notes were filed promptly after the interview to ensure maximum accuracy.

It has been stated that the process of qualitative data analysis 'involves working with data, organising it, breaking it down, synthesising it, searching for patterns, discovering what is important and what is to be learned, and deciding what you will tell others'.\(^{26}\) It has also been described as a process of data selection, simplification, abstraction and transformation.\(^{27}\) In order to analyse and interpret qualitative data, researchers should always bear in mind the purpose of their research and its direction.\(^{28}\)

Although there are numerous publications on the techniques of qualitative interview data analysis,\(^{29}\) there is no single standard approach. The data analysis approach adopted in this study was based mainly on Miles and Huberman's approach.\(^{30}\) From the mass of collected interview data, a data reduction process was carried out. "Data reduction" refers to "the process of selecting, focusing, simplifying, abstracting and


\(^{27}\) Miles and Huberman, op cit note 19.


\(^{29}\) Bryman op cit note 11; Miles and Huberman, op cit note 19.

\(^{30}\) Miles and Huberman, op cit note 19.
transforming the data that appears in written-up field notes or transcriptions”. From the data reduction process, the researcher produced a large number of notes, narrative extracts, and important quotations. Emphasis has been given to reasons for entering China and on legal and regulatory considerations.

By employing King’s thematic template analysis method, the researcher interpreted the collected textual data to identify themes. The template analysis method provided a structured approach to handling the data. A list of codes was identified from the data. Each code was a label attached to a section of text to index a particular theme or issue which it concerned. This coding reduced the text, so that it could be displayed in an explicit form for interpretation.

After an initial round of reading and coding of the transcripts, they were then re-read and the applied codes were checked. The provisional template presented in table 12 was produced based on the existing literature, the interview guide and the researcher’s observations.

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31 Ibid.
33 Ibid.
Based on the initial template constructed, the interview transcripts and notes were systematically reviewed to identify portions of each interview that were relevant to the research aims. The template was revised by inserting new codes and revising the existing codes.

One important aim of this research was to gather rich qualitative data by exploring how decisions were made by each franchising company and their interpretations of the impact of the applicable Chinese laws. Each manager’s personal experience was significant in such regard. Narrative extracts are used to illuminate each interviewee’s decision-making experiences and their views on the impact of the applicable Chinese laws.

In accordance with Yin, each individual case study in this research consists of a “whole” study. Each case begins with analysis to ‘indicate how and why a particular
proposition was demonstrated (or not demonstrated)'\(^34\). Across cases, the report indicates which certain cases were predicted to have particular results, and why others were predicted to have contrasting results.\(^35\) Cross case analysis is discussed in Chapter 9.5.

9.2.2.5 Validity, Reliability and Limitations of the Research

Evaluation of qualitative research is a difficult issue for qualitative researchers on international business.\(^36\) Strauss and Corbin's criteria for qualitative research suggest that judgments have to be made by evaluating: 1) validity, reliability and credibility of the data; 2) the theory itself; 3) the adequacy of the research process which the theory generated; and 4) conclusions about the empirical grounding of the research.\(^37\) The interviewees were senior managers of KFC and McDonald's with established reputations in China and Asia in relation to and international franchising. Pilot studies ruled out possible ambiguous questions which may have confused the interviewees. The topic of the case study was based on existing literature and on the researcher's own professional and personal experiences. King's template techniques were employed to define the relationships between themes and interview data and the relevance of the case study.\(^38\)

Qualitative research is better at 'constituting arguments about how things work in particular contexts, rather than representing the full range of experience'.\(^39\) However, the qualitative interview has its own advantages and disadvantages due to the nature and characteristics of this research method. On reviewing this study, the limitations of this research have become apparent. Reflecting upon the research process, some of the practical issues made certain limitations during the qualitative interviews. The

\(^{34}\) Yin (2003) op cit note 2
\(^{35}\) Ibid.
\(^{36}\) Bryman and Bell, op cit note 11.
\(^{38}\) King op cit note 32.
availability of suitable case study sites was limited. In particular, the case study is based on two major fast food systems which are well established in China without cross comparison to less well performed or resourced foreign enterprises in China.

The issue of bias may exist at stage of data collection and analysis. Some of the author’s personal interview skills, such as how to probe questions to get rich and deeper meanings and how to control the conversations of the interview may also effect the data collecting. However, during the research process, the author incrementally built up her qualitative research ability and her confidence through pilot studies.

9.3 KFC’S ENTRY AND EXPANSION IN CHINA

9.3.1 Background on KFC

Colonel Harland Sanders, the founder of Kentucky Fried Chicken (which in 1991 changed its name to KFC) who first served his fried chicken in 1930 from “Sanders Court & Café” at a gas station he owned in North Corbin, Kentucky, has left a very large footprint in fast-food. His likeness and his statue are prominently displayed at each of KFC’s more than 15,000 outlets worldwide. Colonel Sanders is synonymous with KFC and indeed with franchised fast food more generally. In 1940 Sanders devised what came to be known as his “Original Recipe”, seasoned with his secret herbs and spices, and introduced pressure cooking to fry chicken and serve his customers faster. Sanders first franchised his concept in 1952 to Pete Harman with

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41 The development of KFC is discussed by Sanders, in his autobiography, Life As I Have Know It Has Been Finger Lickin' Good (1974) Creation House Illinois, and is related on the KFC official website, http://www.kfc.com/about/history.asp.
whom he opened the first “Kentucky Fried Chicken” outlet. By 1964, KFC had more than 600 stores in the US and Canada and its first overseas outlet, in England. In the same year, Sanders sold his interest in the company to a group of investors but remained as the company’s public spokesman. KFC became a public company in 1966 and listed on the New York Stock Exchange in 1969. When Heublein Inc. acquired KFC Corporation in 1971, there were more than 3,500 franchised and company-owned KFC stores worldwide. KFC became a subsidiary of R. J. Reynolds Industries Inc. in 1982 and was bought by Pepsi Co Inc. in 1986. In 1991, the company formally changed its name from Kentucky Fried Chicken to KFC which since then has been used on all graphics, advertising and packaging materials. In 1997, Pepsi Co Inc. spun-off its quick service restaurants - KFC, Taco Bell and Pizza Hut - into Tricon Global Restaurants Inc., which subsequently changed its corporate name to YUM! Brands Inc. in 2002. Today YUM! is the world’s largest restaurant company with several prominent brands. Today, KFC has more than 15,000 outlets in more than 80 countries and territories around the world about 76 percent of which are franchised.

42 http://www.kfc.com/about/history.asp.
43 The first KFC outside of the US and Canada was opened in Preston, England in 1965, making KFC the first US fast food chain to open in the UK. http://www.kfc.com/about/history.asp
45 http://www.kfc.com/about/history.asp
47 In addition to KFC, Pizza Hut, Taco Bell, YUM! also owns A&W, All-American Food Restaurants and Long John Silvers.
48 http://www.kfc.com/about/history.asp
9.3.2 KFC in China

KFC was the first major franchise system to enter Mainland China and is undoubtedly one of the most successful. With 1500 outlets it is the largest restaurant chain in China (foreign or local) in terms of revenues, profits and outlets. In February 1986, after nearly three years of negotiations with government agencies, it entered into a joint venture contract with two state owned enterprises – Beijing Corporation of Animal Production, and Beijing Travel and Tourism Corporation.

On 12 November 1987, KFC opened its first outlet in Beijing. Its distinctive outlet and its distinctive product attracted massive consumer interest. The opening day of the 650 seat Beijing restaurant was a spectacular success breaking KFC world sales records. Subsequently it opened an outlet in Shanghai in 1989. It took almost 10 years (1987-1996) for KFC to open 100 outlets but its expansion since then has been rapid. It only took 11 months in 2001 for KFC to expand from 400 to 500 outlets. Today, it has over 2,300 outlets in more than 400 cities.

Its China expansion is outlined below:

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50 English and Xau, ibid; Warren K Liu, ibid.
52 It is translated as Beijing Corporation of Production and Processing by some scholars, for example as Wilke English and Chin Xau in International Franchising in Emerging Markets, op cit note 49 at 48.
53 Wilke English and Chin Xau, op cit note 49 at 48.
54 Wilke English and Chin Xau, op cit note 49 at 49.
KFC’s success in China is a matter of record. Despite heavy competition from Western counterparts like McDonald’s and Subway, and Chinese’s domestic food chains like Ronghua Chicken, it maintains market leadership in the fast food market. As Warren Liu, in *KFC in China*, observes:

> Elsewhere around the world KFC lags behind McDonald’s in brand equity, market share, and consumer preference. Not in China. Take size, for instance. McDonald’s had over 30,000 restaurants around the world at the end of 2005, outnumbering KFC by more than two to one. In China, it’s the reverse–KFC outnumbers McDonald’s by more than two to one.\(^{57}\)

Liu’s book takes on the task of explaining this “anomaly”. KFC’s success can be attributed not only to its first-mover advantage. Its efforts in localisation, cultural sensitivity, maintaining good relationships with Chinese government officials and promoting a positive image are also suggested as major reasons.\(^{58}\) KFC’s products were immediately popular with consumers but KFC also localised its menu offerings.

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\(^{57}\) Warren Liu, *op cit note 51*, xii.

It was the first fast food chain in China to introduce a drive-through. Both interviewees (see below) confirmed that KFC’s commitment to China and its cooperation with local government and local business have been essential factors in KFC’s success in China. In the words of Tony Wang, one of the interviewees, “KFC has been committed to China from the beginning”.

Although over three quarters of KFC’s 15,000 plus outlets worldwide are franchised, its expansion in China has been mainly through company owned outlets. KFC granted its first franchise in China, in Xi’an, in 1993, but did not grant further franchise until 2000. Today, of KFC’s 2,300 outlets, only about 50 are franchised.60

9.3.3 The Interviews

Two interviews were conducted regarding KFC’s entry and expansion modes in China. Mr. Tony Wang, the former Vice President of KFC’s Southeast Asia division, who brought KFC to China, was interviewed in Zhuhai on 16 December 2007 and Beijing on 20 December 2007. Mr. Dominick Morizio JR., the current Franchise Development Director of YUM! Restaurants, China, was interviewed in Shanghai on 19 December 2007.

9.3.4 The Decision to Enter China

Wang acknowledged that:

China’s Open Door policy provided the opportunity for KFC to enter China.

KFC was the first major US franchise system to enter the Chinese market and, as

noted above, has been one of the most successful. Wang confirmed that the significant decision for KFC to expand into China was motivated by reasons which are highly influential in any international expansion beyond the home market – increasing competition and market saturation in the home market. At the time of KFC's China entry, expansion in the US had become more difficult due to increasing competition from other fast food systems, Wang commented that:

*China's huge population and high potential demand was [KFC's] motivation to enter the Chinese market.*

This comment is consistent with theory and practice on international expansion which noted in Chapter 8.

At the time of its Chinese entry, KFC was already operating in Hong Kong and Japan and thus had some experience in Asia. Wang emphasised that:

*KFC's Chinese market entry plan was first formulated in the early 1980s after several successful expansions in South East Asia. China's Open Door policy provided the opportunity for KFC. China became one of the fast growing developing countries soon after its reformed started in the late 1970s. The Open Door policy provided foreign investors with the opportunity to explore the market.*

He nevertheless acknowledged that:

*The Chinese operation took much longer to launch. Beijing in the 1980s was a very different experience for a Westerner and the first visit to Beijing by a senior KFC manager was not successful.*

The appointment of Wang as the vice-general manager for KFC's South East Asia region to establish KFC in China was clearly significant. Wang was born in China and educated in Taiwan and in the USA. He had experience in food industry in both China and US. He commented that:

*I opened the first Sino-US joint venture restaurant in Beijing in 1982, so I was familiar with doing business in China. In addition to my China experience, I had worked with KFC in the US and they knew*
9.3.5 Entry Mode

KFC's first footprint in China was through a joint venture contract with two state-owned enterprises, the Beijing Corporation of Animal Production and the Beijing Tourist Bureau, in 1986. Its successive expansion has been, Morizo explained, through establishing joint ventures with different parties in different regions of China.

9.3.5.1 Legal and Regulatory Considerations

A range of entry modes (discussed in Chapter 3) is generally available to the internationally expanding franchise company – particularly for an enterprise such as KFC which Wang described as “a big and strong international company with financial means, human resources and experience for international expansion”. However, in the environment of the restrictive foreign investment regime that existed in the late 1980s prior to market liberalisation, Wang noted that

... for KFC's China entry mode the legal and regulatory considerations were significant. The joint venture was virtually the only available mode at the time. KFC's entry mode decision was made after advice from lawyers.

For regulatory reasons, in a market to which entry had not been liberalised the joint venture was the most viable option. Morizio made a similar comment:

*Market entry other than by a joint venture before China opened its market's under WTO accession commitments was not really a choice.*

Both interviewees commented on the market entry complications that existed at the time. Although foreign investment through an equity joint venture had been
sanctioned, there were nevertheless complications in the parent company granting franchising rights to the Chinese joint venture company. Wang explained that -

When KFC was negotiating the contact with the joint venture partners, there was no single law in China which mentioned the word franchising. When KFC headquarters need to grant the franchising right to the joint venture, it couldn’t be done through a franchising contract as normally practised in other countries. The approval officials would not approve a joint venture contact which they did not understand and which was not specified in law. But I believe there was flexibility in the government policy, as KFC, a fast food chain, was not operating in a politically sensitive area. Later, our lawyers found a way to complete the transaction through a Technology Transfer Agreement.

Wang acknowledged that:

To use a Technology Transfer Agreement was not ideal and it was not what we would prefer if there was a more defined commercial law and a franchise law, but we were determined to enter China and we had to work within what we could do under Chinese law.

Wang stated:

As the law was immature in China, political intervention and government attitude, either support or disproval, was very important. We solved political issues through connections and guanxi and with deep appreciation of Chinese culture. But to have a smart local lawyer to draft the joint venture contract and advise on other issues relating to law and policy was significant for us entering China.

In relation to the interesting question of what entry mode KFC would adopt if it was entering China today in a liberalised market entry environment in which all FDI entry modes are available, Wang commented that -

Possibly, I would suggest a similar entry mode although the share of joint venture may vary with KFC having higher percentage. In comparison with the WFOE, the disadvantage of a joint venture is the time required for negotiating the joint venture contract. Furthermore, differences between the parties may result in time wasting in decision making. But the joint venture offers the resources other parties can

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61 See discussion in Chapter 6 and Chapter 7.6.
bring to the joint venture in particular ‘guangxi’. Our partners provided significant contributions getting KFC through approval and registration requirements in China.

He emphasised that:

*If a company only considers the law in making a decision, it will fail. Consideration has to be given to cultural, political and other issues.*

In relation to alternative entry vehicles in an increasingly liberalised era, Morizio commented that-

*After WTO accession, whether or not to enter or remain as a joint venture is optional. It has become a strategic decision.*

He explained that KFC’s operations in China have been through joint ventures in different regions of China and that KFC is happy with these arrangements. It is seen as “strategic long term cooperation”.

Interestingly in this context, in the early 2000s YUM! developed a new concept and brand – Dongfangjibai – a Chinese style fast food system which it established as a wholly foreign owned enterprise. The first Dongfangjibai outlet opened in Shanghai in 2004 under the newly liberalised foreign investment regime allowing a WFOE involved in retailing and franchising to establish outlets in certain cities in China. When asked to explain the use of a WFOE for the new venture, Morizio suggested that—

*KFC is happy with the joint venture arrangements it has made in the past and, we are happy with our partners. We don’t particularly want to change that. But the law now allows us to adopt a WFOE and a WFOE has its advantages. Dongfangjibai is new system and a WFOE allows YUM! to have full control of the brand.*

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62 Liu, in *KFC in China*, notes that: “Since the mid-1990s, KFC has not only refrained from entering any new joint venture agreement, but also has actively sought to buy out local partners from existing joint ventures, with some success. These buyouts are based on mutually agreeable terms, with price usually standing out as a deal breaker” (op cit note 51 at 50).

63 东方既白.
9.3.5.2 Cultural, Commercial and other Considerations

As noted above, both interviewees expressly acknowledged that, at the time of KFC’s initial Chinese entry in 1987, a joint venture was the only entry mode practicably available. Both interviewees nevertheless strongly suggested that even if other entry modes had been available the joint venture would still have been the preferred entry vehicle. Wang emphasised that “when choosing an entry mode the environmental factors are a greater concern than regulatory factors”. He stressed that -

An entry mode decision is made after balancing various factors, legal, political, commercial and cultural.

Wang suggests that, even if other entry modes had been legally available, KFC’s initial entry would still have been through a joint venture emphasising that –

When selecting an entry mode, commercial and cultural considerations, and other environmental factors including cultural and political considerations, are the major concerns.

Although Wang noted that entering China through a joint venture was a commercial decision taking into account China’s culture and political environment. He stated that:

A joint venture arrangement was a decision made partially due to legal restrictions, but was the right decision considering the commercial, cultural and political environment of China at the time.”

KFC’s initial joint venture partners (who held a minority interest ensuring that KFC had both total commitment and control) were carefully selected to provide necessary synergies. The Beijing Corporation of Animal Production facilitated the supply of chicken. To establish a close connection with the government agencies which would be essential to KFC’s future success, the Beijing Tourist Bureau (responsible for the supervision of the construction and operation of all hotels and restaurants in Beijing), was chosen to be the other joint venture partner. He stated:
This Joint venture provided good 'guanxi' with government agencies. It also solved one of our major logistic problems - good quality chicken. ... Everything went very smoothly after the contract was signed. We got the necessary approvals with our joint venture partner's connections with the government agencies. The joint venture arrangement gave KFC access to local culture and business networks and good connection with government agencies, which are crucial to success in local market.

When commenting the difficulty on choosing a joint venture, Wang suggested that:

* A joint venture agreement takes a very long time to negotiate and there is always a balance of power between the parties. But such cooperation gave us a positive image and good relations with the Chinese government, both of which were critical to KFC's success.

Wang's insights were echoed by Morizio:

*KFC's outlet opened in Beijing in 1987 was the first KFC in a socialist country. We have to keep the political and cultural differences in mind and build good relationships with government. A joint venture arrangement gave us a better chance to achieve that.*

9.3.6 Expansion

Unlike KFC's expansion in the United States which is primarily through franchising, KFC in China has expanded to date almost exclusively through company owned outlets. KFC granted its first franchise in Xi’an in 1993 and today only about 50 of its 2300 outlets in China are franchised.

9.3.6.1 Legal and Regulatory Considerations

Reference has been made elsewhere to KFC's expansion within China being primarily by owned and managed outlets rather than by franchised outlets as it is in other markets. Wang acknowledged that the absence of a regulatory regime for franchising was a significant factor in this decision -
There was no franchise concept or practice in the early years of KFC's China operation. There was no law governing franchising, no adequate commercial law and no enforcement to support franchising either. It was not possible to use franchising as a primary method for KFC's expansion.

In addition to the absence of the necessary legal infrastructure for the regulation of franchising – either because of the absence of a specific regime or the underdevelopment of the commercial law and systems for its enforcement – Wang noted other factors which meant franchising was impracticable at that time (discussed at 9.3.6.2 below). However, he stated that the primary reason for KFC not franchising at the beginning was due to “no support in law”.

In Wang's opinion – and he qualified his comments by emphasising that he was not a lawyer – the dominant legal issue was not the absence of a specific regulatory regime but the absence of an adequate system of commercial law.

Morizio agreed that KFC's failure to embrace franchising was based more on the lack of protection under contract law than on the lack of a code of specific franchise law. The 2007 Franchise Regulation was nevertheless regarded by Morizio as of great significance and “very important”:

With the new 2007 Franchise Regulation and an improving general legal and commercial environment, KFC currently plans to grant 15 to 20 franchise each year.

Morizio noted that the significance of the 2007 Franchise Regulation transcends the legal regime it lays down:

It is very important in educating local authorities.

He further explained that:

KFC wants to expand outside the major cities in China, where franchising is still virtually an unknown concept. The 2007 Franchise Regulation provides a simple solution for us to convince the local authority that our business is legal and supported by the central government.
Wang also acknowledged the real significance the 2007 *Franchise Regulation* although he commented that "the law is too young" and expressed concerns as to its enforcement.

### 9.3.6.2 Cultural, Commercial and other Considerations

The emphasis the interviewees placed on environmental factors beyond the exclusively legal and regulatory considerations was noted above in relation to entry mode choice but is equally applicable in relation to expansion strategy. Although expansion through franchising was not possible due to the absence of the appropriate legal machinery to support it, Wang noted the existence of other factors which made franchising impracticable:

*The concept of franchising was virtually unknown in China at that time and the lack of official recognition of franchising and chain stores made it difficult in the early stages.*

Morrzio discussed KFC’s current franchising strategy. Although the 2007 *Franchise Regulation* provides a much stronger legal environment for franchised expansion, there are still massive challenges from cultural and commercial factors. Morrzio explained that KFC’s new franchising strategy is a ‘not starting from zero’, or a ‘born again franchising’ program which has been designed to meet these challenges:

*Under the ‘not starting from zero’ strategy, KFC grants a franchisee the right of the existing company-owned store. By doing that, we are providing not only a proven brand and concept, KFC; we actually provide franchisee a proven outlet.*

This strategy was designed to address the commercial challenge in greenfields operations which flow from the relative immaturity of the franchise sector in China and the lack of real understanding of the intricacies of the concept. Morrzio also

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64 In *KFC in China*, Liu, a former vice president for China of Yum’s Brands expands on this strategy. This strategy has been adopted, so that “a franchise would receive a profitable, operating restaurant and all assets associated with the ongoing operation of that restaurant,
A prospective franchisee undergoes a comprehensive screening process and must be an entrepreneur with restaurant experience, willing to take on a hands-on management role and not simply investors. KFC will only franchise existing company owned outlets operating profitably in medium seized cities.

In Wang's opinion, franchising should remain a subsidiary strategy for KFC's expansion despite the 2007 Franchise Regulation removing the legal and regulatory impediments to it:

Furthermore, although the franchise concept is now known in China there is lack of real understanding of the concept and there is a general lack of business credibility and honesty in China. From many perspectives, China is not ready for franchising.

9.4. MCDONALD'S ENTRY AND EXPANSION

9.4.1 Background on McDonald's

The founders of McDonald's, brothers Richard (Dick) and Maurice (Mac) McDonald, opened their first drive-in restaurant, 'The Airdrome', in Pasadena in 1937 and moved to San Bernardino where they renamed their restaurant as 'McDonald's' in 1940. After noting that almost all of their profits came from hamburgers, the brothers re-engineered the restaurant to incorporate what they called a "Speedee Service System", which included reducing 25 menu items to only hamburgers, milkshakes, and French fries. A streamlined hamburger assembly line was introduced in the late 1940s. They soon achieved great success and granted a licence to Neil Fox, their first licensee in 1952. However, because of lack of

including the entire restaurant staff if so desired. This saves a franchisee from having to select a restaurant site, negotiate a lease agreement, oversee restaurant construction, recruit and train employees, and source supplies, thus reducing operational as well as financial risks, with a much stronger prospect for financial success compared to building a new restaurant from scratch in a big city." (op cit note 51 at 111)

uniformity of product and brand among licensees, inadequate supervision and a
general lack of appreciation for the franchising concept (which was hardly surprising
as franchising was then in its embryonic stage), the McDonald brothers did not
exploit the opportunity to take their system nationwide. McDonald's was taken
townwide, and later worldwide, by Ray Kroc, who acquired McDonald's national
franchising rights in 1955. Unlike Sanders, although the McDonald brothers' name
adorns McDonald's stores worldwide today, their story is not as well known by the
general public and the founder of McDonald's is generally considered to be Ray
Kroc, who is frequently credited with the invention of business format franchising.
Kroc refined the McDonald's system through imposing the discipline of an entire
business format and management system on the looser licensing arrangement which
had previously characterised of the McDonald's brother's unsuccessful attempts at
building a network. Kroc had a great success, with 100 stores opened by 1959 and
500 stores by 1963. McDonald's “Hamburger University” opened in 1961 to train
franchisees in standardised product and services offerings and all aspects of business
management. McDonald's went public in 1965 and went international in 1967.
Despite some negative anti-American sentiments due to the golden arches being a
symbol of "Americana" and globalised institutionalised standardisation, McDonald's has achieved great success internationally. Before Kroc's death in

68 Ray Kroc founded McDonald's Systems, Inc. on 2 March 1955 as the legal structure for his
franchising strategy.
70 The first McDonald's restaurant opened by Kroc (which was indeed the 7th of McDonald's) was
72 John F. Love, op cit note 65 at 229-248. A hundred shares McDonald's costing $2,250 dollars
that day would have multiplied into 74,360 shares today, worth over $1.8 million on December
31, 2003. In 1985 McDonald's was added to the 30-company Dow Jones Industrial Average.
McDonald's opened stores in Canada and Puerto Rico in 1967.
73 John F. Love, op cit note 65 at 442.
74 See generally George Ritzer, The McDonaldization of Society: An Investigation into the
January 1984, McDonald’s had 7778 stores in 32 countries.\textsuperscript{75} Today, McDonald’s is the number one franchising company in terms of worldwide sales.\textsuperscript{76} It has more than 30,000 restaurants serving nearly 50 million people in 118 countries and regions each day.\textsuperscript{77} Worldwide about 70 percent of McDonald’s are franchised.\textsuperscript{78}

\subsection*{9.4.2 McDonald’s in China}

McDonald’s entered the Chinese market shortly after KFC with its first outlet opening in Shenzhen, one of the first Special Economic Zones in the south of China in which more liberal market entry was tolerated, in 1990.\textsuperscript{79} In April 1992 McDonald’s opened an outlet in Beijing in a joint venture contract with a state owned enterprise, Beijing Corporation of Farming Industry and Commerce, signed in November 1990.\textsuperscript{80} In February 1993, McDonald’s first store in Guangzhou was opened and the transactions on that day broke the world sales record for McDonald’s stores. McDonald’s opened stores in other major cities, Shanghai and Tianjin, in 1994. Today, McDonald’s has more than 1000 outlets in China and the ‘golden arches’ has become the icon for Americana, modernity and youth in China.\textsuperscript{81} McDonald’s expansion in China outlined below:

\textsuperscript{75} Kroc died on 14 January 1984. By the end of 1983, McDonald’s had 7778 stores in 32 countries.
\textsuperscript{76} Ranked by \textit{Franchise Times}, http://www.franchisetimes.com.
\textsuperscript{78} \textit{Franchise Times}, http://www.franchisetimes.com.
\textsuperscript{79} The Shenzhen outlet was opened and operated by McDonald’s Hong Kong master franchisee in cooperation with McDonald’s.
\textsuperscript{80} Wilke English and Chin Xau, op cit note 50 at 45.
McDonald's size and influence in such that its Chinese experience is newsworthy. In November 1994 the *Wall Street Journal* announced that the world's busiest McDonald's store, located in Wangfujin, Beijing's major shopping street, had to move to make room for a new commercial development\(^{82}\) despite holding a over 20 year lease over the premises. The shock was not so much the commercial impact but the political implications. Western businesses interpreted, possibly exaggerated, the forced relocation of McDonald's as symbolic of the Chinese government's attitude towards foreign invested enterprises. In fact McDonald's was not an isolated case and many other shops, including the Wangfujing Bookstore, considered to be a Beijing icon, were also affected.\(^{83}\) Concerns as to the sanctity of contract may have been justified but not the concerns as to any anti-FDI sentiment.

Although 79 percent of McDonald's outlets in the US are franchised, and about 70 percent worldwide, McDonald's expanded through company owned outlets in China exclusively until 2003, when Sun Mengmeng, a young female, who had studied in


\(^{83}\) Wangfujing McDonald's store remained open until the middle of 1996 and relocated to 150 metres north of the original site soon after.
Canada, and had previously worked for state-owned enterprises in China as well as for McDonald’s, was chosen from more than 1,000 applicants to be McDonald’s first China franchisee. After satisfying McDonald’s requirements of full-time training and assessment for more than one year, she became the franchisee of a store in Tianjin. Currently, McDonald’s has only three franchised stores in China.

9.4.3 The Interviews

An interview on McDonald’s entry and expansion strategy in China was conducted with Mr. Lai who was the manager of McDonald’s China from 1990 to 2006. Two interviews were conducted in Mr Lai’s office in Beijing on 21 December and 26 December 2007.

9.4.4 The Decision to Enter China

In explaining why McDonald’s decided to enter the Chinese market in the late 1980s, Lai recalled that:

*The major motive for McDonald’s to move into the Chinese market was the desire to take advantage of a Chinese market with great potential and to establish its brand name in China.*

From Lai’s explanation, the motive of McDonald’s entering the Chinese market was straightforward and hardly surprising: the huge market size in China and the opportunity of establishing its brand in a potentially massive consumer market. Before coming to Mainland China, McDonald’s had already operated in Taiwan and Hong Kong.

As with KFC’s appointment of Wang, McDonald’s, in appointing Lai, harnessed cross-cultural and restaurant experience. Lai was born in Taiwan and educated in Taiwan and the US. He was appointed for his understanding of Chinese culture and
his experience in food industry. He said:

My first attempt to work for McDonald’s in Taiwan many years ago failed. When I think back, I was young and ambitious. I didn’t understand the certain qualities McDonald’s was looking for. I worked for other restaurant and had my own restaurant before finally working for McDonald’s and later being appointed by McDonald’s to work in Beijing.

9.4.5 Entry Mode

McDonald’s China entry was by equity joint venture. Lai explained that there were two major reasons for adopting the joint venture structure:

Legal restrictions at the time of McDonald’s entry into China were an important reason. The other reason was to utilise the joint venture partner’s resources.

McDonald’s subsequent expansion in different regions has been through what Lai described as “adopting multiple arrangements for different regions” through multiple joint ventures with local partners in particular regions.

9.4.5.1 Legal and Regulatory Considerations

Legal and regulatory restrictions on the vehicles available for Chinese market entry in the late 1980s were the reason for McDonald’s entering China through an equity joint venture – the first foreign investment vehicle available for foreign investment. Lai stated that:

Legal restrictions were the key reason for adopting the equity joint venture as it was the only foreign investment vehicle available at that time when we started negotiations. The wholly foreign owned subsidiary was not available.84

84 The Law of People’s Republic of China on Chinese-Foreign Equity Joint Ventures was adopted on 1 July 1979 and the Regulation for the Implementation of the Law on Chinese-Foreign Equity
While the joint venture is a lesser form of ownership than a wholly foreign owned enterprises, Lai nevertheless pointed out that -

*McDonald’s has the majority share in the Beijing McDonald’s which gives it control of the quality and helps build the brand name in the Chinese market.*

A joint venture vehicle nevertheless offered the advantage of control and human resources as well as local knowledge and connections.

Lai had no doubt that even if other entry vehicles had been available, McDonald’s entry via joint venture was the appropriate strategy:

*Multiple joint venture arrangements was right choice for McDonald’s. Apart from the legal restrictions which left McDonald’s very few choices, the joint venture also suited McDonald’s entry to China. Considering the huge market and the cultural differences, the joint venture allowed McDonald’s to have the control of the system in China as well as accessing the resources of the local partner.*

*A joint venture allowed McDonald’s to have the control of the system in China which we would not have with direct franchising or master franchising. We have control and also the chance to buy back the shares in the joint venture.*

Lai’s reference to “multiple joint venture arrangements” is a reference to McDonald’s entering a series of joint venture agreements with local partners in particular regions to exploit local knowledge. He nevertheless acknowledged that –

*Localisation was not the major reason for McDonald’s to choose the joint venture. Localisation can be achieved through employing local personal without a joint venture arrangement.*

Master franchising was not regarded as an entry option for McDonald’s since, apart from questions as to its legal status, it would not give McDonald’s full control over its brand and the commercial understanding of franchising was too immature at that

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Joint Ventures was promulgated on 20 September 1983. The WFOE Law was first introduced in 1986 but the Regulation for the Implementation of the Law on Wholly Foreign-Owned Enterprises was not promulgated until December 1990 (see discussion at Chapter 6).

See discussion in Chapter 7.
Generally speaking, franchising modes have lower or no risk, but the value of Chinese business at that time was very different from Western business. We thought it would be hard to control the franchisee.

The WFOE was not available because of regulatory restrictions at that time but even if it had been, the advantage of total control would have been outweighed by the advantages a joint venture offered through being able to "utilise the joint venture partner's human resources and connections".

While the Beijing McDonald's was an equity joint venture, for later joint ventures with different partners in different regions McDonald's adopted the cooperative joint venture. Lai commented that:

*In Shenyang and Haerbing McDonald's adopted co-operative joint ventures and our local partners did not invest financial resources.*

As noted at 9.4.3.4 below, the priority for McDonald's in entering cooperative joint ventures was not the partner's financial resources but human resources and connections. In response to a question as to what McDonald's would do if it was entering China for the first time in a much more liberated environment for foreign investment, Lai simply stated that:

*The Chinese market is a big market and adopting multiple arrangements for different regions was a good decision.*

### 9.4.5.2 Cultural, Commercial and other Considerations

With respect to McDonald's joint venture partner for its China entry in Beijing, Lai stated:

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86 The Law on Chinese-foreign Cooperative joint venture was adopted on 13 April 1988 — after McDonald's commenced negotiations for their initial Chinese entry but before the contract was signed.
The joint venture partner, Beijing Corporation of Farming Industry and Commerce, not only helped to secure the logistic of meat, but also the right connection with government agencies. Because the majority of property and companies were state owned at that time, the right connections with government agencies and local companies were important.

Lai stressed repeatedly that, irrespective of legal issues, the joint venture structure suited McDonald's entry to China having regard to the size of the market and the cultural and social values. He stated that:

Multiple joint venture arrangements were the right choice for McDonald's taking into account not only the size of China, but more importantly, the diversity, unbalanced development, culture and local bureaucracy. To utilise the local partner's resources is important to McDonald's, but financial resources are not essential. The connections and 'guangxi' as well as building a positive image is more important to McDonald's. The other important reason was to utilise local resources. For McDonald's, financial resources is not the priority, rather the human resources and connections which we call 'guanxi' in China were essential."

9.4.6 Expansion

9.4.6.1 Legal and Regulatory Considerations

Legal and regulatory considerations have been prominent in McDonald's expansion being almost exclusively to date through company owned and managed outlets rather than through franchised outlets. The strong comment in 2002 of Peter Tan, at that time the President of McDonald's in China, has already been noted:

"McDonald's will begin franchising only after relevant regulations and laws are defined in China." 87

McDonald's clearly regarded the introduction of a comprehensive regulatory regime for franchising as a necessary prerequisite to their adopting a franchising strategy for

87 Peter Tan, President of McDonald's China Development Co, cited in the Dai Yan, 'International Chain of firms to Expand: McDonald's Mulls over Franchise System after KFC', China Daily, 8 July 2002.
expansion. Lai stated that McDonald's was "very prudent" in its move to franchising because of "the lack of relevant laws for commercial franchising" adding that "the law was not there to protect both parties".

With the introduction of the 2007 Franchise Regulation a move to franchising is a more viable strategy.

9.4.6.2 Cultural, Commercial and other Considerations

As noted above, McDonald's was not prepared to adopt a franchising strategy for system expansion before the introduction of an appropriate regulation regime for franchising. The 2007 Franchise Regulation provides the regulatory infrastructure to encourage a franchising strategy but a range of other environmental factors suggest that McDonald's will move cautiously and slowly.

When asked why McDonald's had only three franchised outlets in China, Lai explained that —

In China's current cultural atmosphere, the soil for franchising in China is not as fertile as we imagined. The major reason not to franchise is 'man power'. There is not an appropriate franchisee pool in China. It is hard to find the appropriate franchisees. As we all know, McDonald's franchise fee is quite high. Chinese people who have that kind of financial resources would not normally be interested in a restaurant. The second reason is that, the law was not there to protect both parties.

In order to expand to meet market demand in the Chinese market, in 2002, we announced a franchise strategy where the franchisees should at least meet the following demands: noble conduct; first time in the market, awareness of the target market culture and customs, full time availability to put into McDonald's business development, willingness to accept a period of about 12 months training, have management experience, be qualified to work in a franchising organisation and the, ability to invest an amount not less than US $0.3 million."

McDonald's first franchised outlet opened in Tianjin (a major city near Beijing) in
2003 – 10 years after KFC appointed its first franchisee in Xi’an in 1993. The Tianjin franchisee was selected from over 1000 applicants. Lai explained that the number of candidates who meet McDonald’s demands is rare in China. McDonald’s is looking for “the person in whom tomato ketchup flows in the blood”.

Despite currently having only three franchise outlets Lai acknowledged that McDonald’s long term vision is franchising in China:

*We’re a franchise company and the long-term vision is franchising in China. But we want to continue to refine McDonald’s Chinese operations before we set up a franchising model.*

9.5 THE IMPACT OF CHINA’S REGULATORY REGIME ON FOREIGN FRANCHISORS’ ENTRY AND EXPANSION STRATEGIES: THE EXPERIENCE OF KFC AND MCDONALD’S

KFC and McDonald’s entered China and have expanded their networks within China in a different manner from that applied in most other countries. Entry was by joint venture rather than by subsidiary. Expansion has been primarily through joint venture owned and managed outlets rather than through franchised outlets. The qualitative research, in the form of case studies through semi-structured interviews with executives of both companies, supports the research in the body of this thesis: namely that entry and expansion strategies in China are shaped by both legal and regulatory issues and by other environmental issues.

**entry strategy**

Both KFC and McDonald’s adopted the equity joint venture as their entry strategy. In both cases this decision was virtually compelled by the then regulatory regime. At the time of their first entry, the equity joint venture was the only structure available for foreign direct investment. For reasons referred to at 9.3 and 9.4, cross border franchising by way of master franchising was not an attractive strategy for either company and, in any event, there were - and still are - regulatory complexities in
relation to its validity.\textsuperscript{88}

Both KFC and McDonald's were fortunate in that the equity joint venture – the only viable entry mode – was also the most appropriate entry mode taking into account China's cultural, commercial and political environment at that time and the very real benefits provided by a local partner.\textsuperscript{89}

The experiences of both companies also highlight the central role of law in China and its key influence in franchise sector development. Although the \textit{Equity Joint Venture Law} allowed FDI entry through the equity joint venture vehicle the implementation of the law remained an impediment to entry for foreign franchising companies without the resources and tenacity of KFC and McDonald's. Government bureaucrats were unwilling to take political risks if the law was not expressly defined. The approval procedure to establish a foreign invested enterprise was complicated and unclear due to lack of understanding, inexperience and the ambiguity in and complexity of the law. In these circumstances their Chinese partners played important roles in providing connections with the government agencies.

\textit{expansion strategy}

Reference was made above to the Peter Tan, the then President of McDonald's in China, who stated in 2002 that "McDonald's will begin franchising only after relevant regulations and laws are defined in China."\textsuperscript{90} Without an appropriate regulatory and commercial law environment to recognise and protect contractual and proprietary interests in the franchising relationship, expansion through franchising could not be a viable strategy at a sustained level. As the regulatory regime has become increasingly sophisticated during the journey from the 1997 \textit{Interim

\textsuperscript{88} See generally Chapter 7.6.
\textsuperscript{89} When KFC first entered the Japanese market in the early 1970s, it chose to form a joint venture, with a large local poultry producer, even though other entry vehicles were available to facilitate its business operations in a very different legal, commercial and cultural environment.
\textsuperscript{90} Peter Tan, cited in the Dai Yan, 'International Chain of firms to Expand: McDonald's Mulls over Franchise System after KFC', \textit{China Daily}, 8 July 2002.
Franchising Measures to the 2007 Franchise Regulation, expansion through franchising has become a more attractive option for foreign franchisor. The 2007 Franchising Regulation clarifies the legal status of the foreign invested enterprises engaged in franchising and will facilitate expansion through franchising. The experience of both KFC and McDonald’s nevertheless clearly confirms that the decision to franchise is a complex commercial decision that can be taken only after balancing many other environment factors – cultural and commercial. Without an appropriate legal environment franchising is not possible. But without a well developed commercial environment, franchising is not viable.

9.6 CHAPTER SUMMARY

Through case studies on two major fast food franchise systems which have entered China through foreign investment vehicles, this chapter has reviewed the influence of the regulatory regime on a foreign franchisor’s entry and expansion decisions. Legal factors were highly significant in the entry of both companies through equity joint ventures, but both KFC and McDonald’s maintain that this was the appropriate entry vehicle in any event having regard to political, cultural and commercial factors. Both enterprises have nevertheless not used the equity joint venture strategy exclusively for their later establishments. McDonald’s has used cooperative joint ventures for its later establishments in North China with no financial investment from a China partner. YUM established Dongfangjibai, KFC’s sister company in China, through a WFOE.

Both enterprises emphasise the impact of the law on entry and expansion strategies while at the same time making it clear that law and regulation are not the exclusive considerations. Both enterprises acknowledged that the 2007 Franchise Regulation has created an environment in which expansion through franchising is now a viable strategy from a legal perspective. However, whether the opportunity offered by the 2007 Franchise Regulation is taken up will depend on other environmental factors
bringing into consideration cultural, social and commercial issues.
CHAPTER TEN

CONCLUSION

10.1 INTRODUCTION

This chapter summarises the key research findings which were discussed in Chapters 4-9 in relation to the Research Questions outlined at Chapter 3.6 and discusses their theoretical and practical implications. A summary of the research findings is presented in Chapter 10.2 and is followed by a discussion of the contribution of this thesis to the literature in Chapter 10.3 and its implications in Chapter 10.4. The limitations of this research, and possible future research directions, are discussed in Chapter 10.5.

10.2 CONCLUSIONS ON RESEARCH QUESTIONS

10.2.1 The Development of the Regulatory Regime for the Entry to and Expansion of Foreign Franchisors in China

The First Research Question was:

*How have the laws governing the entry mode for, and expansion strategy of, foreign franchisors in China developed under the influence of China's WTO negotiation and accession commitments and to what extent do they provide an appropriate regime for foreign franchisors?*

The Open Door policy introduced by Deng Xiaoping in the late 1970s ended three decades of isolation and re-engaged China with the outside world. It also created an environment in which franchising could be used as a business expansion strategy. However, in addition to the normal legal, commercial and cultural issues which challenge any franchise system in its international expansion, foreign franchisors proposing to enter China faced additional regulatory obstacles. Market entry, participation in particular business sectors and even the use of franchising as a
method of business operation and expansion have all raised complex regulatory issues.

An integral element of China's opening was a legislative framework sufficient to attract international investment. Foreign investment in China has been allowed since 1979 through arrangements involving an equity joint venture,\(^1\) since 1986 through a wholly foreign owned enterprise\(^2\) and since 1988 through a contractual or cooperative joint venture\(^3\) albeit with certain restrictions in particular commercial sectors. Nevertheless, given China's long period of isolation, it is not surprising that the stated priority of China's massive economic and legal reforms was to "assist China in reaching its goals of economic and technical modernisation rather than to assist foreigners in exploiting the Chinese domestic consumer markets."\(^4\)

The laws governing foreign investment have been revised at various times to liberalise the formerly restrictive requirements\(^5\) driven by the desire to attract further foreign investment. It has nevertheless been China's WTO accession commitments - generally, to improve its legal system in relation to uniformity, transparency and non-discrimination, to accelerate the transformation of governmental activities, enhance policy transparency, reform the administrative approval system to reduce administrative intervention, and to continue to open its markets\(^6\) - which have driven a significant reform agenda.

Today, the underlying legal infrastructure is largely in place, although, in relation to

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\(^1\) The *Law of People's Republic of China on Chinese-Foreign Equity Joint Ventures (Equity JV Law)* was first adopted at the Fifth NPC on 1 July 1979. Discussed in Chapter 6.


the influence of local levels of government bureaucracy and administrative
discretions, and enforcement generally, the Chinese legal system is still in an
immature state from a western perspective. The transformation from a socialist law
system to a civil law system is not complete but is progressing steadily, particularly
under WTO influence.

There have been three elements to the effective opening at the Chinese market for
foreign franchisors: i) liberalisation of foreign direct investment through joint
venture or wholly foreign owned enterprise vehicles, ii) liberalisation of restrictions
on foreign entry into retail, service and franchise sectors, iii) unification of the
regulatory regime for franchising for domestic and foreign franchisors.

i) liberalisation of foreign direct investment through joint venture or wholly foreign
owned enterprise vehicles

An internationally expanding franchise system has a range of alternative entry
vehicles. In the case of China, foreign participation in franchising by way of direct
foreign investment through establishing a legal entity (through a cooperative or
contractual joint venture, an equity joint venture or a wholly foreign owned
enterprise) is today (and particularly since the 2004 Commercial FIE Measures)8
routine. Since 1 June 2004 for joint ventures and 11 December 2004 for WFOEs, the
Chinese franchise sector has been opened to foreign-invested enterprises. However,
cross border franchising into China without establishing a legal entity in China
(through master franchising and area development franchising) remains of doubtful
legitimacy.9

For many major international franchise companies, ownership and control are a
prerequisite for international expansion. The market liberalisation reforms which
allow foreign investment through approved commercial foreign invested enterprises
- the joint venture or the WFOE - provide appropriate alternative vehicles for the
entry of systems through foreign investment in China. However for less substantial

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7 See Chapter 3.
8 The Commercial FIE Measures were promulgated by MOFCOM on 16 April 2004, took effect
on 1 June 2004. See Chapter 6.4.
9 See Chapter 7.6.
or resourced enterprises, or for more risk averse enterprises, Chinese market entry through a foreign investment vehicle may not be the preferred or the appropriate option. Internationally cross border franchising, utilising master franchising or area development agreements, is more common than foreign direct investment through joint ventures or WFOEs. However whereas the joint venture and the WFOE have been expressly legitimised, entry without direct foreign investment through master franchising or area development agreements has not been.

ii) liberalisation of restrictions on foreign entry into retail, service and franchise sectors

The liberalisation of direct foreign investment did not of itself open the domestic franchise sector to foreign franchisors. Entry into specific industry sectors has been regulated by the *Provisions on Guiding Foreign Investment Direction* which classifies foreign investment projects into four categories: *encouraged, permitted, restricted* and *prohibited* which are listed in the *Catalogue for the Guidance of Foreign Investment Industries*. Franchising has been included as *restricted* under the heading “Wholesale and Retail Trade Industries”. Under the Protocol governing its membership of the WTO in 2001, China agreed to open franchising (with certain restrictions) to foreign franchisors in the wholesale, retail, services and franchise sectors, by the end of 2004. Pursuant to these commitments, in June 2004 the *Measures for the Administration of Foreign Investment in Commercial Enterprises (2004 Commercial FIE Measures)* came into effect. It repealed previous Measures,  

10 The *Interim Provisions on Guiding Foreign Investment Direction* was promulgated by the State Planning Commission, SETC and MOFTEC on 20 June 1995, which have been replaced by the *Provisions on Guiding Foreign Investment Direction (PGFID)* which came into force on 1 April 2002. Discussed in Chapter 6.

11 The *Catalogue of Restricted Foreign Investment Industries* in the *Catalogue for the Guidance of Foreign Investment Industries* was first issued in 1995 and revised in 2002, 2004 and 2007. Article 6, Part 2, of Current *Catalogue of Restricted Foreign Investment Industries* was issued by the National Development and Reform Commission and the Ministry of Commerce on 31 October 2007 and took effect on 1 December 2007.

clarified many issues for franchise sector entry by commercial FIEs, and opened the previously restricted distribution sector.

iii) unification of the regulatory regime for franchising for domestic and foreign franchisors

Foreign franchisors until recently nevertheless still faced additional complications from the then-operative franchise specific regulations. Today, entry to the Chinese market via the three foreign invested enterprises - equity joint venture, cooperative joint venture and WFOE - is legitimised and uncontroversial. Upon their establishment, foreign invested enterprises are subject to the same requirements as domestic franchisors under the unified regime of the 2007 Franchise Regulation. However, it is unfortunate that Chinese government has not expressly authorised master and direct franchising, and area development agreements, from other countries although such liberalisation is a part of China’s WTO commitment and has been unofficially confirmed by the officials of the Ministry of Commerce.

10.2.2 The Development of Franchise Sector Regulation in China

The Second Research Question was:

What have been the major influences driving the development of China’s regulatory regime for the operation of franchising in China and to what extent does it provide an appropriate regime for domestic and foreign franchisors?

Whether franchise-specific laws are needed to supplement general commercial laws to support the orderly development of franchising has been the subject of intense debate worldwide. In developed countries, the justification for franchise-specific

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13 See Chapter 6.3.
14 The Franchise Regulation was approved in principle by the State Council on 31 January 2007 and signed by the Premier on 6 February 2007, issued by Decree No 485 of the State Council, took effect on 1 May 2007.
regulation has been to address unfair practices in franchising which arise from the information and power imbalance inherent in a franchising relationship. In China, more basic imperatives have driven the development of franchise-specific regulation. In a system in which business activity is impliedly prohibited unless expressly authorised, a law which legitimises franchising as a method of business operation was essential for franchise development. In this context the 1997 *Interim Franchise Measures* were the necessary starting point for the development of franchising in China despite their limitations in applying only to domestic franchisors.

To comply with China's WTO commitments, the 2005 *Franchise Measures* were introduced to provide a unified regulatory regime for both foreign and domestic franchisors. However it subjected FIE franchisors to an application and approval system which did not apply to domestic franchisors and which was of doubtful validity under WTO commitments. This requirement has been deleted and is not part of the current 2007 *Franchise Regulation* which subjects domestic and FIE franchisors to a uniform registration and reporting protocol.

The further initiative in the 2005 *Franchise Measures* – the requirement that prior to franchising the franchisor, or its holding or subsidiary entity, had itself operated at least two stores in China for more than a year (article 7(4)) – nevertheless remained. The 2007 *Franchise Regulation* has changed this provision to a requirement that for a franchisor to be engaged in franchising they must have “at least two directly operated company owned outlets that have been carrying on business for more than one year” (article 7). The removal of the reference to “in China” in relation to the two stores presumably allows an FIE franchisor to establish its credentials on the basis of its home operations.

15 Discussed in Chapter 7.2.
16 The 1997 *Interim Franchise Measures* were issued by the then Ministry of Internal Trade and therefore applicable only to domestic invested franchisors and the 2005 *Measures* imposed burdensome approval requirements on foreign invested but not domestic franchisors.
17 See Chapter 7.4 and Chapter 7.6.
18 See Chapter 7.4.4 and 7.6.2.3.
The 2007 *Franchise Regulation* provides, for the first time, an authoritative franchise law at the State Council level. The previous 1997 *Interim Franchise Measures* and the 2005 *Franchise Measures* were merely Ministry rules of lesser legal status. It is generally believed that a prior disclosure regime is essential to address the information imbalance inherent in franchising. With the current 2007 *Franchise Regulation* and its associated *Implementation Measures*, China has clarified its regulatory position on prior disclosure and mandatory registration. Given its very long gestation period, the 2007 *Franchise Regulation* is perhaps an anti-climax. However, this may be one of its strengths. It contains no real surprises and is a refinement rather than a re-engineering of the previous regime. The broadness and generality of many of its provisions will, however, remain a source of concern and frustration to franchisors. So too, will the influence of local government bureaucracy and possibly inconsistent interpretations in applying the law. While these issues are to some extent inherent in the Chinese legal system, it is debateable whether a decade of regulatory activity has resulted in an improvement in the law to the extent that Deng Xiaoping might have contemplated. Undoubtedly, the greatest frustration with the 2007 *Franchise Regulation* is that the opportunity was not taken to authoritatively clarify the legal status of direct franchising into China by way of master franchising and area development arrangements.

The decade of China's development of franchise sector regulation commenced with the 1997 *Interim Franchise Measures*. These provided rudimentary industry rules, the main significance of which was that they signalled government approval and authorisation for franchised distribution, albeit only for domestic invested enterprises. The enactment of this experimental, provisional law prevailed over the alternative of waiting to develop a more carefully constructed regulatory regime for the embryonic

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19 The *Measures for the Administration of Commercial Franchises* (the 2005 *Franchise Measures*) was promulgated by the Ministry of Commerce on 31 December 2004, effective 1 February 2005.
20 See Chapter 7.2.
21 See Chapter 7.5.2.
23 See Chapter 7.6.2.5.
franchise sector. The decade closed with the introduction of the 2007 *Franchise Regulation* which provides a solid foundation for future development, through its status as a law of the State Council and the prescription of a unified regime for domestic and foreign franchisors.

10.2.3 The Role and Impact of China's Regulatory Environment on the Development of Franchising in China and the Entry Mode and Expansion Strategies of Foreign Franchisors

The Third Research Question was:

*To what extent has the legal and regulatory environment influenced the development of franchising in China and the entry mode and expansion decisions of foreign franchisors?*

Franchising was introduced to China in the late 1980s by the US franchising fast food pioneers, KFC and McDonald's, within a decade of the introduction of Deng Xiaoping's Open Door reforms. However, it was the implementation a decade later of the 1997 *Interim Franchise Measures* which was the major catalyst for sector development through prescribing a rudimentary regulatory environment for the development of franchising. Franchising in China has come a long way in the decade 1997 to 2007. The franchise sector has grown rapidly as franchising has become an increasingly popular expansion strategy for both domestic and foreign enterprises. The rapid development of the Chinese franchise sector has been accompanied by the sustained development of laws to recognise, facilitate, validate, promote and regulate its development.

The significant role that the 1997 *Interim Franchise Measures* played in signalling government support for franchising was welcomed by the franchise sector in China. This research concludes that claims that franchise regulation unduly constrains entrepreneurial development are not valid in the case of China.

Apart from restrictions on foreign franchisors, neither the 1997 *Interim Franchise
Measures nor the later 2005 Franchise Measures or the 2007 Franchising Regulation have introduced any requirements beyond those commonly included in the franchising laws of Western countries. The requirements imposed (other than special provisions on FIE franchisors) were, in fact, particularly welcomed by foreign franchisors as is evident in this thesis by empirical research. However, in keeping with the nature of a developing legal and regulatory regime, the current system was found to be replete with approval processes and bureaucratic discretions at local levels, with numerous exceptions to the general rules.

The success of prominent international franchise brands in China, proves that the regulatory and bureaucratic challenges can be overcome. However, the operations of these companies in China have been primarily through a chain network of owned and managed outlets with a local joint venture partner, rather than through conventional franchising. It is evident from the qualitative study that joint ventures were the favoured entry mode in the 1980s and 1990s, due to restrictions in Chinese law. With neither franchising law nor official recognition of franchising, commercial expediency has from necessity been resorted to to provide a solution to regulatory uncertainty. KFC, for example, which has enjoyed great success in China entered China in a joint venture combined with a technology transfer agreement under which KFC’s proprietary information and brands were licensed to the joint venture.

In China, as in other countries, the law has a significant role in improving the environment for franchising. China has made significant progress in meeting this challenge. Laws relevant to franchise operations in China, such as intellectual property and contract law, have been revised according to the requirements of WTO accession. The underlying legal infrastructure is largely in place although the Chinese legal system is still in an immature state from a Western perspective. This is particularly so in relation to the influence of local government bureaucracy and administrative discretion, and with regards to enforcement generally. The

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24 See Chapter 7.6.
25 Discussed in Chapter 5.5.
transformation within China from a Socialist Law system to a Civil Law system is not complete but is progressing steadily, particularly under WTO influence.

Reference was made in Chapter 1 to the statement of the Organisation for Economic Cooperation and Development that -

Entrepreneurship and business activities are shaped not only by markets, but also by regulatory and administrative environments established by governments.26

The "transactions and relationships that constitute commerce are embolden in the law".27 While the law inevitably impacts on and shapes business activity, in the case of franchising in China the role of the law and the regulatory regime has been even more fundamental in creating the environment in which franchising can be applied as business strategy. Market liberalisation reforms have opened China's market to foreign investment but the development of a comprehensive regulatory regime for franchising has made business expansion within this market possible. The author suggests that there would be wide agreement among foreign franchisors with the 2002 statement of McDonald's China President that "McDonald's will begin franchising only after relevant regulations and laws are defined in China."28 Without the certainty provided by validation of franchising as a legitimate business strategy and an enforcible regime to govern it, expansion through franchising is not a practicable and viable option for a foreign franchisor.

This research also suggests that with increasing market liberalisation there has been a trend to move to WFOEs in comparison to joint ventures. However, choosing to have a local partner remains a necessary strategy in certain situations, despite the law now allowing franchising through WFOEs. Furthermore, despite wide criticism that

28 Peter Tan, President of McDonald's China Development Co, cited in Dai Yan, 'International Chain of Firms to Expand: McDonald's Mulls over Franchise System after KFC', China Daily, 8 July 2002.
China lacked laws which adequately defined FIE franchising, the research found that the lifting of these restrictions has had very little impact. The decision of FIE franchisors to expand through company-owned stores was attributed to these restrictions. However, company-owned stores are still favoured due to other commercial and non-commercial issues in China. The requirements of ‘2+1’ and registration are welcomed by the major foreign franchisors as a positive influence for the healthy growth of the franchise sector.

10.3 CONTRIBUTIONS OF THIS RESEARCH

Building on the existing literature, this research makes the following original contributions to the body of knowledge in the area of the regulatory regime for foreign franchisors in China in the period 1978 – 2009, with a focus on the period 1997-2007.

This research has examined trends in the development of the franchise sector in China and the impact of regulatory factors within this sector on foreign franchisors. It finds that foreign investment law and market entry restrictions have significantly impacted on the choice of entry mode by foreign franchisors, and that the absence of an enforceable regulatory regime for franchise operations has encouraged expansion by franchise owned and managed rather than by franchised chains. In addition to the main research focus of this thesis (on the role and influence of the law on the development of franchising in China and the entry and expansion strategies of foreign franchisors), relevant environmental factors, other than the regulatory regimes, have been identified and discussed in context.

Secondly, this research was an exploratory study on the relationship between choice of entry and expansion modes and regulatory impact. In Chapter 9, a decision model is discussed for better explaining foreign franchisors’ concerns in choosing entry and expansion strategies in China, and for explaining their assessment and understanding of Chinese laws.
Finally, this research has provided an in-depth analysis of China's regulatory progress in two areas—market access liberalisation and franchise specific laws. This progress has occurred gradually since China introduced the Open Door policy. It has been driven by China's WTO accession commitments to improve the consistency, transparency and non-discrimination of its legal system, and to accelerate the transformation of its governmental activities to reduce administrative intervention, and to continue to open its markets.29

10.4 IMPLICATIONS OF THIS RESEARCH

10.4.1 Implications for Theory

Theories on franchising and international franchising have been widely discussed and tested through empirical research in Western countries. This research has contributed to the literature on international franchising theory by developing a framework for better understanding the influence that regulation has on international franchisor in their choice of entry and expansion modes into the markets of developing and transitional economies. The framework for this research can be used by other researchers to develop further the theories of international franchising in relation to other developing countries. It has also tested the theories developed in relation to Western developed countries and their application to a developing economy. Through empirical research, it finds that franchise regulation plays a significant role in relation to sector development. This research has added to the sparse literature on the role of regulation on franchise sector development within developing countries and transitional economies.

10.4.2 Implications for Practice

For an internationally expanding franchising company, in addition to choosing a target country it also has to choose an entry mode by considering factors such as risk, cost and control in relation to the alternative entry vehicles. Further considerations arise when the target country is a developing country with legal restrictions on foreign investment and on franchising. China’s environmental factors (including its stage of economic development, social and cultural conditions, and regulatory and political conditions) were found to have significant influence on foreign franchisors’ choice of entry. Advice from local legal practitioners with an understanding of not only the law, but also on governmental policy and direction, can play an important role in making the right decisions when entering China.

Ambiguity in China’s laws and regulations still raises serious concerns for Western companies. The reform of franchising-related laws in China has generally been in compliance with China’s WTO commitment. But it was unfortunate that the 2007 Franchise Regulation did not clarify the legal status of cross border franchising, a frequently used mode of expansion by franchisors. In addition, the influence of local government bureaucracy, the persistence of administrative discretions, and a lack of enforcement remain major issues for foreign franchisors.

10.5 LIMITATIONS AND FUTURE RESEARCH DIRECTIONS

This research examined the introduction of franchising in China and the growth of the Chinese franchise sector. It analysed the development of China’s regulatory regime for foreign franchisors and its impact on foreign franchisors’ decisions. However, there are certain limitations in this research. Legal reforms and developments in the market and commercial infrastructure of China are ongoing. The study in relation to foreign investment law covers the period 1978-2007 and, in relation to specific franchising on franchising regulations, 1997-2007.
The sample for the qualitative research conducted for this thesis was limited to the two major foreign fast food companies operating in China. Therefore, the findings of this research may only be applicable to large and well-established franchising systems in particular industries.

Entry and expansion modes are not only influenced by environmental factors, but also by organisational factors which are not addressed in this research. The impact of regulation can vary, depending upon the industry and size of a firm. Future studies may investigate the influence of regulatory impact on franchisors in other industries or on franchisors of smaller scale and prominence than those considered here.

10.6 CHAPTER SUMMARY

The recent regulatory reforms which have liberalised entry for FDI franchisors to China and its franchise market, combined with the regulation of franchising under the 2007 Franchise Regulation, suggest that the future success of franchising in China will depend more on market competition than government policies. The experience of the past twenty years of franchise development in China, combined with the increasing sophistication of the economy, the increased development of its commercial law and law and its vast potential consumer market, strongly suggest that the continuing growth of the franchise sector is inevitable. Given the vast potential of China as a consumer market, and the proven successes of franchising, the future development of franchising in China seems assured.
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APPENDIX I: 2007 FRANCHISE REGULATION

中华人民共和国国务院令
第 485 号

People's Republic of China State Council
Ordinance No. 485

《商业特许经营管理条例》
"Commercial Franchise Administration Regulation"

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August 30, 2007

Readers should be aware that both legally and linguistically the only authoritative text of the
Regulation is the Chinese version. A translator is often required to make imperfect choices in
preparing a translation. A translation is thus also an interpretation of the Regulation. For this
reason we have included the original Chinese text. This translated text has been provided as a
guide only. For more complete answers with regard to the interpretation of this Regulation
readers should consult the Chinese text and a lawyer familiar with the two languages and the
two systems of law. Thanks are due to 王之琼 (Zhiqiong June Wang) of the University of New
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人民共和国国务院令
第 485 号

People's Republic of China State Council

Ordinance No. 485

《商业特许经营管理条例》已经 2007 年 1 月 31 日国务院第 167 次常务会议通过，现予公布，自 2007 年 5 月 1 日起施行。


总 理 温家宝
Premier Wen Jiabao

二〇〇七年二月六日
On February 6, 2007

商业特许经营管理条例

Commercial Franchise Administration Regulation

第一章 总则
First Chapter - General Principles

第一条 为规范商业特许经营活动，促进商业特许经营健康、有序发展，维护市场秩序，制定本条例。

Article 1 – This Regulation has been promulgated for the purposes of regulating commercial franchising activities, to promote the healthy and orderly development of commercial franchising, and to maintain market order.

第二条 在中华人民共和国境内从事商业特许经营活动，应当遵守本条例。

Article 2 – Commercial franchising activities conducted within the territory of the People's Republic of China shall comply with this Regulation.¹

¹ Under the principle of “one country, two systems” the Hong Kong and Macau Special Administrative Regions have their own separate legal systems, even though they are within the territory of the
Article 3 – In this Regulation a commercial franchise (hereafter referred to as a “franchise”), refers to an arrangement whereby an enterprise (hereafter referred to as a “franchisor”) through an agreement grants other operators (hereafter referred to as the “franchisees”) the right to use its business operating resources, including registered trademarks, logos, patents, and proprietary technologies; whereby the franchisee conducts business under a uniform mode of operation; and whereby the franchisee pay franchise fees according to the agreement.

No entity or individual other than an enterprise may conduct business as a franchisor.

Article 4 – Persons engaged in franchising shall follow the principles of voluntariness, fairness, honesty and good faith.

Article 5 – The commercial administrative department under the State Council shall be responsible for the supervision and administration of franchising activities nationwide in accordance with this Regulation. The commercial departments of the governments of provinces, autonomous regions, and municipalities directly under the central government shall be responsible for the supervision and administration of franchising activities at the provincial, autonomous region, and municipal levels respectively.
responsible for administrative supervision and the management of franchising activities in their respective territories in accordance with this Regulation.

Article 6 - Any legal entity or individual has the right to report violations of this Regulation to a commerce department. Upon receipt of such reports the relevant commerce department shall deal with the report in a timely manner and in accordance with the law.

Second Chapter – Franchising Activities

Article 7 - To be engaged in franchising a franchisor shall have a mature business model, and shall be able to provide franchisees with continuous operational guidance, technical support, training and other services.

For a franchisor to be engaged in franchising it must have at least 2 directly-operated company-owned stores and have operated them for at least 1 year.

Article 8 - Franchisees shall file their franchising contracts within 15 days after signing them, and shall report any violations of this Regulation to the relevant commerce department. Each subordinate level of government can exercise the same powers as the national level (with certain exceptions) provided that they do not contradict or conflict with the laws and regulations adopted by a superior level of government. See China’s Constitution and in particular Article 100, and the Legislation Law of the People’s Republic of China, adopted at the Third Session of the Ninth National People’s Congress on March 15, 2000 that came into force on July 1, 2000, and in particular Chapter 2 of that Law.

The Chinese word “拥有” (yōngyǒu) in this context can mean both “own” and “be able to provide.” Accordingly we have chosen to translate it as “have.”

Chinese does not have verb tenses as do English or French, and concepts of past actions are conveyed through “aspect” and context. But on this wording a native speaker of Chinese would assume that the franchisor is currently required to own and operate the two locations for more than one year. Thus a franchisor that has in the past owned and operated the required locations, but does not now own or operate them, would not be qualified. The term “直营店” (zhí yíng diàn) is a term developed in China as part of an effort to distinguish different types of chain stores.
In accordance with the provisions of this Regulation a franchisor shall register at the relevant commercial department within 15 days after signing its first franchise agreement. In provinces, autonomous regions, and directly-administered municipalities the franchisor shall register at the section of the local department of commerce that is in charge of franchising. Where the franchise is inter-provincial, or engages in franchising in another area such as an autonomous region or directly-administered municipality, the franchisor shall register with the commerce department of the State Council.

In order to register the franchisor shall submit to the relevant commerce department the following documents and the materials:

(1) a copy of its business license or a copy of its enterprise registration certificate;

(2) a standard form of franchise agreement;

(3) the franchise operating manual;

(4) its marketing plan;

(5) a written undertaking that the franchisor complies with the requirements for franchisors as

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7 The Chinese phrase “备案” (bei an) literally means to “set up a file” or “set up a record” and this Article is often translated accordingly. However we feel that in this context, and for a non-Chinese audience, the word “register” better conveys the meaning, as there are significant consequences for failing to “set up a file.”

8 In accordance of the regulations of Corporation Law and the provisions of the State Administration for Industry & Commerce, an enterprise shall operate its business strictly in accordance with the business scope stipulated in their articles of incorporation. Before applying for their registration with the local administrations, the enterprises shall obtain the permission or registration first from the authority if there is an approval process or a record requirement when operating a special industry.
set out in Article 7 of this Regulation and other relevant evidence of compliance; ⁹

(6) other documents and materials prescribed by the commercial administrative department of
the State Council.

特许经营的产品或者服务，依法应当经批准方可经营的，特许人还应当提交有关批准文件。

If the products or services of the franchise system are required by law to have other
authorizations before they can be sold or provided, the franchisor shall also submit such
authorizations or certificates.

第九条 商务主管部门应当自收到特许人提交的符合本条例第八条规定的文件、资料之
日起 10 日内予以备案，并通知特许人。特许人提交的文件、资料不完备的，商务主管部
门可以要求其在 7 日内补充提交文件、资料。

Article 9 – The relevant commerce department shall register the franchisor within 10 days of the
date that they have received all the documents by Article 8, and then notify the franchisor. If the
submitted documents and materials are incomplete, the relevant commerce department shall
require the franchisor to submit supplementary documents and materials within seven days.

第十条 商务主管部门应当将备案的特许人名单在政府网站上公布，并及时更新。

Article 10 – The relevant commerce department shall post the name of the registered franchisor
on the list of franchisors on a government website, and update such information in a timely
manner.

第十一条 从事特许经营活动，特许人和被特许人应当采用书面形式订立特许经营合同。

特许经营合同应当包括下列主要内容；

Article 11 – The franchisor and the franchisee shall use a written form of franchise agreement
when engaging in franchising.

The franchise agreement shall contain the following provisions:

（一）特许人、被特许人的基本情况；

(1) the franchisor’s and the franchisee’s basic information;

⁹ A copy of one form of such undertaking is attached as Annex 1 to our translation of the Commercial
Franchise Registration Administrative Measures.
(2) franchising provisions and the term of the agreement;

(3) the types of franchise fees, the amounts to be paid and the method of payment;

(4) specific provisions regarding the standards of operation for the franchised business, the technical support to be provided by the franchisor and the training services to be provided and how these will be delivered;

(5) the standards for the quality of the products or services and quality guarantees, and how these will be monitored and maintained;

(6) how the promotion and advertising of the products or services will be conducted;

(7) provisions regarding the protection of consumer rights and interests by the franchisee and franchisor and allocation of responsibilities and liabilities for compensation;

(8) provisions regarding amendment, cancellation and termination of the franchise agreement;

(9) default provisions and liability;

(10) dispute settlement mechanisms;

(11) other provisions which the franchisor and franchisee have agreed upon.

\[10\] Or more literally “liability for breach of contract.”
Article 12 – The franchisor and the franchisee shall provide in the franchise agreement that for a certain period of time after signing the franchise agreement the franchisee may unilaterally terminate the franchise agreement.

Article 13 – The franchise agreement shall have a minimum term of three years. But it may be shorter if the franchisee agrees.

This Article does not apply to the extension or renewal of an agreement between a franchisor and a franchise.

Article 14 – The franchisor shall provide a franchise operating manual to the franchisee, and provide continuing operational guidance, technical support, business training and other services to the franchisee in accordance with the franchise agreement.

Article 15 – The quality and standard of the products and services supplied by the franchise system shall be in accordance with the law, the relevant administrative rules and regulations and other related governmental requirements.

Article 16 – If a franchisor requires a franchisee to pay any fees before the parties enter into the franchise agreement, the franchisor shall specify in writing the purpose of such fees, and the conditions and methods for the refund of such fees.

Article 17 – Fees for promotion and marketing of the franchise system shall be applied in...
accordance with the terms of the franchise agreement. Promotional and marketing expenses shall be promptly disclosed to franchisees.

A franchisor shall not engage in deceit or misleading behavior in the promotion or marketing of the franchise. A franchisor shall not make claims in its advertising about franchisee earnings from their franchise operations.\(^{11}\)

Article 18 – A franchisee does not have the right to transfer the franchise to a third person without the consent of the franchisor.

A franchisee shall not reveal or permit other persons to access the franchisor’s commercial secrets.

Article 19 – A franchisor shall in the first quarter of each year submit a report to the relevant commercial department on the status of the franchise agreements signed during the last year.

Third Chapter – Information to be Disclosed

Article 20 – Franchisors shall establish and implement a complete\(^{12}\) disclosure system in accordance with the rules of the Commerce Department of the State Council.\(^{13}\)

Article 21 – A franchisor shall not include information about franchisee earnings from their franchise operations in its advertising.

\(^{11}\) This last sentence could be more literally translated as “A franchisor shall not include information about franchisee earnings from their franchise operations in its advertising.”

\(^{12}\) The Chinese word 完备 (wan bei) is translated in some dictionaries as “complete, perfect.” The translation of the Regulation by MOFCOM available at http://www.fdi.gov.cn/publish/FDI_EN/Laws/law_en_info.jsp?docid=76667 uses the word “perfect.”

\(^{13}\) In China regulations, including Tiaoli (regulations such as this one) emanating from the State Council, must be interpreted in accordance with the relevant laws. See the “Note Regarding Interpretation in General and the Disclosure Requirements in Particular” at the beginning of this translation. Franchisors thus should take into account the provisions of Article 42 of the Contract Law when preparing disclosure documents pursuant to Article 20 of this Regulation.
Article 21 – A franchisor shall provide a franchisee with all information required pursuant to Article 22, together with a copy of the franchise agreement, not less than 30 days before signing the franchise agreement.

第二十二条 特许人应当向被特许人提供以下信息：

Article 22 - The franchisor shall disclose to the franchisee the information set out below:14

(1) the franchisor's name, place of business, legal representative, registered capital, the scope of its franchise business and basic information about its franchise activities;

(2) basic information about the franchisor's registered trademarks, business logos, patents, 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 the terms and conditions for the products, services and equipment provided by the franchisor;

14 It should be noted that there is no statement in the Regulation that the list of disclosures in Article 22 is exhaustive of the matters that a franchisor is required to disclose. Regard should be had to the Note at the beginning of this translation. In addition MOFCOM has issued Ministry of Commerce 2007 Decree No. 16, Commercial Franchise Information Disclosure Administrative Measures (Commercial Franchise Information Disclosure Administrative Measures) in force May 1, 2007 that provide further guidance in this area, particularly in Article 5.

15 Each corporation in China must have a “法定代表人” (fading daibiao ren) a person with broad powers and potentially significant liability as the agent for the corporation. The name of the person should appear on the business license (营业执照 or yingye zhizhao) of the corporation. This individual can sign for the corporation. It does not refer to the lawyers for the franchisor. For further information see Neal Stender, William Soileau & Yan Zeng, “Representative Roulette- Individual and Corporate Risks & Precautions Affected by China Law Changes,” March 2007 Amcham China Brief. Available online at http://www.orrick.com/fileupload/1146.pdf;

16 The Chinese phrase 专有技术 (zhuan you ji shu) can also be translated as “know how.”
(5) detailed content, delivery methods and implementation plan regarding the continuous services to be provided to the franchisee, including operating guidance, technical support, training and other services;

(6) detailed method of guidance and supervision regarding the franchisees' operations;

(7) the investment budget for a franchise location;

(8) the number and location of existing franchise outlets within the territory of China, their distribution by region, and an assessment of their business performance;

(9) summaries of the financial statements and audit reports, audited by an accounting firm, for the most recent 2 years;

(10) franchise related lawsuits and arbitrated matters for the last five years and their status;

(11) whether the franchisor or its management legal representative have been convicted of serious illegal operations;

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17 Chinese does not have definite and indefinite articles. A number of translators, including those at MOFCOM, have translated this sentence using “the,” thereby implying that the investment budget to be provided should be specific to the location proposed to the franchisee. However we have chosen the indefinite article “a” because the literal translation is “franchise outlet investment budget” and the word “网点” (wang dian) here translated as “outlet” also means “a network of commercial establishments.” In other words it does not appear to be location specific.

18 When the Regulation first appeared there was considerable discussion as to the meaning of the phrase regarding “assessment of business performance.” After the issuance of the Information Disclosure Decree (supra note 11) it became clear that what is required is an earnings or financial performance claim, see Article 5 (VIII)(2). This guidance is in line with the application of Article 42(2) of the Contract Law as referred to in the Note at the beginning of this translation, which prohibits the intentional concealment of material facts related to the making of the contract.

19 It is not clear from the Chinese text whether these are fiscal years or calendar years.

20 See note 27, supra.
（十二）国务院商务主管部门规定的其他信息。

(12) other information specified by the Commerce Department of the State Council.

第二十三条 特许人向被特许人提供的信息应当真实、准确、完整，不得隐瞒有关信息，或者提供虚假信息。

特许人向被特许人提供的信息发生重大变更的，应当及时通知被特许人。

特许人隐瞒有关信息或者提供虚假信息的，被特许人可以解除特许经营合同。

Article 23 – The information provided by the franchisor to the franchisee shall be true, accurate and complete and shall not conceal any relevant information, or provide any false information.\(^{21}\)

If there is a significant change in the information provided by the franchisor to the franchisee, the franchisor shall promptly inform the franchisee.

If a franchisor conceals relevant information or provides false information, the franchisee may terminate the franchise agreement.

第四章 法律责任

Fourth Chapter - Legal Liability

第二十四条 特许人不具备本条例第七条第二款规定的条件，从事特许经营活动的，由商务主管部门责令改正，没收违法所得，处 10 万元以上 50 万元以下的罚款，并予以公告。

企业以外的其他单位和个人作为特许人从事特许经营活动的，由商务主管部门责令停止非法经营活动，没收违法所得，并处 10 万元以上 50 万元以下的罚款。

Article 24 – Where a franchisor that does not meet the qualifications set out in Article 7(2)\(^ {22}\) of this Regulation but nonetheless is engaged in franchising, the relevant Commerce Department shall order it to make payments and remedies to correct the situation, confiscate its illegal gains, impose a fine of not less than RMB 100,000 but not more than RMB 500,000,\(^ {23}\) and make

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\(^{21}\) Although the English word “conceal” implies an intent not to disclose something, there are some who interpret the Chinese word “隐瞒” (yinman) as simply requiring the failure to disclose a required item and thus translate this “shall not omit any relevant information.” Therefore it is not clear that a franchisee will have the burden of proving intent on the part of the franchisor in the event of a material omission from a disclosure document. See also the Note at the beginning of this translation regarding the requirements of Article 42 of the Contract Law.

\(^{22}\) This refers to the requirements to have operated two company-owned locations for one year.

\(^{23}\) From about $13,000.00 USD to about $65,000.00 USD at the April 5, 2007 conversion rate.
If legal entities or individuals other than a franchisor engage in franchising, the relevant Commerce Department shall order a cessation of such illegal business, confiscate all illegal income and impose a fine of not less than RMB 100,000 but not more than RMB 500,000.\(^{24}\)

**Article 25** – Where a franchisor has not registered with the relevant Commerce Department according to Article 8\(^{25}\) of this Regulation, the relevant Commerce Department shall order the completion of such registration within a specified time and impose a fine of not less than RMB 10,000 and not more than RMB 50,000.\(^{26}\) If the franchisor has not registered within the time specified a fine of not less than RMB 50,000 and not more than RMB 100,000\(^{27}\) shall be imposed and a public announcement shall be made.

**Article 26** – Where the franchisor has not complied with Article 16\(^{28}\) or Article 19\(^{29}\) of this Regulation the relevant Commerce Department shall order such compliance and fine the franchisor up to RMB 10,000. However if the circumstances of the breach are serious the fine shall be not less than RMB 10,000 and not more than RMB 50,000\(^{30}\) and a public announcement shall be made.

**Article 27** – Where the franchisor has violated the provisions of Article 17(2)\(^{31}\) the

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\(^{24}\) See note 35, supra.

\(^{25}\) This refers to the requirement for the franchisor to register within 15 days of the signing of the first agreement.

\(^{26}\) This applies where the franchisor requires the payment of fees before the franchise agreement is signed.

\(^{27}\) This refers to the obligation on the franchisor to annually report the franchise agreements signed during the past year.

\(^{28}\) From about $1,300.00 USD to about $6,500.00 USD at the April 5, 2007 conversion rate.

\(^{29}\) From about $6,500.00 USD to about $13,000.00 USD at the April 5, 2007 conversion rate.

\(^{30}\) From about $1,300.00 USD to about $6,500.00 USD at the April 5, 2007 conversion rate.

\(^{31}\) This refers to the prohibitions on misleading advertising, and using ads that contain representations regarding franchisee profits.
Administration for Industry and Commerce shall order it to correct the matter and impose a fine of not less than RMB 30,000 and not more than RMB 100,000. If the violation is serious the fine shall be not less than RMB 100,000 and not more than RMB 300,000 and a public announcement shall be made. If the violation constitutes a crime, the franchisor shall be held criminally responsible.

Where a franchisor has used misleading advertising or misleading conduct, the franchisor shall be penalized in accordance with the Advertising Law.

Article 28 – Where the franchisor has violated Article 21 or Article 23 of this Regulation and the violation is reported by a franchisee to the relevant Commerce Department and the violation has been verified, the relevant Commerce Department shall order the correction and fine the franchisor not less than RMB 10,000 and not more than RMB 50,000. If the circumstances of the violation are serious the fine shall be not less than RMB 50,000 and not more than RMB 100,000 and a public announcement shall be made.

Article 29 – Where anyone defrauds others of money or property in the name of franchising, if such activity contravenes the Criminal Code such person shall be held criminally liable. If they are not in contravention of the Criminal Code, they may still be punished by the public security authorities in accordance with the "People's Republic of China Public Security Administrative Punishment Law."

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32 The name of the national level body is the 国家工商行政管理总局 (Guojia Gong Shang Xingzheng Guanli Zongju - State Administration for Industry and Commerce). See www.saic.gov.cn.
33 From about $4,000.00 USD to about $13,000.00 USD at the April 5, 2007 conversion rate.
34 From about $13,000.00 USD to about $39,000.00 USD at the April 5, 2007 conversion rate.
35 The full name of the statute is the 中华人民共和国广告法 (Zhonghua Renmin Gongheguo Guanggao Fa) or Advertising Law of the People's Republic of China, adopted at the 10th Meeting of the standing Committee of the Eighth National People's Congress on October 27, 1994, and in force on February 1, 1995.
36 This refers to the requirement to provide a disclosure document at least 30 days before the franchise agreement is signed.
37 This refers to the requirement that all information provided shall be true, accurate and complete.
38 From about $1,300.00 USD to about $6,500.00 USD at the April 5, 2007 conversion rate.
39 From about $6,500.00 USD to about $13,000.00 USD at the April 5, 2007 conversion rate.
40 中华人民共和国治安管理处罚法 (Zhonghua Renmin Gongheguo Zhi'an Guanli Chufa Fa - People's Republic of China Public Security Administrative Punishment Law) adopted at the 17th Session of the Standing Committee of the Tenth National People's Congress on August 28, 2005 and effective as of March 1, 2006.
Where multi-level marketing activities have been carried on under the name of franchising, the punishment will be in accordance with the "Prohibition of Multi-level Marketing Regulations."

Article 30 – Where a member of the relevant Commerce Department abuses his power, is derelict in his duties, or engages in malpractice for personal gain, he shall be investigated and if he has contravened the Criminal Code, held criminally responsible. If the activity is not a contravention of the Criminal Code the employee should still be disciplined in accordance with the law.

Fifth Chapter - Supplementary Articles

Article 31 – Franchising activities involving trademark licenses or patent licenses shall comply with the related trademark or patent laws and administrative rules and regulations.

Article 32 – Related associations and organizations shall, under the guidance of the commerce department of the State Council, establish standards for franchise activities, strengthen self-regulation in the franchise industry, and provide services to persons involved in franchising.

Article 33 – Franchisors already engaged in franchising prior to the effective date of this Regulation shall register in accordance with the provisions of this Regulation with the relevant commerce department within one year of the effective date of this Regulation. If they have not registered within this time period they shall be punished in accordance with Article 25 of this Regulation.

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\(^{41}\) 禁止传销条例 (Jin Zhi Chuan Xiao Tiaoli - Regulations for the Administration of Direct Selling), Order of the State Council No. 444, promulgated by the State Council on August 23 2005 and effective as of November 1, 2005.

\(^{42}\) This phrase is also used to refer to “playing favoritism.”
Regulation.

Franchisors who are already engaged in franchising prior to the effective date of this Regulation are not required to comply with the second paragraph of Article 73 of this Regulation.

第三十四条 本条例自2007年5月1日起施行。

Article 34 - This Regulation shall come into effect on May 1, 2007.

来源：国务院办公厅

Origin: State Council Office

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43 This refers to the required qualifications to be a franchisor, including the requirement that the franchisor have owned and operated at least two locations for at least one year.
APPENDIX II: 2007 FRANCHISE DISCLOSURE MEASURES

商务部令 2007 年第 16 号

商业特许经营信息披露管理办法

Ministry of Commerce 2007 Decree No. 16

Commercial Franchise Information Disclosure Administrative Measures

Translation and notes by

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Readers should be aware that both legally and linguistically the only authoritative text of the Measures is the Chinese version. A translator is often required to make imperfect choices in preparing a translation. A translation is thus also an interpretation of these Measures. For this reason we have included the original Chinese text. The translated text has been provided as a guide only. For more complete answers with regard to the interpretation of these Measures readers should consult the Chinese text and a lawyer familiar with the two languages and the two systems of law.
The "Commercial Franchise Information Disclosure Administrative Measures," which were adopted at the 6th Inter-Departmental Meeting\(^1\) of the Ministry of Commerce of the People's Republic of China on April 6, 2007, are hereby promulgated and come into force as of May 1, 2007.

部长：薄熙来

Minister: Bo Xilai

April 30, 2007

\(^1\) The Chinese phrase “部务会” (bu wu hui) is a common and somewhat vague phrase and indicates a regular meeting within the particular Ministry.
Article 1  These Measures are formulated in accordance with the Commercial Franchise Administration Regulation (hereinafter referred to as the “Regulation”) for the purpose of protecting the lawful rights and interests of both franchisors and franchisees.

Article 2  These Measures apply to commercial franchise activities conducted within the People’s Republic of China.²

Article 3  The term “affiliated company” as used in these Measures refers to the parent company of the franchisor, the subsidiaries where the franchisor directly or indirectly owns all or most of the equitable rights,³ and companies in which all or most of the equitable rights are owned, directly or indirectly, by the same person or persons who directly or indirectly own most or all of the equitable rights in the franchisor.

Article 4  The franchisor shall in accordance with the provisions of the Regulation not less 30 days before the conclusion of the franchise agreement, disclose in writing to the franchisee the information specified in Article 5 of these Measures, and shall provide a copy of the franchise agreement.

Article 5  The Franchisor shall include the following information in its required disclosure document:

(I) Basic information about the franchisor and its management.

² Under the principle of “one country, two systems” the Hong Kong and Macau Special Administrative Regions have their own separate legal systems, even though they are within the boundaries of the People’s Republic of China. Article 5 of the basic laws of the two regions state that “The socialist system and policies shall not be practiced in the [Hong Kong or Macau respectively] Special Administrative Region, and the previous capitalist system and way of life shall remain unchanged for 50 years.” Accordingly these Measures do not apply in Hong Kong SAR and Macau SAR.

³ The Chinese word “股” (gu) can mean both “share in a company” or “one of several equal parts of a property.” Accordingly here we have chosen to translate “股权” (gu quan) as “equitable rights” which has a broader meaning.
1. The franchisor's name, mailing address, contact information, legal representative, general manager, registered capital amount, business scope as well as the number, addresses and telephone numbers of existing outlets directly operated by the franchisor.

2. Overview of the franchise activities of the franchisor.

3. Basic information regarding the franchisor's registration.\(^5\)

4. Where an affiliate of the franchisor supplies products or services to the franchisees, the basic information regarding such affiliate.

5. Information regarding the bankruptcy of or applications for bankruptcy of the franchisor or its affiliates in the past five years.

(二) 特许人拥有经营资源的基本情况。

(II) Basic information regarding the operational resources of the franchisor.

1. A written statement of the information that it can provide regarding its registered trademarks, business logos, patents, technical know how, operational systems and other business operating resources.

2. Each corporation in China must have a "法定代表人" (fadi daibiao ren) a person with broad powers and potentially significant liability as the agent for the corporation. The name of the person should appear on the business license (营业执照 or yingye zhizhao) of the corporation. This individual can sign for the corporation. It does not refer to the lawyers for the franchisor. For further information see Neal Stender, William Soileau & Yan Zeng, "Representative Roulette- Individual and Corporate Risks & Precautions Affected by China Law Changes," March 2007 Amcham China Brief. Available online at http://www.orrick.com/fileupload/1146.pdf.

3. As required by Article 8 of the Regulation.
1. Where the owner of the above-mentioned operational resources is an affiliate of the franchisor, the basic information regarding the affiliate shall be disclosed and the franchisor shall specify how it will operate the franchise system once the license from the affiliate to use the resource is terminated.

3. Information regarding any litigation or arbitration involving the registered trademarks, business logos, management and other resources, patents, or technical know how of the franchisor or its affiliate.

(III) Basic information about franchise fees.

1. The categories, amounts, rates and terms for payment of the fees collected by the franchisor for itself or on behalf of third parties. Where the information cannot be disclosed an explanation as to why must be given. Where the fees charged are not uniform, the minimum and maximum amounts shall be disclosed and an explanation shall be given.

2. The conditions under which security deposits are collected and refunded, as well as when and how refunds will occur.

3. Where the franchisee is required to pay any fees before the conclusion of the franchise agreement, the franchisor shall specify in writing to the franchisee the purpose of such fees and the conditions and method for the refund of such fees.

(IV) Information regarding the prices and conditions for products, services or equipment supplied to the franchisees.

1. The categories, amounts, rates and terms for payment of the fees collected by the franchisor for itself or on behalf of third parties. Where the information cannot be disclosed an explanation as to why must be given. Where the fees charged are not uniform, the minimum and maximum amounts shall be disclosed and an explanation shall be given.

2. The conditions under which security deposits are collected and refunded, as well as when and how refunds will occur.

3. Where the franchisee is required to pay any fees before the conclusion of the franchise agreement, the franchisor shall specify in writing to the franchisee the purpose of such fees and the conditions and method for the refund of such fees.

(IV) Information regarding the prices and conditions for products, services or equipment supplied to the franchisees.

1. The categories, amounts, rates and terms for payment of the fees collected by the franchisor for itself or on behalf of third parties. Where the information cannot be disclosed an explanation as to why must be given. Where the fees charged are not uniform, the minimum and maximum amounts shall be disclosed and an explanation shall be given.

2. The conditions under which security deposits are collected and refunded, as well as when and how refunds will occur.

3. Where the franchisee is required to pay any fees before the conclusion of the franchise agreement, the franchisor shall specify in writing to the franchisee the purpose of such fees and the conditions and method for the refund of such fees.
1. Whether the franchisees must purchase any products, services or equipment from the franchisor (or its affiliate) and the relevant prices and terms etc.

2. Whether the franchisees must buy products, services or equipment from a supplier designated (or approved) by the franchisor.

3. Whether or not the franchisees are allowed to choose other suppliers and the qualification requirements for such suppliers.

(V) Ongoing services to be provided to the franchisee.

1. The specific content, delivery and implementation methods, including location, method and duration, of the training.

2. The specific components of the technical support, including a description of the table of contents of the operating manual and the relevant number of pages.

(VI) The components and method for the operational guidance and supervision provided to the franchisee.

1. The method and implementation of the franchisor’s guidance and supervision of the operations of the franchisee; and the obligations that the franchisee must fulfill as well as the consequences resulting from the failure of the franchisee to fulfill such obligations.

2. Whether or not the franchisor will have joint and several liabilities for customer
complaints and compensation, and if so how this will be implemented.

(VII) Information about the estimated investment required for a franchise outlet.

1. The investment estimate may include the following expenses: franchise fees; cost of training; cost of real estate and décor; cost of equipment, office furniture and supplies etc.; initial inventory; cost of water, electricity and gas; the cost of obtaining licenses and other governmental approvals; and start-up capital.

2. The basis for such estimates and the source of the data.

(VIII) Relevant information about franchisees in China.

1. The number, geographic distribution, and scope of permitted sales for the existing and anticipated franchisees, and whether or not they have any exclusive territories or rights (if there are any such territories or rights the scope of such).

2. Information regarding an evaluation of the operations of the franchisees. The franchisor shall disclose information regarding the franchisees actual or estimated average gross sales, costs, gross profits and net profits, and describe the relevant time periods and source of the data and the outlets involved. If the information is estimated, the basis for such estimates shall be provided and explained and shall expressly state that actual business operations may be different from the estimates.

This could also be translated as “investment budget.” The Chinese word “预算” is commonly translated as “budget.”
IX) Summaries of the franchisor’s financial statements and audit reports, audited by an accounting firm, for the two most recent years.

(X) Information regarding material litigation or arbitration of the franchisor for the last 5 years.

1. The term “material litigation or arbitration” refers to litigation or arbitration involving 500,000 RMB or more.7

2. Basic information regarding the lawsuits shall be disclosed, including where the claim was filed and the results of such litigation.

(XI) Information regarding any record of material illegal operations with respect to the franchisor or its legal representative.

1. Being fined not less than 300,000 RMB but not more than 500,000 RMB8 by an administrative law enforcement department.

2. Being subject to criminal liabilities.

(XII) Copy of the franchise agreement

1. A sample franchise agreement.

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7 About $65,000.00 USD at the April 5, 2007 conversion rate. The preferred interpretation is that this refers to single matters involving 500,000 RMB or more, not to several matters involving 500,000 RMB or more.

8 From about $39,000.00 USD to about $65,000.00 USD at the April 5, 2007 conversion rate.
2. Where the franchisor will require the franchisee to sign any other franchise related agreement with it or one of its affiliates, it shall provide a sample of such agreement.

第二条　特许人要求被特许人（或关联公司）签订其它有关特许经营的合同，应当同时提供此类合同样本。

Article 6  The franchisor shall not conduct advertising and promotion activities of a fraudulent or misleading nature, or issue any advertising publicizing the earnings from its franchise operations of a single franchisee.

第六条　特许人在推广、宣传活动中，不得有欺骗、误导的行为，其发布的广告中不得含有宣传单个被特许人从事特许经营活动收益的内容。

Article 7  Before it makes any information disclosure to a franchisee a franchisor has the right to require that the franchisee sign a confidentiality agreement.

第七条　特许人在向被特许人披露信息前，有权要求被特许人签署保密协议。

Article 8  After a franchisor makes an information disclosure to a franchisee, the franchisee shall issue an acknowledgement or receipt (in duplicate) to the franchisor specifying the contents of the disclosure received from the franchisor, which shall be signed by the franchisee. One copy shall be retained by the franchisee and the other copy shall be retained by the franchisor.

第八条　特许人在向被特许人进行信息披露以后，被特许人应当就所获悉的信息内容向特许人出具回执说明（一式两份），由被特许人签字，一份由被特许人留存，另一份由特许人留存。

Article 9  Where the franchisor has concealed that should have been disclosed or has disclosed false information; the franchisee may terminate the franchise agreement.

第九条　特许人隐瞒应当披露而没有披露的信息或者披露虚假信息的，被特许人可以解除特许经营合同。

Article 10  Where the franchisor has breached a provision of these Measures, the franchisee may report such breach to the relevant Commerce Department. Upon verification the relevant Commerce Department may order correction of the breach, impose a fine of not less then 10,000

第十条　特许人违反本办法规定的，被特许人有权向商务主管部门举报，经查实的，由商务主管部门责令改正，处 1 万元以上 5 万元以下的罚款；情节严重的，处 5 万元以上 10 万元以下的罚款，并予以公告。

<sup>9</sup> Although the English word “conceal” implies an intent not to disclose something, there are some who interpret the Chinese word “隐瞒” (yinman) as simply requiring the failure to disclose a required item. Therefore it is not clear that a franchisee will have the burden of proving intent on the part of the franchisor in the event of a material omission from a disclosure document.
RMB and not more than 50,000 RMB, or if the circumstances are serious a fine of not less than 50,000 RMB and not more than 100,000 RMB, and make a public announcement.

第十一条 本办法由中华人民共和国商务部负责解释。

Article 11 The Ministry of Commerce of the People’s Republic of China is responsible for the interpretation of these Measures.

第十二条 本办法自 2007 年 5 月 1 日起实施。

Article 12 These Measures shall come into effect on May 1, 2007.

10 From about $1,300.00 USD to about $6,500.00 USD at the April 5, 2007 conversion rate.
11 From about $6,500.00 USD to about $13,000.00 USD at the April 5, 2007 conversion rate.
APPENDIX III: 2007 FRANCHISE REGISTRATION MEASURES

商务部令 2007 年第 15 号

商业特许经营备案管理办法

Ministry of Commerce 2007 Decree No. 15

Commercial Franchise Registration Administrative Measures

Translation and notes by

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Readers should be aware that both legally and linguistically the only authoritative text of the Measures is the Chinese version. A translator is often required to make imperfect choices in preparing a translation. A translation is thus also an interpretation of these Measures. For this reason we have included the original Chinese text. The translated text has been provided as a guide only. For more complete answers with regard to the interpretation of these Measures readers should consult the Chinese text and a lawyer familiar with the two languages and the two systems of law.
Ministry of Commerce 2007 Decree No. 15

Commercial Franchise Registration
Administrative Measures

The "Commercial Franchise Registration Administrative Measures," which were adopted at the 6th Inter-Departmental Meeting of the Ministry of Commerce of the People's Republic of China on April 6, 2007, are hereby promulgated and come into force as of May 1, 2007.

Minister: Bo Xilai
April 30, 2007

Article 1 These Measures are formulated in accordance with the Commercial Franchise Registration Administrative Measures.
Franchise Administration Regulation (hereinafter referred to as the “Regulation”) for the purpose of strengthening the administration of commercial franchise operations and regulating the market order of franchise operations.

第二条 在中华人民共和国境内（以下简称中国境内）从事商业特许经营活动，适用本办法。

Article 2 These Measures apply to commercial franchise activities conducted within the People’s Republic of China.\(^3\)

第三条 国务院商务主管部门及省、自治区、直辖市人民政府商务主管部门是商业特许经营的备案机关。在省、自治区、直辖市范围内从事商业特许经营活动的，向特许人所 在地省、自治区、直辖市人民政府商务主管部门备案；跨省、自治区、直辖市范围从事特许经营活动的，向国务院商务主管部门备案。

商业特许经营的备案工作实行全国联网。符合《商业特许经营管理条例》规定的特许人，都应当通过政府网站进行备案（网址为 [www.mofcom.gov.cn](http://www.mofcom.gov.cn)）。

Article 3 The Commerce Department of the State Council and the Commerce Departments of each province, autonomous region and municipality directly under the central government\(^4\) are the relevant administrative authorities for the registration of commercial franchises. Where a franchisor engages in commercial franchise operations within the territorial scope of a province, autonomous region or municipality directly under the central government, the franchisor shall register with the Commerce Department of the respective province, autonomous region or municipality directly under the central government where it is located. Where a franchisor engages in commercial franchise operations across the territorial boundaries of a province, autonomous region or municipality under the central government, the franchisor shall register with the Commerce Department of the State Council.\(^5\)

\(^3\) Under the principle of “one country, two systems” the Hong Kong and Macau Special Administrative Regions have their own separate legal systems, even though they are within the boundaries of the People’s Republic of China. Article 5 of the basic laws of the two regions state that “The socialist system and policies shall not be practised in the [Hong Kong or Macau respectively] Special Administrative Region, and the previous capitalist system and way of life shall remain unchanged for 50 years.” Accordingly these Measures do not apply in Hong Kong SAR and Macau SAR. Also see Article 17 of these Measures.

\(^4\) The second level of government in China consists of 22 provinces (Heilongjiang, Jilin, Liaoning, Hebei, Henan, Anhui, Shandong, Jiangsu, Zhejiang, Shanxi, Shaanxi, Hubei, Hunan, Jiangxi, Fujian, Guangdong, Hainan, Sichuan, Yunnan, Guizhou, Gansu and Qinghai); five autonomous regions (Ningxia, Inner Mongolia, Guangxi, Xinjiang and Tibet); and four municipalities directly under the authority of the central government (Beijing, Tianjin, Shanghai and Chongqing). China is a unitary state and there is accordingly only a limited division of powers compared to what is found in federal states such as Canada, Germany and the United States. Each subordinate level of government can exercise the same powers as the national level government (with certain exceptions) provided that they do not contradict or conflict with the laws and regulations adopted by a superior level of government. See China’s 宪法 (xian fa or Constitution) and in particular Article 100, and the 中华人民共和国立法法 (Zhonghua Renmin Gongheguo Lifa Fa – Legislation Law of the People’s Republic of China, adopted at the Third Session of the Ninth National People’s Congress on March 15, 2000 that came into force on July 1, 2000, and in particular Chapter 2 of that Law.

\(^5\) Also called the Ministry of Commerce (“MOFCOM”).
A national network shall be used for commercial franchise registrations. Franchisors who meet the requirements of the provisions of the Commercial Franchise Administrative Regulation shall register through the government web site (www.mofcom.gov.cn).

**Article 4** Any entity or individual may report a breach of these Measures to the relevant registration authorities.

**Article 5** Franchisors applying for registration shall submit the following items to the relevant registration authority:

1. The basic information about the commercial franchise system.
2. The location of all of the franchisee stores within China.
3. The franchisor's marketing plan.
4. A photocopy of the business license of the legal entity or a photocopy of any other entity qualification certificate.
5. Photocopies of the registration certificates of the trademarks, patents and operational resources relating to the franchise system.
6. Evidentiary documents issued by the relevant municipal level Commerce Department certifying that the applicant satisfies the requirements of Article 7,

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6 This may also be translated as "juristic person."
second paragraph, of the Regulation. Where the directly operated units are located outside of China, the franchisor shall provide certificates evidencing such operations (together with a Chinese translation), and such certificates shall be notarized by a local notary public and authenticated by the Chinese Embassy or Consulate where such outlets are located.

The preceding paragraph does not apply to franchisors who had already engaged in franchise operations prior to May 1, 2007, but such franchisors shall submit the first franchise agreement concluded between the franchisor and a franchisee in China.

(7) A sample franchise agreement.

(8) The table of contents of the franchise operations manual (the number of pages of each chapter and the total number of pages in the manual shall be indicated. Where such manual is provided on an internal web site of the franchise system, an estimate of the number of pages in a print-out shall be indicated).

(9) Where national laws and regulations require prior approval to offer the product or service to be franchised, the franchisor shall submit an approval document from the relevant administrative authority.

(10) The franchisor shall provide an undertaking signed by its legal representative and stamped with the franchisor's corporate seal.

Items (1) to (3) above may be completed and submitted online. Documents required by (4) to (10) above may be submitted online in PDF format.

第六条 特许人应当在与中国境内的被特许人首次订立特许经营合同之日起的15天内向备案机关申请备案。在2007年5月1日前已经从事特许经营活动的特许人，应当自《条例》施行之日起1年内，依照本办法的规定向有关商务主管部门申请备案。

Article 6 Franchisors shall apply for registration to the relevant Commerce Department within 15 days of concluding their first franchise agreement in China. Franchisors that have engaged in franchise activities prior to May 1, 2007 shall apply to the relevant Commerce Department for registration in accordance with these Measures within one year after the implementation of the Regulation.
Article 7 Where there is a change in the registration information of a franchisor, the franchisor shall within 30 days of the change apply to the registration authority to have the registration amended.

第八条 特许人应当在每年3月31日前将其上一年度订立、撤销、续签与变更的特许经营合同情况向备案机关报告。

Article 8 Franchisors shall, prior to March 31 in each year, submit to the registration authority any terminations, rescissions, extensions or modifications of franchise agreements that have occurred or been entered into in the preceding year.

第九条 特许人应认真填写所有备案事项的信息，并确保所填写内容真实、准确和完整。

Article 9 Franchisors shall faithfully complete all items required for registration and ensure that the information submitted is truthful, accurate and complete.

第十条 备案机关应当自收到特许人提交的符合本办法第五条规定的文件、资料之日起10日内予以备案，并在商务部网站予以公告。

特许人提交的文件、资料不完备的，备案机关可以要求其在7日内补充提交文件、资料。备案机关在特许人材料补充齐全之日起10日内予以备案。

Article 10 The registration authority shall, within 10 days after receiving the documents and materials prescribed in Article 5 of these Measures, complete the registration formalities and publicly announce the registration on the web site of the Ministry of Commerce.

Where the documents or materials submitted by the franchisor are incomplete, the registration authority may require supplemental submissions within 7 days. On receipt from the franchisor of all of the supplemental documents and materials that it required it shall complete the registration within 10 days.

第十一条 已完成备案的特许人有下列行为之一的，备案机关可以撤销备案，并在商务部网站予以公告：
（一）因特许人违法经营，被主管登记机关吊销营业执照的。
（二）备案机关收到司法机关因为特许人违法经营而做出的关于撤销备案的司法建议书的。
（三）特许人隐瞒有关信息或者提供虚假信息经查证属实的。
（四）特许人自行注销的。

Article 11 Where any of the following circumstances apply to a franchisor who has completed the registration procedures, the relevant Commerce Department may cancel the registration and make a public announcement of the same on the web site of the Ministry of Commerce.

(1) The franchisor’s business license is revoked by the relevant registration authority due to its illegal business operations.
(2) The registration authority receives advice from a judicial authority proposing a revocation of the registration because of the franchisor’s illegal business operations.

(3) It is found upon investigation that the franchisor concealed relevant information or provided false information.

(4) The franchisor cancels the registration on its own initiative.

第十二条 各省、自治区、直辖市人民政府商务主管部门应当将备案及撤销备案的情况在 10 日内反馈商务部。

Article 12 The relevant commerce departments of the provinces, autonomous regions and municipalities directly under the central government shall report all registrations and cancellations of registrations to the Ministry of Commerce within 10 days.

第十三条 备案机关在完成备案手续的同时，应当完整准确地记录和保存特许人的备案信息材料，依法为特许人保守商业秘密。

Article 13 In completing the registration formalities the registration authority shall completely and accurately record and maintain the franchisor’s submissions, and shall maintain the confidentiality of the franchisor’s commercial secrets in accordance with the law.

第十四条 公众可通过商务部政府网站查询以下信息：
（一）特许人的企业名称及特许经营范围使用的注册商标、企业标志、专利、专有技术等经营资源。
（二）特许人的备案时间。
（三）特许人的法定经营场所地址与联系方式、法定代表人姓名。
（四）中国境内的被特许人营业地址。

Article 14 The general public shall have access to the following information on the government web site of the Ministry of Commerce:

(1) the franchisor’s business name, registered trademarks, business logo, patents, technical know how and operational resources relating to the franchise system.

(2) the franchisor’s registration date.

(3) the franchisor’s legal address, contact information, and the name of the legal representative\(^{10}\) of the franchisor.

(4) the business address of the franchisees in China.

\(^{10}\) See supra note 9.
Article 15 Where the franchisor does not comply and fails to register as required by the Regulation and these Measures, the commercial administration authority of the State Council and the relevant Commerce Department of the People’s Government of each province, autonomous region, or municipality directly under the administration of the central government where the franchisor is located shall order registration within a specified period of time, and that a fine of not less than 10,000 RMB and not more than 50,000 RMB.\(^{11}\) Where the franchisor fails to register within such specified period of time, a fine of not less than 50,000 RMB and not more than 100,000 RMB\(^{12}\) shall be imposed and a public announcement shall be made.

Article 16 Where the franchisor breaches Article 8 of these Measures,\(^{13}\) the registration authority shall order compliance and may impose a fine of not more than 10,000 RMB.\(^{14}\) If the circumstances are serious it may impose a fine of not less than 10,000 RMB and not more than 50,000 RMB\(^{15}\) and a public announcement shall be made.

Article 17 Franchisors from outside China engaging in franchise operations in China shall be governed by these Measures. Franchisors from Hong Kong SAR, Macau SAR, and Taiwan Region shall be governed by these Measures by analogy.

Article 18 The national trade association\(^{16}\) shall assist the relevant administrative units of the government with the registrations. It shall also completely fulfill its coordination function and strengthen self discipline in the franchise industry.

Article 19 The Ministry of Commerce of the People’s Republic of China is responsible for the interpretation of these Measures.

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\(^{11}\) From about $1,300.00 USD to about $6,500.00 USD at the April 5, 2007 conversion rate.

\(^{12}\) From about $6,500.00 USD to about $13,000.00 USD at the April 5, 2007 conversion rate.

\(^{13}\) This refers to the requirement for a franchisor to annually update its registration.

\(^{14}\) About $1,300.00 USD at the April 5, 2007 conversion rate.

\(^{15}\) From about $1,300.00 USD to about $6,500.00 USD at the April 5, 2007 conversion rate.

\(^{16}\) The 中国连锁经营协会 — zhongguo liansuo jingying xiehui or China Chain Store & Franchise Association (“CCFCA”).
Article 20 These Measures shall come into effect on May 1, 2007.

第二十条 本办法自 2007 年 5 月 1 日起实施。
20 November 2007

Ma Zhiqiong June Wang
School of Business Law and Taxation

Dear Ma Wang,

Project Title: Survey of Foreign Franchising Companies' Entry and Expansion Strategies in China
Approval No: 07663

Following submission of further information, the Australian School of Business Human Research Ethics Advisory Panel recommended to your Head of School/Unit/Centre and the Human Research Ethics Committee that this project, being minimal impact, may proceed.

The approval number for this project is 07663. This approval is valid for 12 months from this date.

Yours sincerely

Dr. Aybuke Aurum
(Convenor)
Australian School of Business Human Research Ethics Advisory Panel

cc: Professor Andrew Terry
Head, School of Business Law and Taxation
APPENDIX V: PARTICIPANT INFORMATION STATEMENT AND CONSENT FORM

UNSW Ethics Approval No: 07663

THE UNIVERSITY OF NEW SOUTH WALES

PARTICIPANT INFORMATION STATEMENT AND CONSENT FORM

Survey of Foreign Franchising Companies' Entry and Expansion Strategies in China

You are invited to participate in a study of Foreign Franchising Companies' Entry and Expansion Strategies in China. We hope to learn what are the most important issues and considerations for foreign franchise companies when entering, and expanding in, China. You were selected as a possible participant in this study because you are major franchising company in China involving foreign investment or licensing. Your support is crucial to our research and we greatly appreciate your cooperation.

If you decide to participate, please suggest the most convenient time and venue. It will take approximately 30 minutes to an hour to complete the interview. Any information that is obtained in connection with this study and that can be identified with you will remain confidential and will be disclosed only with your permission, except as required by law.

- Recording
  With your consent, the interview will be tape-recorded. If you agree to the interview being recorded by signing the attached Consent Form, the recording will not be released to anyone other than the interviewer and Prof. Andrew Terry, except as required by law.

- Identification
  In any publication, information will be provided in such a way that you cannot be identified unless you give us your written permission by signing the attached Consent Form.
Complaints may be directed to the Ethics Secretariat, The University of New South Wales, SYDNEY 2052 AUSTRALIA (phone 9385 4234, fax 9385 6648, email ethics.sec@unsw.edu.au). Any complaint you make will be investigated promptly and you will be informed of the outcome.

We appreciate your participation in this research and we will send you a report of the major findings on the completion of the research by post. We believe our research will help franchising companies in the decision making in the future. If you do not wish to receive our report, please indicate by ticking the appropriate box on the next page.

Your decision whether or not to participate will not prejudice your future relations with the University of New South Wales and the China Chain-store and Franchise Association. If you decide to participate, you are free to withdraw your consent and to discontinue participation at any time without prejudice.

If you have any questions, Ms Zhiqiong June Wang (Mailing address: School of Business Law & Taxation, Australian School of Business, UNSW, NSW 2052, AUSTRALIA; Tel: +61 (2) 9385 1089; Mobile: +61 431 680 533; Fax: +61 (2) 9313 6658; Email: zhiqwang@unsw.edu.au) will be happy to answer them.

You will be given a copy of this form to keep.
UNSW Ethics Approval No: 07663

PARTICIPANT INFORMATION STATEMENT AND CONSENT FORM
(continued)
Survey of Foreign Franchising Companies' Entry and Expansion Strategies in China

I, ________________, of ____________________________ consent to an interview with Ms. Zhiqiong June Wang of UNSW, Australia.

I, ________________, of ____________________________ ☐consent/☐do not consent, to my interview with Ms. Zhiqiong June Wang of UNSW, Australia, being tape recorded.

I, ________________, of ____________________________ ☐consent/☐do not consent to my identity and/or that of ____________________________ being identified in any future publication.

You are making a decision whether or not to participate. Your signature indicates that, having read the information provided above, you have decided to participate.

.......................................................... ..........................................................
Signature of Research Participant Signature of Witness

.......................................................... ..........................................................
(Please PRINT name) (Please PRINT name)

..........................................................
Date

..........................................................
Nature of Witness

Would you like to receive a report of our findings?
☐No
☐Yes, please provide mailing information here:
APPENDIX VI: REVOCATION OF CONSENT FORM

UNSW Ethics Approval No: 07663

REVOCATION OF CONSENT
(Survey of Foreign Franchising Companies' Entry and Expansion Strategies in China)

I hereby wish to WITHDRAW my consent to participate in the research proposal described above and understand that such withdrawal WILL NOT jeopardise any treatment or my relationship with The University of New South Wales, or China Chain-store and Franchise Association.

................................................................. .................................................................
Signature Date

.................................................................
Please PRINT Name

The section for Revocation of Consent should be forwarded to Zhiqiong June Wang: Mailing address: School of Business Law & Taxation, Australian School of Business, UNSW, NSW 2052, AUSTRALIA; Tel: +61 (2) 9385 1089; Mobile: +61 431 680 533; Fax: +61 (2) 9313 6658; Email: zhiqwang@unsw.edu.au.
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