FRANCHISING IN MAINLAND CHINA

1992

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I. Introduction

Global business is booming, and international franchising has become an extremely popular way to do business in the world.[1] Franchised businesses cover a wide range of products and services, including hotels and motels, fast food restaurants, automotive products, printing shops, real estate brokerages, convenience stores, apparel shops, cosmetics, home appliances, office supplies and toys.[2] Mainland China is the largest potential market in the world with a population of over one billion people.[3] With a few recent and limited exceptions, franchisers have not yet discovered how to enter and develop this enormous market.

A. Definition of Franchising

Franchising has no precise definition. In general, it is a relationship that involves the grant of a right to use a trademark or logo and a developed system, product, or service in exchange for payment of a fee.[4] Franchising involves, to a certain degree, the legal concepts of employer and employee, distributorship, licensor and licensee, agency, and vendor and purchaser.[5]

The popularity of international franchising results from the substantial benefits it provides to both franchisers and franchisees. Franchisers can expand their businesses through the efforts and local expertise of franchisees and do not have to make the enormous capital outlays required to establish wholly owned branches in the host countries.[6] Franchisees gain the benefit of proven business systems and the management expertise, marketing research and name recognition of the franchisers.[7] In short, franchisees do not have to start from scratch and suffer through many of the risks and perils common to many start-up businesses.

In a typical franchise relationship, the franchiser and franchisee enter into a written agreement which defines their respective rights and obligations. In general, the franchise agreement will usually include a description of: (1) the system, product or service being franchised; (2) the trademarks, copyrights and patent rights being transferred; (3) the length of the franchise agreement and provisions for its termination; (4) the franchisee's exclusive sales rights, if any, concerning products, territories, and customers; (5) the methods and amount of "up front" or royalty payments; (6) competition restraints on the franchisee during and after the franchise term; (7) minimum performance provisions; and (8) choice of law provisions.[8]

B. Overview of Franchising Method

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1 Currently, approximately 400 U.S. companies have more than 39,000 franchise units in as many as 150 different countries. *See* Zeidman, Pacific Rim Prosperity Beckons Franchisers, *New Jersey Law Journal* S2 (June 22, 1992).
2 *Id.* at S1.
3 *See* Spence, *The Search for Modern China* at xix (1990).
4 *See* Pengilley, *International Franchising Arrangements and Problems in Their Negotiation,* 7 Northwestern Journal of International Law & Business 185 at 187 (1985) [hereinafter *International Franchising Arrangements*].
5 *Id.* at 186.
6 *See International Franchising Arrangements, supra* note 4, at 188.
7 *Id.*
8 *Id.* at 193.

There are two primary methods of franchising. The first method is direct franchising, which involves franchising single units from the home office or from a branch established in the host country.[9] Direct franchising allows the franchiser to retain a great degree of control and a large percentage of profits because there is no middleman. Additionally, franchising done directly from the home office avoids a large initial investment in the host country.[10] The biggest disadvantage to direct franchising is the lack of local marketing and political expertise that a host country agent could provide.

The second franchising method is master franchising.[11] This method involves appointing a master franchisee to develop a territory or a certain number of units in the host country. The master franchisee may subfranchise units or own units directly. The advantages of this method include reduced costs of administration and support and a greater ability to quickly and successfully adapt the franchise to unique local market conditions. The disadvantages to this method are loss of direct control and loss of potential profit.[12] The master franchisee may take the form of a joint venture between the franchiser and a joint venture partner in the host country.

C. Structure of Required and Relevant Laws

In a franchise relationship, each party has interests it wants to obtain, protect and promote. The primary interests of the franchiser are: (1) protection of patents, trademarks, copyrights and other proprietary know-how; (2) preservation of the overall franchise image and quality of service; (3) effective promotion of franchise units; and (4) receipt of agreed upon royalty fees.[13] The primary interests of the franchisee are: (1) use of the franchise system; (2) assistance from the franchiser; (3) flexibility to adapt the franchise system to the local market and to purchase goods and services at the best price; (4) preservation of exclusivity provisions; and (5) maximum financial return after paying royalty fees.[14]

An adequate structure of laws must be present in the host country to protect and promote these interests. Intellectual property laws must exist to protect patents, trademarks, and copyrights. A body of contract law must exist to enforce the parties' contractual rights and obligations. Business enterprise law must exist to govern what business forms the franchises may or may not take. Further, the host country's judicial system must be able to effectively deter and compensate wrongful conduct.

Additional laws may become applicable when franchises cross international borders. For example, the host country may have laws which: (1) prevent or restrict franchising or other direct foreign investment; (2) require government approval for franchise agreements; (3) control the freedom to contract on certain issues; (4) regulate foreign exchange; and/or (5) create customs or tariff barriers.[15]

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[9] *See* Jesse, *How to Take a U.S. Franchise System into a Foreign Market,* 38 The Practical Lawyer at 62 (1992) [hereinafter *Taking a U.S. Franchise System into a Foreign Market*].
[10] *Id.*
[11] *See International Franchise Arrangements*, *supra* note 4, at 192, 193.
[12] *See* Konigsberg, *Practical Problems and Suggested Solutions Associated with International Franchising*, 7 Franchise Law Journal at 27 (1988) [hereinafter *Practical Problems and Suggested Solutions*].
[13] *See Taking a U.S. Franchise System into a Foreign Market*, *supra* note 9, at 60.
[14] *Id.*
[15] *See generally* Loewinger, *Multiple-Unit Franchise Arrangements in the Pacific Rim: Problems and Solutions*, Franchise Law

Finally, if the host country's government exercises direct control over private enterprise, the prospective franchising parties should be aware of the political structure and stability of the host government and understand the rationales and motivations underlying government policy making.

II. The Chinese Environment for Franchising

Since 1979, the Chinese government has enacted over four hundred laws and regulations concerning the economy and foreign trade and investment.[16] Although not one of these laws deals specifically with franchising, several contain provisions which relate to the franchise relationship. For example, the PRC has enacted legislation concerning foreign economic contracts[17], the transfer of foreign technology[18], and the control of foreign exchange[19]. Certain provisions in these laws and regulations can be interpreted to allow, discourage or even prohibit various forms of franchising[20]. Since all the legislation in the PRC is for the most part a product of the policy goals of the Communist Party of China, an accurate prediction of its effect on franchising requires an understanding of the politics and economy of the PRC. A discussion of the Chinese legal environment for franchising will therefore be preceded by a brief overview of the Chinese political and economic systems and the changes they are currently undergoing.

A. Political System

In 1949, Mainland China became a socialist state centrally controlled by the Communist Party of China (CPC)[21]. The new socialist system, led by Mao Zedong was a reforming reaction to the alleged corrupt capitalist government of Chiang Kai-shek and the long running abuses and control of domestic, elitist families and foreign imperial powers.[22] The goal of the CCP was to return political power to the workers and to create a political structure that would preserve the worker's rights.[23]

The political structure implemented by the communists was highly centralized and rigid. Its formation was influenced by the Soviet model, wartime autocratic rule, the mainland's remnant feudalism, and China's dynastic tradition of a single,

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Journal 3 (1990) [hereinafter *Multiple-Unit Franchise Arrangements*].

16 *See* Mu, *Chinese Economic Law and the Chinese Legal System*, Chinese Foreign Economic Law, at page 8 (1989) [hereinafter *Chinese Economic Law*].

17 Foreign Economic Contract Law of the People's Republic of China, adopted March 21, 1985 at the 10th Session of the Standing Committee of the 6th National People's Congress.

18 Regulations on Administration of Technology Import Contracts of the People's Republic of China, promulgated May 24, 1985 by the State Council.

19 Regulations Concerning the Question of Balance of Foreign Exchange Receipts and Expenditures of Joint Ventures Using Chinese and Foreign Investment, promulgated by the State Council on January 15, 1986.

20 *See, e.g.*, article 9 of the Technology Import Contracts Regulations, *supra* note 18, which severely restricts the degree of control a licensor can exercise over a licensee.

21 *See Chinese Economic Law*, *supra* note 16, at 1, 33.

22 Comment made by a Chinese Professor during an informal interview by the writer; *See also* Jianfan, *Building New China's Legal System*, 22 Columbia Journal of Transnational Law at 3 (1983).

23 *See* Chiu, Dobinson, Findlay, Legal Systems of the PRC at 33 (1991) [hereinafter *Legal Systems of the PRC*].

powerful ruler.[24] The communist system contains no separation of powers or checks and balances and all political institutions are uniformly instruments of the state.[25]

The Chinese government is divided into a central government and many local governments on different levels. The two primary institutions of central political power in China are the National People's Congress ("NPC") and the State Council. The NPC consists of approximately two thousand representatives elected by People's Congresses at the provincial level.[26] The NPC is the sole legislative body in China.[27] It acts primarily through a standing committee which normally meets six times a year.[28] The NPC's legislative powers include the power to pass or amend the Constitution, statutes, the economic plan, and the state budget.[29]

The NPC elects the State Council upon recommendation of the Communist Party.[30] The State Council is the administrative arm of the central government and is its most powerful and influential body.[31] The State Council oversees government planning through its Central Planning Committee and enacts wide ranging administrative rules and regulations.[32]

Below the state are three levels of local governments, consisting of the provincial level, the county level and the township level. The provincial level is made up of twenty-two provinces, five autonomous regions and the cities of Beijing, Shanghai, and Tianjin.[33] Each one of these administrative units has a People's Congress and a Standing Committee. Below the provincial level are approximately 2,300 county level administrative units consisting of counties and county level municipalities.[34] The lowest level of government is the township level which is made up of towns, townships, and districts.[35] The central government retains control over the local governments.

The Chinese judicial system consists of four levels of courts[36], four levels of prosecutorial offices, and a police force. Each court has a president, a vice president, and several judges[37], and is divided into four sections: Criminal; civil; administrative; and economic.[38] The courts in China use

[24] *See* Xian, *Political Structural Reform and the Future of Democratization in China*, 16 Journal of Legislation at 48 (1989) [hereinafter *Political Structural Reform*].
[25] *See Chinese Economic Law, supra* note 16, at page 33.
[26] *See* M. Blecher, China: Politics, Economics and Society 116-117 (1986).
[27] *See* Constitution of 1982 art. 58 (People's Republic of China), 1979-84 PRC Collection of Laws and Regulations 369 (pub. by People's Publishing House 1984) (adopted at Fifth Session of Fifth NPC on Dec. 4, 1982).
[28] *See Chinese Economic Law*, *supra* note 16, at page 5.
[29] *See* Clarke, *What's Law Got To Do With It? Legal Institutions and Economic Reform In China,* 10 UCLA Pacific Basin Law Journal 1 (1991) [hereinafter *hat's Law Got To Do With It?*].
[30] *Id.*
[31] *See* Dong, Zhang, and Larson, Trade and Investment in China at 11 (1992) [hereinafter *Trade and Investment in China*].
[32] *See Chinese Economic Law, supra* note 16, at 5.
[33] *See What's Law Got To Do With It?, supra* note 29.
[34] *Id.* at 17.
[35] *Id.*
[36] The Supreme People's Court; the People's High Courts; the People's Intermediate Courts; and the Basic Courts.
[37] *See What's Law Got To Do With It?, supra* note 29, at 21, 22.
[38] *See Trade and Investment in China*, *supra* note 31, at 4.

statutes and regulations to decide cases, and individual decisions do not create binding law as in the common law tradition. Only one appeal is allowed to a higher court.[39] The vast majority of judges and staff members in the Chinese judicial system are poorly educated because very little legal education occurred in China in the 1960s and 1970s.[40]

The judicial system, State Council and National People's Congress are all completely dominated by the Communist Party of China. The CPC controls the judges, prosecutors and police through Political and Legal Affairs Committees.[41] These Committees are made up of CPC members and usually include the court president, chief prosecutor and chief of police.[42] The Committees review important cases and offer recommendations for their proper disposition. The State Council and NPC are also made up of CPC members, all with strong allegiance to communist ideology and doctrine.[43] The local governments are similarly controlled by CPC members.

Strict loyalty to the communist party is maintained through a cadre system which numerically ranks members according to position and seniority.[44] For example, a Prime Minister has the rank of from 1 to 3, a minister has the rank of from 4 to 11, and a bureau head has the rank of from 12 to 14. The ranks go all the way through 25, which is the rank of a party staff member. Salary, benefits and job prestige are all determined by the rank a communist party cadre has achieved. Promotions within the ranking system are decided by party organizations at the various levels, which retain a great deal of discretion in the decision making process. As long as a cadre does not make a serious political or economic mistake, he can hold his position for life. However, a cadre who is not loyal to the party can quickly lose his position, benefits, and salary. This constant and pervasive threat makes Chinese cadres cautious and tentative in their business dealings in general, and with foreign businessmen in particular.

The political system designed and implemented by the Communist Party has been effective in eliminating and controlling any attempted resurgence by capitalistic, elitist or bourgeois interests. Communist domination has been so pervasive and complete that virtually no part of Chinese society or the Chinese economy was left untouched by its firm grip.

But a high price has been paid. Tight Party control effectively squeezed all of the creative life blood and motivation out of the workers and created a massive, inefficient and unproductive bureaucracy.[45] The stifling, highly centralized political system became an enormous drag on potential economic development. In 1979, party leadership led by Deng Xiaoping realized that sweeping structural changes had to be made.[46] Political and economic reforms were thereafter initiated,

[39] *See What's Law Got To Do With It?, supra* note 29, at 20.
[40] *Id.* at 21, 22.
[41] *See Trade and Investment in China*, *supra* note 31, at 5.
[42] *Id.*
[43] *See Legal Systems of the PRC, supra* note 23, at 43-46.
[44] This brief discussion of the Chinese cadre system generally follows that found in *Trade and Investment in China, supra* note 31 at page 197, 198.

[45] *See generally Political Structural Reform, supra* note 24 and Leung, *Some Observations on Socialist Legality of the People's Republic of China,* 17 California Western International Law Journal 102 (1987) [hereinafter *Observations on Socialist Legality*].
[46] *See Observations on Socialist Legality, supra* note 45, at 104.

particularly with regard to the relationships between the government and economic institutions.[47] These reforms are discussed in the next section.

In conclusion, although the Chinese Government has legislative, administrative and judicial institutions in its political structure which might look familiar to those existing in western legal systems, there are significant differences. The rule of man, rather than the rule of law, still dominates in China.[48] And without question, the rule of man is still the rule of the Communist Party.

B. Economic System

The Chinese economic system is based on Marxist economic theory, which requires that all factors of production (land, labor and capital) are owned and controlled by the state.[49] Under Marxist theory, each person contributes according to their ability, consumes according to their needs, and exploitation of man by man is prohibited.[50]

Before reforms commenced in 1979, the entire Chinese economy was completely planned and controlled by the central government. Each year the State Planning Commission formulated an economic plan through a complex procedure requiring coordination between the central ministries and the provincial governments.[51] Through the economic plan, the government controlled all integral components of the production process, including raw material supply, production targets, distribution channels, and labor.[52] All private sales were prohibited and all enterprise profits and losses were absorbed by the government.[53]

Under the state planned system, incentives did not exist to develop more effective or efficient methods of production. State enterprises were only required to fulfill the production quota set by the government and workers salaries were fixed within a tight range regardless of worker performance.[54] Anyone who did suggest improvement or change could be punished by the government for contempt of authority.[55] The workers and managers were passive and obedient and the economy simply slumbered along.

In the late 1970s, the Communist Party leadership realized that China was being left behind economically and technologically by the rest of the world.[56] The communists likely became concerned that unless its leadership could begin (1) providing consumer products and services comparable to western standards, (2) obtaining advanced technology to ensure national security and advancement of industrial productivity, and (3) building infrastructure improvements, the party might eventually be threatened by revolutionary forces for change from within China or by successful economic or military aggression from without. However, the perplexing problem the leadership faced was how to reinvigorate the economy through individual incentives (capitalistic "greed") without relinquishing state ownership and ultimate Communist Party control. The compromise solution was a new economic theory calling

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47 *See Chinese Economic Law, supra* note 16, at 7.
48 *See Observations on Socialist Legality, supra* note 45, at 109.
49 *See Trade and Investment in China, supra* note 31, at 16.
50 *See* Chinese Constitution of 1982, art. 6.
51 *See Trade and Investment in China, supra* note 31, at 11.
52 *Id.* at 12.
53 *Id.*
54 *Id.* at 12, 13.
55 *Id.* at 13, 14.
56 *See Political Structural Reform, supra* note 24, at 48.

for a socialist market system and "separation of ownership from management."[57]

Under the new pragmatic economic theory, land and enterprise ownership rights were retained by the state, but central government control over the means and methods of production was relaxed or eliminated.[58] The economic changes began in the agricultural sector. Deng Xiaoping made the shrewd political calculation that 800 million peasant farmers, after being convinced of reform benefits, would constitute a powerful coalition for change before reforms were attempted in the more politically entrenched industrial sector.[59] Agricultural reforms included replacing the commune system with an individual household contract system and relaxing price controls on agricultural products.[60] Farmers were allowed to sell their excess agricultural production in open markets after satisfying their state planning requirements and to retain their profits.

In the industrial sector, managers were given greater authority over basic business decisions such as purchasing, planning, marketing, pricing and hiring.[61] Enterprises were given the opportunity to retain a portion of their profits and to sell excess production in developing open markets at prices determined by supply and demand.[62] The newly energized enterprises began eliminating waste and inefficiency in the economic system by soaking up surplus labor and reclaiming unused raw material that previously had been just thrown away.[63] The reform movement even overcame the thorny problem of land ownership by granting long term land leases to business enterprises.[64] In sum, although ultimate economic control was still retained by the Chinese government, the control was now exercised through indirect methods such as taxing and credits rather than by direct administrative command.[65]

The ultimate impact that the economic reforms will have on the Chinese political system is unknown. Free markets, private sales and profit retention will almost certainly mean the rise of a successful merchant class which will probably develop enough financial and political clout to successfully challenge Communist Party policies in the future. Some outspoken Chinese entrepreneurs have even publicly declared that "in ten years, private business will completely overwhelm the state."[66] One Chinese professor believes that state control, at least over the short term, should remain sufficient to dominate the business sector. His argument is that the government need only threaten suspension or revocation of the business license of a Chinese

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57 *See Trade and Investment in China, supra* note 31, at 15.
58 *Id.*
59 *See* Tanzer, *The Chinese Way*, Forbes Magazine, page 42 (September 28, 1992) (stating that the real farm incomes of China's peasants, who comprise 80% of the workforce, quadrupled in eight years after reforms were commenced in 1979).
60 *See China - Overseas Business Report*, 1992 National Trade Data Bank Market Reports at 7 (March 11, 1992) [hereinafter *China - Overseas Business Report*].
61 *Id.*
62 *See Chinese Economic Law, supra* note 16, at 13.
63 *See* Kahn, *Free Market fills need in Communist China*, The Dallas Morning News, page 10 A (November 16, 1992) (quoting former professor and private businessman Li Jie [a pseudonym]) [hereinafter *Free Market fills need*].
64 *See* General Rules of Civil Law, art. 80 ¶ 2 (People's Republic of China); *See also Trade and Investment in China, supra* note 31, at 86-93.
65 *See China - Overseas Business Report, supra* note 60, at 7.
66 *See Free Market fills need, supra* note 63.

enterprise to enforce political compliance.[67] However, the lessons of history may favor the balance of power shifting more toward the rising merchant class over the long term. It was the emerging European merchant class, made wealthy by trade with the new world after Columbus' initial voyage in 1492, that finally broke the bonds of European feudalism, displaced the ruling landed aristocracy, and replaced socialism with capitalism.[68]

In conclusion, the Chinese economy is currently in a state of transition from a state owned and centrally planned economy to a modified free market system. The goal of the government is a system whereby direct government controls are reduced and traditional market forces such as supply and demand are allowed to guide the business decisions of Chinese enterprises. However, the Chinese government will continue to control enterprises and the economy through indirect methods and will not hesitate to resume tighter control if necessary. Although market forces are being allowed to operate, the Chinese government still maintains strict control over foreign investment and all agreements with foreigners must be approved by the appropriate authorities. Therefore, potential franchisors should understand who they can enter into a business relationship with, who must approve the agreement, what types of foreign investment are likely to be accepted and what forms of agreement have the best chance of being approved. These topics are covered in detail infra.

C. Legal System

The Chinese government has enacted a steady stream of laws and regulations since 1979 in order to promote and institutionalize economic reforms and to encourage foreign investment. Over 340 laws have been enacted in the economic area alone.[69] Although the pace and breadth of legislation has been impressive, the Chinese Legal system is still developing and many imperfections still exist.[70] For that reason, many of the laws do not have the power and meaning that similar legislation may have in a western legal system. Before the laws which relate to franchising are introduced and discussed, a general overview of the Chinese legal system will be provided.

The supreme law in China is the Constitution of 1982.[71] The Constitution sets forth the fundamental principles of the state and incorporates the basic guarantees of fundamental rights for Chinese citizens. There have been four Constitutions since the People's Republic of China was established.[72] Next in order of importance is a set of organic laws which establish the structure of the state and the administrative functions of government institutions, including the judiciary, procuratorates and supervisory and security organs.[73] Basic criminal procedure is contained in a code of criminal procedure law.[74] Chinese civil procedure is set forth in a civil procedure law[75] and a body of general rules of civil

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67 A Chinese Professor made this comment during an informal interview by the writer.

68 *See* Heilbroner and Thurow, *Economics Explained*, page 16 (1987).

69 *See Chinese Economic Law, supra* note 16, at 8.

70 Chinese legislation may contain such qualifying words as "Provisional", "For Trial Implementation", and "Temporary". *See Observations on Socialist Legality, supra* note 45, at 107.

71 The Constitution of the PRC, promulgated for implementation on Dec. 4, 1982.

72 *See Legal systems of the PRC, supra* note 23, at 33.

73 *Id.* at 40.

74 Law on Criminal Procedure, effective Jan. 1, 1980.

75 Law on Civil Procedure, adopted March 8, 1982.

law[76]. All of these laws were promulgated by the National People's Congress and its Standing Committee. Finally, economic law is contained in a constantly developing set of rules and regulations published by the State Council. These economic rules and regulations were given the full status of law by the Chinese Constitution of 1982.[77]

The Chinese economic laws that will most affect the franchise relationship and the franchise decision making process are the laws concerning business enterprises, the Joint Venture Law[78], the Foreign Economic Contract Law[79], the Technology Licensing Contract Law[80], the Intellectual Property Laws (Trademark[81], Patent[82], and Copyright Laws[83]), the Foreign Exchange Control Laws[84], the Tax Laws[85], and the Labor Laws[86]. Each of these laws will be introduced and briefly discussed below.

1. Law of Business Enterprises

Four categories of domestic business enterprises currently exist under Chinese law: State owned enterprises; collectively owned enterprises; individual enterprises; and private enterprises.[87] State owned enterprises are, not surprisingly, owned by the state. They may belong to the central government or to local governments. Each state owned enterprise is subordinated to one industrial department or bureau and government officials are charged with the responsibility of managing these enterprises.[88] Since 1979, the ministries and local governments have been given a great degree of management autonomy and the right to retain a percentage of profits under the "Financial Responsibility System."[89]

Two special types of state owned enterprises are the state owned farms and the army run enterprises.[90] The state owned farms cultivate government land for agricultural production. Many of the farms have developed agriculturally related industries in addition to their crop production. The army-run enterprises began as Ministry of Defense industries engaged in military research and development. Many of these enterprises have changed their emphasis from producing military products to producing civilian products. They are usually staffed with talented engineers who possess technological expertise, but who often lack management and marketing skills.

There are two types of collectively owned enterprises - the Large Collective and the Small Collective.[91] The Large Collectives consist of private craftsman who were organized during the collectivization campaign in 1956. The ownership rights to these collectives was purposefully left

[76] General Principles of Civil Law of the People's Republic of China, adopted April 12, 1986.
[77] *See* Chinese Constitution of 1982, art. 89.
[78] Law on Joint Ventures Using Chinese and Foreign Investment, adopted July 1, 1979.
[79] Foreign Economic Contract Law, adopted March 21, 1985.
[80] Regulations on Administration of Technology Import Contracts, promulgated May 24, 1985.
[81] Trademark Law, adopted Aug. 23, 1982.
[82] Patent Law, effective April 1, 1985.
[83] Copyright Law, adopted Sept. 7, 1990.
[84] Provisional Regulations of the PRC on Foreign Exchange Control, promulgated Dec. 18, 1980.
[85] *See, e.g.,* The Joint Venture Income Tax Law, promulgated Sept. 10, 1980.
[86] Regulations of the PRC on Labour Management in Joint Ventures Using Chinese and Foreign Investment, promulgated July 26, 1980.

[87] *See Trade and Investment in China, supra* note 31, at 25-32.
[88] *Id.* at 25.
[89] *Id.* at 26.
[90] *Id.* at 27.
[91] *Id.* at 28.

ambiguous, probably to make it more politically acceptable to the entrepreneurial craftsman who were forced to give up their direct economic benefits. The Large Collectives are currently accountable to the Craftsmen Administrative Bureaus, which are under the control of local governments. The Small Collectives are an outgrowth of small workshops originally staffed by housewives. These collectives have been strengthened under the economic reforms and are an important contributor to agricultural and textile processing in China. The primary practical difference in collectively owned enterprises and state owned enterprises is that the government usually exerts less management control over collectively owned enterprises.

Individual enterprises are small privately owned businesses that are not allowed to have more than eight employees.[92] These enterprises primarily produce domestic consumer goods. Chinese law does not recognize individual enterprises as legal persons and they are not permitted to enter into contracts with foreigners for economic cooperation.[93]

The final type of Chinese enterprise is the private enterprise.[94] A private enterprise can be established as a proprietorship, partnership, or limited liability company. The limited liability company form is entitled to formal legal status under Chinese law and must comply with various rules and regulations concerning form of organization, rights and duties, promoter's activities, and operational structure. Although private enterprises are privately owned, they remain subject to state control, particularly in the areas of foreign trade and investment.

Direct foreign investment in China is permitted through three different business forms: The equity joint venture; the contractual joint venture; and the wholly foreign-owned enterprise.[95] Each business form is regulated by its own law.[96]

The equity joint venture is the most popular form of Sino-foreign enterprise.[97] It requires the formation of a limited liability Chinese company,[98] and partners share profits and losses according to their percentage of contribution. In a contractual joint venture, profits and losses are determined by contractual terms rather than by equity participation. A contractual joint venture does not require the formation of a limited liability company. Approximately 34% of all Sino-foreign enterprises are contractual joint ventures.[99] Wholly owned foreign enterprises have been permitted in China since 1979. Their existence was further legitimized when the Foreign Enterprise Law and Regulations for implementation were enacted in 1986 and 1990, respectively.

In general, these foreign investment enterprises are treated the same as domestic Chinese enterprises under Chinese law.[100] In some areas they are even given advantages, such as greater discretion in production, marketing, and the hiring and

92 *Id.* at 29.
93 *See* Chinese Foreign Economic Contract Law, art. 2.
94 *Id.* at 31.

95 Chinese Constitution, art. 18.
96 Sino-Foreign Equity Joint Venture Law of 1979; Sino-Foreign Cooperative Joint Venture Law of 1988; Wholly Foreign-Owned Enterprises Law of 1986.
97 Over 50% of Sino-foreign enterprises are equity joint ventures. *See Trade and Investment in China, supra* note 31, at 147.
98 *See* Regulations for the Implementation of the Law of the PRC on Sino-Foreign Joint Equity Enterprises, art. 2.
99 *See Trade and Investment in China, supra* note 31, at 147.
100 *Id.* at 152.

firing of employees.[101] The laws and regulations concerning these three types of Sino-foreign enterprises are further explained in the next three sections of this memo.

2. Equity Joint Venture Laws

The two primary laws which govern equity joint ventures ("EJVs") in China are the Joint Venture Law and the Joint Venture Regulations. Article 3 of the Joint Venture Law requires that EJVs must meet certain requirements and qualifications and must be approved by the Chinese authorities.[102] In general, an EJV must be able to "promote the development of China's economy and the raising of scientific and technological levels for the benefit of socialist modernization."[103]

The Joint Venture Regulations permit EJVs to engage in a broad range of activities in the agricultural, industrial and service sectors of the Chinese economy.[104] However, EJVs are not permitted to participate in the national defense industry, transportation, communication, public media, culture, or education.[105] Further, service industry participation is limited to daily living services such as lodging, eating and repair services and does not include banking, insurance, commerce, or trade services.[106]

An EJV must meet at least one of following four specific economic requirements to obtain approval: (1) Adopting advanced technology and scientific management; (2) benefitting technical renovation of existing enterprises; (3) expanding exports; or (4) training Chinese personnel.[107] The Chinese authorities will not approve an EJV that conflicts with China's laws or national economy, will cause environmental pollution, or does not equitably distribute rights between the EJV parties.[108]

There are four steps to establishing an EJV.[109] First, a project proposal and preliminary feasibility study are submitted by the prospective EJV partners to the Chinese authorities for approval. Second, a detailed feasibility study which explains the technical, economic, financial and practical aspects of the proposed business venture is submitted to the same authorities for approval. Third, the agreements, contracts, and articles of association entered into by the parties are submitted. Forth, the parties register to obtain a business license. Each step must be completed before the next step is taken. The Chinese party is responsible for submitting the documents for approval and for following the proper procedures. The approving authority for an EJV is MOFERT[110] or one of its authorized local government agents.

The full technical details of organizational form and initial financing of EJVs are beyond the scope of this paper. For our present purposes it is sufficient to know that there is no upper limit on the percent of foreign equity ownership of an EJV, that an EJV is controlled through a board of directors, and that the foreign partner's initial investment is expected to be in the form of foreign hard currency and technology. Further, 1990 amendments to

101 *Id.*
102 Joint Venture Law, art. 3.
103 *Id.*
104 *Id.*
105 *See* Chu, *Laws and Regulations Concerning Business Enterprises with Foreign Participation*, Chinese Foreign Economic Law, page 80, International Law Institute (1989).
106 *Id.*
107 Joint Venture Regulations, art. 4.
108 *Id.*, art. 5.
109 *Id.*, art. 9.
110 Ministry of Foreign Economic Relations and Trade.

the Joint Venture Law now permit the foreign partner to appoint the board chairman[111] and stipulate that EJVs shall not be nationalized or expropriated by the state except in special circumstances to meet public interests, in which case appropriate compensation must be paid.[112]

3. Contractual Joint Venture Law

A separate law regulates Sino-Foreign cooperative (contractual) enterprises.[113] Although the laws concerning equity joint ventures and contractual joint ventures are similar, there are some significant differences. The profits in a contractual joint venture are determined by the terms of the contract rather than by equity participation. Therefore, non-cash investments in the enterprise such as equipment, buildings and industrial property rights do not have to be valued by the parties. Further, a contractual joint venture can be formed either as a partnership or as a limited liability company.

4. Wholly Owned Foreign Enterprise Law

The Law on Wholly Foreign Owned Enterprises ("WFOE") was enacted in April of 1986 and the Regulations on Implementation were enacted in December of 1990. The WFOE law defines these enterprises as those "established within the territory of China in accordance with relevant laws of China and whose entire capital is invested by foreign investors, but not including branches of foreign companies and other economic organizations." Like contractual joint ventures, WFOEs need not be formed as limited liability companies. The requirements for forming a WFOE are more rigorous than for a joint venture. Before it will be approved by the Chinese authorities, a WFOE must (1) use advanced technology and equipment, conserve energy and raw materials, engage in development of new products, or substitute for imports, or (2) produce exports which exceed fifty percent of its total annual production to generate foreign exchange.[114]

Several other major differences exist between WFOEs and joint ventures under Chinese Law. For example: (1) The procedure for establishing a WFOE is more streamlined than for a joint venture; (2) no laws exist describing how a WFOE may independently resolve a foreign exchange imbalance; (3) WFOEs are not required to use government labor agencies, but must pay workers at the rate of at least one hundred twenty percent the wage rate of state owned enterprises[115]; and (4) WFOE have complete management autonomy and do not have to share technology and knowhow. In general, the law and regulations concerning WFOEs are not as developed or as comprehensive as the laws regulating joint ventures.

In sum, a potential franchisor has three different general forms of business enterprise it may use when franchising: An equity joint venture, a contractual joint venture, and a wholly foreign owned enterprise. The two joint ventures may be formed with state owned enterprises, collectively formed enterprises or privately owned enterprises. A potential franchisor may not form a joint venture with an individually owned enterprise. The advantages and disadvantages of these

[111] Equity Joint Venture Law, art. 6.
[112] *Id.*, art. 2.
[113] *See* Law on Chinese-Foreign Cooperative Ventures, promulgated April 13, 1988.
[114] *See* Regulations on Implementation of Chinese Foreign Enterprise Law.
[115] *See* Regulations of Ministry of Labor on the Right of Autonomy of Foreign Enterprises in Hiring Personnel and on Wages, Insurance and Welfare Expenses.

different business forms in the context of franchising are discussed later in this paper.

5. Foreign Economic Contract Law

Two completely distinct bodies of contract law exist in China. The Chinese Economic Contract Law ("ECL") governs contracts between domestic Chinese enterprises and the Foreign Economic Contract Law ("FECL") applies to economic contracts between Chinese and foreign enterprises. A joint venture agreement will be governed by the FECL. However, once the joint venture is formed and begins to contract with other domestic Chinese enterprises, the ECL will apply because the joint venture is deemed to be a Chinese enterprise.

In the event a decision is made to franchise in China, the two chinese contract laws should be researched and reviewed in detail before any contracts are entered into. However, several general observations about the FECL should be made preliminarily.

The FECL applies to economic or trade contracts, except international transport contracts, between Chinese enterprises or economic organizations and foreign enterprises, other economic organizations, or individuals.[116] Chinese individuals are prohibited from entering into foreign economic or trade contracts. Further, only Chinese enterprises or economic organizations authorized by MOFERT to engage in foreign trade are entitled to enter into contracts with foreigners. The contract must fall within the declared scope of business of the Chinese enterprise or the contract will be declared void or voidable.

The FECL contains three general rules regarding contract formation.[117] First, a contract is formed when two parties reach a written agreement signed by both parties. Although the precise meaning of the term "written agreement" is left unclarified by the law, under Chinese practice, agreement is formed when an unconditional offer is accepted unconditionally by the offeree.[118] Second, if an agreement is formed through correspondence, telegram or telex and one party demands a written confirmation, then the contract is formed only after the written confirmation is signed. Third, if the contract requires approval by the Chinese authorities, then the contract becomes effective only after the approval is obtained. Franchisors should note that contracts for the formation of Chinese equity and contractual joint ventures, and contracts for the transfer of technology must be approved by the Chinese authorities.

Article 12 of the FECL provides that contracts should generally contain the following terms:

1) The corporate or personal names of the contract parties and their nationalities, principal place of business or residence addresses;

2) date and place of signature of the contract;

3) type of contract and the kind, scope of the subject matter of the contract;

116 Foreign Economic Contract Law, art. 2.
117 *Id.,* art. 7.

118 China ratified the U.N. Convention on Contracts for the International Sale of Goods in 1986, effective January 1, 1988. Contracts entered into by foreign companies having their place of business in another contracting state are therefore governed by the rules of offer and acceptance in the Convention. China declared reservations in articles 11 and 29 of the Convention. Chinese law therefore still requires contract formation, modification and termination to be in writing.

4) technical conditions, quality, standard, specifications and quantities of the subject matter of the contract;

5) Time limit, place and method of performance;

6) Terms of price, amount and way of payment, and various additional changes;

7) whether the contract could be assigned or conditions for assignment;

8) compensation and other liabilities for breach of the contract;

9) ways for settlement of disputes in case of disputes arising from the contract; and

10) languages to be used in the contract and their effectiveness.

The FECL provides in article 9 that "[c]ontracts which are against the Laws and the public interest of the People's Republic of China shall be null and void." Article 10 provides that "[c]ontracts signed by false representation or under duress are invalid." Article 58 of the General Rules of Civil Law declares the following civil legal acts to be invalid:

1) Those performed by a person without capacity for civil acts;

2) those which, according to law, may not be carried out independently by a person with limited capacity for civil acts;

3) those which have been performed under circumstances where one party uses deceptive or coercive means;

4) those which are performed in malicious conspiracy harming the interests of the state, a collective, or a third party;

5) those which violate the law or are contrary to public interest;

6) economic contracts that are contrary to a mandatory state plan; and

7) those which conceal an illegal aim by giving the act a lawful form.

Four remedies for breach of contract are made expressly available under the FECL: Damages; indemnities; suspension of performance; and cancellation. In general, the measure of damages is the economic loss suffered by a party as a consequence of the breach. The Supreme Court has interpreted the loss provision to include destruction or loss of property, expenses paid by the injured party to mitigate the loss, and expected profit. The amount of damages may not exceed those losses that were a foreseeable consequence of the contract breach.

The FECL contains four potential methods for dispute resolution: Consultation; mediation; arbitration; and litigation in the People's Courts.[119] Disputes in China are normally resolved through the mediation and arbitration process, although court cases are on the increase. In general, the parties may choose the law which will govern the contract. If no law is chosen, then the law of the country with the closest connection to the contract will control. Relevant exceptions to these two rules are contracts for the formation of Chinese foreign equity joint ventures and Chinese foreign cooperative joint ventures, which must be governed by Chinese law.

[119] *See* Foreign Economic Contract Law, arts. 37, 38.

6. Technology Import Contract Regulations

All foreign business transactions involving the transfer of technology are subject to the provisions of the Regulations on Administration of Technology Import Contracts ("RATIC"). Since virtually all franchising contracts involve the transfer of some form of technology, this law is extremely important to the business approach and decision making process of potential franchisors.

Forms of technology transfer covered by RATIC include: (1) Assignment or licensing of patent or other industrial property rights; (2) know-how provided in the form of drawings, technical data, technical specifications, etc., such as production processes, formulas, product designs, quality control and management skills; and (3) technical services. Article three of RATIC requires that the imported technology be advanced and appropriate and conform to at least one of the following requirements:

1) Capable of developing and producing new products;

2) Capable of improving quality and performance of products, reducing production costs and lowering consumption of energy or raw materials;

3) Favourable to maximum utilization of local resources;

4) Capable of expanding product export and increasing earnings of foreign currencies;

5) Favourable to environmental protection;

6) Favourable to production safety;

7) Favourable to improvement of management; and

8) Contributing to advancement of scientific and technical levels.

Article 6 of RATIC requires that the supplier "ensure that it is the rightful owner of the technology provided and that the technology provided is complete, correct, effective and capable of accomplishing the technical targets specified in the contract." Article 7 provides that the "recipient shall undertake the obligation to keep confidential, in accordance with the scope and duration agreed upon by both parties, the technical secrets contained in the technology provided by the supplier, which have not been made public." Article 8 provides that "[t]he duration of the contract shall conform to the time needed by the recipient to assimilate the technology provided and, unless specially approved by the approving authority, shall not exceed ten years."

The most important and limiting provision in the RATIC as far as franchisors should be concerned is article 9, which prohibits the supplier from requiring the recipient to accept conditions which are "unreasonably restrictive." This is potentially the most troublesome area of the law with regard to traditional franchising methods. Under article nine, a contract shall not include any of the following restrictive provisions unless specially approved by the authorities:

1) Requiring the recipient to accept additional conditions which are not related to the technology to be imported, such as requiring the recipient to purchase unnecessary technology, technical service, raw materials, equipment and products;

2) Restricting the freedom of choice of the recipient to obtain

raw materials. parts and components or equipment from other sources;

3) Restricting the development and improvement by the recipient over the imported technology;

4) Restricting the acquisition by the recipient of similar or competing technology from other sources;

5) Non-reciprocal terms of exchange by both parties of improvements of the imported technology;

6) Restricting the quantity, variety and sales price of products to be manufactured by the recipient with the imported technology;

7) Unreasonably restricting the sales channels and export markets of the recipient;

8) Forbidding use by the recipient of the imported technology after expiration of the contracts; and

9) Requiring the recipient to pay for or to undertake obligations for patents which are unused or no longer effective.

When applying for approval of a Technology Import Contract, applicants are required to submit a written application for approval, a copy of the contract executed by both parties and its Chinese translation, and documents evidencing the legal status of the contracting parties.[120] The Chinese authority charged with the responsibility of interpreting the regulations and approving the applications and contracts is MOFERT.[121]

7. Trademark/Tradename

Millions of people stop each year to eat hamburgers under the golden arches of McDonald's and chicken under the red and white bucket and colonel of Kentucky Fried Chicken. Since franchises are primarily identified by their trademarks and tradenames, protection of these intellectual property rights is one of the most important legal considerations to franchisers and franchisees.

The two primary laws which govern trademarks in China are the Trademark Law adopted in 1982, effective March 1, 1983 and the Implementing Regulations of the Trademark Law as amended January 13, 1988. The Chinese Trademark Law provides in article four that "any enterprise, institution or individual producer or trader, intending to acquire the exclusive right to use a trademark for goods produced, manufactured, processed, selected or marketed by it or him, shall file an application for the registration of the trademark with the Trademark Office." The trademark of a service may not be registered.

Under Chinese law, an exclusive right to use a trademark can only be acquired by registration. This system is different from that used in other countries, such as the United States and United Kingdom, which permit the acquisition of a trademark right through use of the trademark. In China, there is no requirement of use or intent to use. With the exception of certain goods such as pharmaceutical products for human use and tobacco products, registration of the trademark is voluntary.

120 Regulations on Administration of Technology Import Contracts, art. 10.

121 *Id.*, art. 12.

There are two requirements that a character or figure must possess in order to become a trademark. First, the mark must be distinctive enough to distinguish the goods of one enterprise from those of another.[122] Second, the mark must not be misleading or deceptive.[123] Article eight of the Trademark Law provides a list of characters and figures that should not be used as trademarks, including national flags and emblems, foreign flags and emblems, the red cross and red crescent, marks which discriminate against any nationality, and those detrimental to socialist morals and customs.

A foreigner or foreign enterprise may file a trademark application in China provided their country of nationality has reciprocal trademark relations with China. This includes any country which is a signatory to the Paris Convention for the Protection of Industrial Property, which China acceded to in 1985. Although there are no rights of priority in the Trademark Law, a provisional administrative rule[124] provides that any national of a Paris Union country who files first in their own country and later in China may claim a right of priority up to six months after the date of the first filing.

The duration of a registered trademark is ten years from the date of approval.[125] The trademark may be extended for an unlimited number of ten year periods by making application within six months of the expiration date.[126] Registered trademark rights may be transferred by succession or assigned by contract.

Once registered, trademark rights are protected by Chinese Law. The Trademark Law provides that the following acts constitute trademark infringement:

1) Unauthorized use of a registered trademark for the same goods;

2) Unauthorized use of a registered trademark for similar goods;

3) Unauthorized use of a trademark similar to a registered trademark;

4) Unauthorized making or sale of representations of the registered trademark of another person;

5) Other prejudice to the exclusive right in a trademark.

When an infringement takes place, any person may make a complaint to the appropriate authorities, including, of course, the person or entity whose rights have allegedly been infringed. The authorities have the power to order the wrongdoer to immediately cease and desist the infringing, to seize any representations of the trademark, to order the removal of the trademark from existing goods, and to order appropriate compensation.[127] The measure of compensation is the unlawful profit obtained by the infringer or the damages suffered by the person infringed upon.[128] For serious violations, criminal sanctions such as fines may also be imposed. A party dissatisfied with the administrative ruling may appeal to the People's Courts. The person whose trademark rights were

[122] Trademark Law, art. 5.
[123] *Id.,* art. 8.
[124] *See* Provisional Provision for Claims of the Right of Priority with Respect to Applications for the Registration of Trademarks promulgated by the State Administration for Industry and Commerce of the People's Republic of China on March 15, 1985.
[125] Trademark Implementing Regulations, art. 23.

[126] *Id.*, art. 24.
[127] *Id.,* art. 43.
[128] Trademark Law, art. 39.

infringed may completely bypass the administrative process and file their complaint initially in the People's Courts.

Tradenames, as contrasted with trademarks, are protected by the Interim Provisions Concerning the Registration and Administration of the Names of Industrial and Commercial Enterprises promulgated on June 15, 1985. After the name of any foreign enterprise is examined and registered, the enterprise has the exclusive right to use the name throughout China.

8. Copyright Law

Franchisers and franchisees often desire legal protection for their literature, menus, company manuals and other proprietary documentation. China now protects these rights through the Copyright Law adopted September 7, 1990 and the Implementing Rules for the Copyright Law adopted September 1, 1990. The Copyright Law protects the literary, artistic and scientific works of authors.[129] Works of foreigners that are first published in China are protected under the law. Works of foreigners that are first published outside of China receive protection under the law in accordance with agreements between their country of nationality and China.[130]

The works protected by the law include writings, orally delivered works, artistic and photographic works, film, television and video works, engineering designs, maps, other graphic works, and computer software.[131] The period of copyright protection is the author's lifetime plus fifty years after his death.[132] The remedies for infringement upon a copyright include an injunction, public apology and compensatory damages.[133]

9. Patent Law

A franchise agreement often contains transfer of technology and patent rights that need legal protection in the host country. In China, patent protection can be obtained for inventions, utility models and designs that are novel, possess inventiveness and that have industrial application.[134] Novelty means that no identical invention or utility model has been publicly published in China or abroad or used in China. The date used to determine novelty is the date of filing rather than the date of invention. Inventiveness means that an invention has prominent substantive features that represent a notable progress and that a utility model has substantive features and represents progress.

A foreign individual or enterprise may obtain a patent in China if they are a national of a country that has entered into a reciprocal patent agreement or treaty with China.[135] An application for a patent must contain a request, a description, one or more claims, and an abstract of the invention or utility model.[136] The process for obtaining a patent is complex and is beyond the scope of this paper.

Once a patent is obtained, the patentee enjoys the exclusive right to exploit the patent in China. The patent right may be assigned by written contract registered with the patent office.[137] Should anyone attempt to exploit the patent without authorization,

[129] Copyright Law, art. 1.
[130] *Id.,* art. 2.
[131] *Id.,* art. 3.
[132] *Id.*, art. 21.
[133] *Id.,* art. 45.
[134] *See* Zongshun, *Protection of Industrial Property*, Chinese Foreign Economic Law at 139-146 (1989) [hereinafter *Protection of Industrial Property*].
[135] Patent Law, art. 18.
[136] Patent Implementing Regulations, rule 39.
[137] Patent Law, art. 10.

the patentee may bring an action for infringement to the administrative authority for patent affairs or directly to the People's Courts.[138] The remedies available include injunction, damages and other relief including seizure and disposition of the infringing products. If the infringement is serious, criminal sanctions may also be imposed.[139]

10. Foreign Exchange Control Laws

Franchisors consider franchising in Mainland China presumably to make money and to repatriate profits. However, the basic unit of currency in China, the Renminbi, is not convertible on international currency markets. One of the major challenges facing franchisors will therefore be how to convert their profits into hard currency and to return the profits to their own accounts.

The Chinese government regulates all transactions in foreign exchange and Chinese Law requires all foreign joint ventures and enterprises to maintain a balance between foreign exchange income and expenses.[140] In general, Renminbi must be used to settle all accounts between foreign enterprises and Chinese enterprises. Government regulation is accomplished through a requirement that all foreign currency must be deposited in accounts with the Bank of China or other approved banks.[141] Maintaining a positive foreign exchange balance will be one of the most difficult challenges facing franchisors.

The primary way that foreign investors obtain foreign hard currency is to produce exports that generate hard currency. This is a potential problem for franchisors because franchise operations usually just sell their products or services to domestic enterprises or individuals for local currency and do not generate exports. However, there are various methods available to help solve the foreign currency problem. In some cases, the balancing of foreign exchange may be waived by the government. In other cases, the government which approved the enterprise and which is now responsible for it may assist the enterprise in maintaining a foreign exchange balance. Further, some local government have formed foreign exchange adjustment centers to facilitate the balancing of foreign exchange.

The maintenance of a positive foreign exchange balance is a complex problem that must be anticipated and planned for in detail before a franchisor makes the decision to franchise in China. It will do franchisors little good to have an enormously successful franchise chain in China but no way to repatriate their profits. The type of franchises chosen and the way business is conducted will have a tremendous impact on whether the foreign exchange challenge can be successfully met. Potential solutions to the balancing of foreign exchange are discussed in a section below.

11. Tax Law

A detailed discussion of Chinese tax law is beyond the scope of this paper. However, franchisors should generally be aware of the major tax laws which affect foreign investment enterprises. The four most important tax laws are: (1) the income tax concerning equity joint ventures; (2) the income tax law concerning foreign enterprises; (3) the individual income tax;

[138] *Id.,* art. 60.
[139] *Id*., art. 63.
[140] *See* Provisional Regulations for Exchange Control of the PRC, promulgated Dec. 18, 1980.
[141] *See* Rules for the Implementation of Exchange Control Regulations Relating to Enterprises with Overseas Chinese Capital, Enterprises with Foreign Capital, and Sino-Foreign Joint Equity Ventures, promulgated on Aug. 1, 1983.

and (4) the industrial and commercial consolidated tax.[142]

The equity joint venture tax rate is 33% - a 30% tax on joint venture income plus a local 10% surcharge on taxable income. An additional 10% tax is levied upon profits that are repatriated abroad. The taxes are based on net income, which is calculated by deducting only costs and expenses actually incurred from gross income. Many joint ventures may be entitled to tax holidays and tax rebates, depending on the type of business they conduct, their term of operation[143], and their geographic location.

The foreign enterprise tax applies to contractual joint ventures and wholly owned foreign businesses. The current version of this tax law became effective on July 1, 1991. It has tax rates identical to the rates in the equity joint venture tax.

The individual income tax law applies to income earned either inside or outside China of individuals who have resided in China for one year or more. For non-residents or individuals living in China for less than one year, only income earned in China is taxed. The individual income tax contains a progressive tax rate ranging from 5% to 55% on wages and salaries. Income from personal services, royalties, interest, dividends, bonuses, property leases and other income is taxed at a flat 20% tax rate. Income earned outside of China by foreigners who live in China for more than a year is exempt from taxation if the primary purpose of the visit is business related.

The Consolidated Industrial and Commercial Tax is the Chinese version of a sales tax. It is applicable to both domestic Chinese enterprises and foreign enterprises. The tax contains many different rates, depending on whether the sales involve industrial products, transportation, agricultural products, import, retail, or services. The basis for the tax is sales value. Foreign joint ventures and wholly owned enterprises may be entitled to various tax exemptions or reductions.

12. Labor Laws

Franchisors should be aware that China has a comprehensive set of laws and regulations that govern labor relations in foreign joint ventures.[144] This legislation limits the joint ventures' ability to hire, fire, regulate and compensate workers. For example, article 8 of the Regulations of the People's Republic of China on Labour Management in Joint Ventures Using Chinese and Foreign Investment provides that the wages shall be 120% to 150% of the real wages of the workers and staff members at state owned enterprises. A joint venture must also pay for workers' labour insurance, medical expenses and various other government subsidies. The rights of the workers and management must be spelled out in a detailed labor contract which becomes part of the joint venture documentation.

E. Special Economic Zones

China has created areas with special economic policies which encourage foreign investment and enterprise.[145] These areas

[142] *See Trade and Investment in China, supra* note 31, at 172.

[143] For example, with approval of the tax authorities, an equity joint venture with a term of business of ten years or more may be exempt from taxes the first and second year and may obtain a fifty percent reduction for the third through fifth years.

[144] *See, e.g.*, Provisions for the Implementation of the Regulations on Labour Management in Joint Ventures Using Chinese and Foreign Investment, promulgated Jan. 19, 1984.

[145] *See* Chen, *Special Economic Zones and Coastal Port Cities: Their Development and*

are called special economic zones, coastal port cities, and coastal economically open areas. The benefits granted to foreign investors in these special areas are significant and vary slightly from region to region. The benefits include income tax reduction and exemption, reduction or exemption from customs duties on imports and exports, cheaper labor rates, flexible labor relations laws, less formal and simpler laws concerning the formation of new enterprises, greater flexibility in land use rights, reductions in land use fees and preferences in banking and finance.[146] Franchisors should consider the benefits of these special economic areas when developing their franchising entry strategy.

IV. Franchising in China

Although franchising is probably the most popular and effective way to expand existing small business operations into new markets, this form of business has not yet developed to any significant degree in China. The lack of development of traditional franchising is due to various practical, cultural, legal, and political factors which stand in the way of the franchiser. These obstacles and their potential solutions are discussed below.

A. Obstacles to Franchising

1. General Obstacles

The primary problem potential franchisers face is that the Chinese "open door" policies are designed more to build up China's internal technology base and to generate foreign exchange than to satisfy domestic consumer demands. Although China has passed an impressive number of laws and regulations to encourage foreign investment, these laws are carefully drafted to prevent the type of foreign exploitation that China has suffered in the past. Many types of franchises may have difficulty getting approved by the government if they simply plan to sell common products or services under a particular trade name and do not have advanced technology or export potential to offer.

Another serious problem facing franchisers in China is that individuals and individual enterprises are not allowed to enter into contracts with foreign individuals or enterprises. This eliminates the tradition franchise arrangement whereby a franchiser licenses individual entrepreneurs to operate the franchises. All Sino-foreign franchising in China must be done through state owned enterprises, collective enterprises or private enterprises which have more than eight people. This limitation greatly reduces the flexibility of the small franchiser and the number of potential franchisees.

A third problem involves the current relatively unsophisticated status of Chinese domestic consumers. The vast majority of Chinese people have not yet developed discriminating consumer tastes. They simply need products or services that are available and satisfactory and do not really care if the products or services are brand X or brand Y.[147] Franchise success and customer loyalty in large part depend on subtle product image distinction which may be unimportant to many Chinese at this stage of their domestic market development.

2. Legal Obstacles

As explained in the sections above, the Chinese government has developed a commercial legal framework to provide predictability and security to foreign investors. Laws are in place which govern contracts, business enterprises, and taxes,

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Legal Framework, Chinese Foreign Economic Law at 391 (1989).

[146] *Id.*

[147] Comment made by a Chinese Professor during an informal interview with the writer.

and which protect patents, copyrights, and trademarks. But not all of the laws are beneficial to foreign franchisers. The two bodies of law which present the greatest challenges to foreign franchisers are the technology transfer laws and the laws regulating foreign exchange.

One of the usual distinguishing characteristics of a franchise business operation is the uniformity of appearance, product, and service at each franchise location. The franchiser is particularly concerned about the quality of each franchise because one bad store or outlet can affect the reputation and business of the entire chain. Franchisers therefore like to retain as much control as possible over such franchise operations as franchise equipment purchases, raw material purchases, and product selection and price.

In addition to quality control, franchisers may require their franchisees to purchase equipment and raw product from them in order to increase the profit of the franchiser. Although this requirement may look suspiciously like illegal tying arrangements under antitrust law, franchisers have been able to convince courts that it is the overall concept of the business that is being franchised, including the franchisers' equipment and raw goods.[148]

These purchasing requirements and the retention of control by the franchiser are prohibited by article nine of the Chinese technology import contract regulations. For example, unless specially approved by the approving authority, a contract cannot contain provisions which restrict the freedom of choice of the franchisee to purchase raw materials, equipment, or products and cannot restrict the quantity, variety and sales price of products. Further, subsection 3 of article 9 prohibits restrictions on the development and improvement of the imported technology by the recipient. This prohibition runs contrary to the need of the franchiser to keep all franchise technology consistent and uniform. Given the list of restrictions in article nine, it will be one of the primary challenges of the franchiser to convince the approving authorities that the needs of the franchise are in the best interest of China.

An additional potential problem for franchisers arising from the Chinese technology import regulations are the requirements of article 3 that the technology imported must be advanced and appropriate. Although each franchiser can claim that its management systems[149], products and services are unique in some manner, it will probably also have to convince Chinese authorities that the differences and contributions are substantive as well as stylistic.

The second major legal obstacle facing foreign franchisers is foreign exchange control. The Chinese government maintains rigid, centralized control over foreign exchange and requires all enterprises to balance their foreign exchange accounts. This is a particular problem for franchise operations because franchisees usually sell goods and services on the domestic market in exchange for domestic currency. Since nothing is exported, franchisees do not generate foreign currency and no profits may be repatriated to the franchiser. The balancing of foreign exchange is a serious problem for Sino-foreign enterprises and the

[148] *See* Principe v. McDonald's Corp., 631 F.2d 303 (4th Cir. 1980), *cert. denied*, 451 U.S. 970 (1981); *Cf*, Siegel v. Chicken Delight, 448 F.2d 43 (9th Cir. 1971) and Kentucky Fried Chicken Corp. v. Diversified Packaging Corp., 349 F.2d 368 (5th Cir. 1977).

[149] Management skills are included in the definition of imported technology under the Technology Import Contract Regulations. *See* article 2(2).

Chinese government has enacted legislation to help deal with the problem. This legislation is discussed in a section below.

3. State Planning System

One of the long-term goals of the economic reforms in China is to replace the state planning system with a free market economy. However, much of the state planning apparatus is still in place and the government still controls many important raw materials and marketing channels. This means that a Chinese enterprise must often deal with and operate through a maze of entrenched and often confusing bureaucratic channels in order to conduct business.

The primary way Sino-foreign enterprises coordinate with the government planning system is through a formal feasibility study report the enterprise must initially prepare.[150] In the report the enterprise should inform the government of the types and amounts of raw material it will need and the degree of integration it will require with the state distribution system.[151] Problems can arise if there are government raw material shortages and the enterprise does not have adequate foreign exchange reserves to purchase substitute materials on international markets.

The Chinese government also exercises control over the marketing and pricing of various products and commodities.[152] If a product is listed on the state plan, the foreign investment enterprise must comply with state directions in order to sell the product in China. In the case of consumer goods, the distribution channel is often through designated commercial distribution centers. However, an enterprise can get approval form the state to market through its own business facilities.[153] The prices for Chinese domestic products must be consistent with the state regulated prices for products with similar quality. This can sometimes be a problem because state regulated prices may bear no relation to market value.

Different products and commodities are controlled to different degrees by the government. Potential franchisors should carefully investigate the amount of supply, price and marketing control exercised by China over any product or commodity it wishes to sell through franchisees.

4. Government Bureaucracy

Franchisers and franchisees in the United States are already familiar with various government approvals and licenses a new franchise unit must obtain before commencing business. The franchisee must comply with such matters as building codes, zoning ordinances, health and safety laws and must pay various franchise and inspection fees. In China, the degree of government involvement is increased probably over one hundred fold.[154] For example, the feasibility report of the enterprise must be studied and approved by government organizations at different levels responsible for water, gas, electricity, landuse, supplies, marketing, pricing, foreign exchange, foreign trade, financing, customs, labor, transportation,

150 *See Trade and Investment in China, supra* note 31, at 181, 182.
151 *Id.* at 182.
152 *Id.* at 185.

153 *Id.* at 186. The ability to market out of independent outlets or stores is an important requirement of any franchise operation and FI must be careful to get this type of marketing approval.
154 It is not uncommon for a Chinese foreign enterprise to obtain over one hundred and twenty separate approvals from various levels of government before commencing business operations. Comment made by a Chinese Professor in an informal interview with the writer.

communication, taxation, public sanitation and environmental protection.[155] If the report is not approved at any stage or level, the business enterprise will be subjected to substantial delays or outright failure.

B. Methods and Techniques

For the reasons discussed above, traditional franchising operations are difficult to establish in Mainland China. However, there are a number of methods and techniques available to U.S. franchisers that still wish to venture forth into the Chinese market. They are discussed below.

1. Joint Ventures

The first and most popular method franchisors can use to enter the Chinese market is to form a joint venture with a Chinese enterprise. Joint venturing is not franchising in the traditional sense because franchisors will be more involved in management activities, will probably contribute more to the enterprise initially, and will share more directly in profits and losses.[156] The usual contributions that foreign enterprises make to joint ventures are trademarks, tradenames, product and equipment specifications, and management expertise.[157] All joint ventures are regulated by the Chinese authorities and franchisors will be expected to make contributions that contribute to the development of China's economy and its scientific or technical levels.

A disadvantage to franchising through a joint venture is that the franchiser becomes more of a management partner than a licensor. The Chinese regulations are designed to prevent a relationship between the franchiser and franchisee where the franchiser has strict control over the franchisee's activities. Potential franchisors may not want to enter into a relationship where they must relinquish indirect control from the U.S. and assume a local, hands on, management position. A partial solution to this problem might be to form a contractual joint venture that has the rights and duties of the parties designed more along a traditional franchise basis. Profits and losses would not be determined by equity percentages, but rather by contract terms that could provide the franchisor initial licensing fees and percentage royalty payments. Should a franchisor decide to forego a strong, local, management presence (by having little representation on the board of directors), perhaps the franchisor could convince Chinese authorities that stronger contract terms are justified to maintain the integrity of the franchise.

A tremendous advantage to franchising through a joint venture is that the Chinese partner can assist the joint venture in working its way through the labyrinth of Chinese regulations and bureaucratic controls. This asset is particularly helpful during the initial feasibility study report phase when numerous approvals are required. With this in mind, potential franchisors should carefully select a Chinese partner that is politically well connected and that has established reliable channels of raw material supply and distribution. State owned and collectively owned enterprises are generally in a better position to offer these assets than private enterprises.

2. Wholly Owned Subsidiary

Should franchisors want to retain full control over the management and technology of one of their franchise operations, the formation of a wholly owned foreign enterprise is an option. Once the

[155] *See Trade and Investment in China, supra* note 31, at 183.
[156] *See* Han and Oechsli, *Franchising in Mainland China*, 58 Antitrust Law Journal 1013, 1014 (1990).
[157] *Id.*

enterprise is established, it can enter into agreements with Chinese distributors or other Chinese enterprises to act as franchisees. These agreements will be governed by the economic contract law of China rather than the foreign economic contract law.

Franchisors should probably not choose this form of business enterprise for two important reasons. First, the Chinese government is more stringent on wholly owned foreign enterprises in terms of the degree of technology required. Since most franchise operations will be marginal on imported advanced technology anyway, this problem could be a major obstacle. Second, a wholly foreign owned enterprise will not have the benefit of assistance from a Chinese partner. Even if it obtains initial approval, a wholly foreign owned enterprise may find itself frozen out of supply and distribution channels as it tries to expand or as domestic competition increases.

3. Technology Licensing

In the event a franchisor does not desire to establish any type of business presence in China, it has the option of franchising through a technology licensing contract.[158] In this type of arrangement, the licensor grants a Chinese enterprise the right to use technology along with its tradename and trademarks. The Chinese enterprise will have the right to manage the operation and to use the technology as it deems appropriate. Although this approach more closely resembles traditional franchising than a joint venture, the great disadvantage to technology licensing is that the licensor has virtually no control over the licensee and therefore cannot maintain the uniformity and integrity of the franchise. Additionally, the licensor cannot restrict the use of the license by the licensee after the contract expires.

[158] *Id.* at 1014.

4. Management Contracts

Some management hotel companies have entered into management agreements with Chinese enterprises whereby the hotel companies provide their management and marketing expertise and tradename.[159] These management contracts resemble franchising relationships in that the hotel companies receive a licensing fee and a percentage of profits. However, the management contracts are not traditional franchises because the hotel companies assume some of the actual hotel management responsibilities.[160] These contracts have probably received ready approval from the Chinese government due to the unique ability of an internationally recognized hotel chain to generate hard currency from foreign visitors. It is unknown whether this business format would be readily transferrable to other services or products.

5. Distributorships

Another option available to a franchisor is to market products through Chinese distributors.[161] This option is limited, however, because the distributors are all government owned and competitors products will also be distributed by the same government organization.

6. Compensation Trade Contracts

A final business technique which should be mentioned is a compensation trade contract. The most common form of compensation trade contract is known as "buy-back."[162] In a buy-back, the seller delivers goods such as equipment, a factory

[159] *Id.*
[160] *Id.* at 1015.
[161] *Id.*
[162] *See* McVey, *Overview of the Commercial Practice of Countertrade,* Barter in the World Economy at 16 (1985).

or technology and receives output from the equipment, factory or technology as payment.[163] Compensation agreements generally involve large amounts of money and are for long periods of time.[164] This business form differs from franchising in that the licensor must usually make a large initial investment and must receive their compensation in produced goods. Although a franchisor will probably not want to use a compensation trade contract as an exclusive, substitute method of franchising, it is often useful as a tool to complement an overall, successful franchising strategy.

C. Overcoming Foreign Exchange Problems

The greatest obstacle that will confront a franchisor should it decide to franchise in Mainland China is how to balance foreign exchange. The problem has been discussed in earlier sections of this paper. In 1986, the Chinese government passed legislation designed to assist foreign enterprises with the foreign exchange problem.[165] This new law describes five ways that a foreign enterprise can seek to balance foreign exchange.

The first method allowed under the Balancing Regulations involves converting renminbi to hard currency through assistance from the government or through foreign exchange swap centers. Article three of the Balancing Regulations provides that an approved joint venture's foreign exchange accounts should be balanced by the governmental unit that approved the contract. However, the authorities try hard to avoid being placed in this position by refusing to approve enterprises that will be unable to generate foreign exchange. In practice, this method of balancing foreign exchange is rare and franchisors should not rely upon the approving authority for assistance.

Article 9 of the Balancing Regulations permits joint ventures of a common foreign investor to balance foreign exchange surpluses and deficits between themselves by swapping RMB for hard currency. A subsequent regulation broadened the scope of currency swaps by dropping the requirement of common ownership.[166] This change led to the creation in 1987 of foreign exchange adjustment centers where an enterprise could purchase hard currency for RMB at market rates. Although swap centers are helpful, they are not a panacea for foreign currency balancing problems. An enterprise must first be located that is willing and able to sell hard currency, a commission to the center must be paid, approval must be obtained by the State Administration of Exchange Control, and a premium price must be paid.[167] Franchisors should plan on using the currency swap centers on only a short term, emergency basis.

The second method of balancing foreign exchange is for the enterprise to reinvest its RMB profits into another

[163] *See* Guyot, *Countertrade Contracts in International Business,* 20 Int'l Law. 921 at 948 (1986).

[164] *See* Zeller, *Countertrade, the GATT, and the Theory of the Second Best,* 11 Hastings Int'l and Comparative Law Review 247, 249 (1988)

[165] Regulations Concerning the Question of Balance of Foreign Exchange Receipts and Expenditures of Joint Ventures Using Chinese and Foreign Investment, promulgated by the State Council on January 15, 1986. (hereinafter *Balancing Regulations*)

[166] Provisions for the Encouragement of Foreign Investment, art. 14.

[167] *See* Conroy and Young, *The Balancing of Foreign Exchange in the PRC: Anomalies and Alternatives*, 18 Hong Kong Law Journal at 405 (1988) [hereinafter *The Balancing of Foreign Exchange*].

enterprise within China that is capable of generating foreign exchange.[168] The foreign exchange from the second company may then be repatriated by the first.

The third method is for the enterprise to pay its Chinese taxes in RMB. In 1986, the Chinese Ministry of Finance issued a notice indicating that enterprises with foreign investment could pay their taxes in RMB.[169] According to two respected practitioners, local Chinese tax officials apply the provisions of the notice liberally and allow enterprises and foreign investors: 1) to pay even their tax on foreign exchange income in RMB; and 2) to use RMB earnings from one Chinese enterprise to pay the taxes of another.[170]

The forth method involves the sale of products on the domestic market for foreign exchange. Although products sold in China's domestic markets normally must be paid for in RMB, article five of the Balancing Regulations permits foreign exchange to be paid for products which substitute for those which would otherwise be imported.

The State Council has passed detailed regulations concerning the approval process for import substitution status.[171] Article 3 of the Import Substitution Measures requires that the product: 1) must be produced by a technologically advanced enterprise in temporary need of foreign exchange; 2) must be genuinely needed by China; 3) must be one that is presently imported and will continue to be imported by the local governments or the central government; 4) must meet international quality standards and the requirements of domestic users; and 5) the price must not exceed international market prices. Import substitution status must be requested when the enterprise submits its feasibility study report.[172]

The final method described under the Balancing Regulations is the RMB purchase of domestic products to export for foreign exchange. Article 6 of the Balancing Regulations allows an enterprise, upon approval by MOFERT, to purchase domestic goods for RMB and then sell the products abroad to obtain hard currency. The purchase may be made by the joint venture or by the foreign partner.[173] The availability of this method may be limited because companies which have exportable products will probably want to export the products themselves to generate foreign currency.

D. Customs Law and Import and Export Controls

In the event franchising operations and strategy involves importing or exporting goods into or out of China, franchisors should be aware of the Chinese tariff and non tariff measures. China does not levy a tariff on exports unless they are in short supply domestically.[174] The amount of tariff on imports is based on the category the good falls within. The general rates on imports

[168] *See Balancing Regulations*, art. 10.
[169] *See* Supplementary Notice on the Question of the Income of and the Income Tax on Joint Ventures Using Chinese and Foreign Investment, Co-operative Joint Ventures, and Wholly Foreign-owned Enterprises.
[170] *See The Balancing of Foreign Exchange, supra* note 167, at 406, 407.
[171] Measures for the Substitution of Importation with Products of Chinese-Foreign Equity Joint Ventures and Chinese-Foreign Co-operative Joint Ventures, promulgated by the State Council on Oct. 19, 1987. [hereinafter *Import Substitution Measures]*.
[172] *Id.,* art. 4.
[173] *See The Balancing of Foreign Exchange, supra* note 167, at 411.
[174] *See* Regulations on Customs Duties of the PRC, art. 9.

range from 0 percent on newspapers and magazines to 180 percent on tobacco products.[175] There are also special tariff rates which are calculated based on the country the product is imported from. Both import and export tariffs are based on the value added to the product.

China also applies various nontariff measures to imports.[176] For example, all commodities that are to be sold to consumers in the domestic market or used to production must be inspected. Certain listed commodities are subject to a strict licensure system requiring application for a safety mark. Unlisted commodities may be tested by the end user unless they fall into categories such as pharmaceuticals and food which must be inspected by special authorities. Further, enterprises desiring to import and export must apply for a license. The Chinese authorities also have established a "control list" to prevent the unauthorized export of certain advanced technologies.[177]

D. Common Franchise Issues

There are a number of specific legal issues that repeatedly arise in the context of international franchising. These common issues are reviewed below applying Chinese law.

1. Amount and Form of Franchise Fees and Royalties

Some countries by statute impose limitations on the amount and form of franchise fees and royalties that can be received by the franchiser. China has no such restrictions. The joint venture laws provide that a foreign owned business may own any percentage of the joint venture and therefore may receive any percentage of the profits.[178] The technology import contract laws and foreign economic contract laws also do not contain any percentage restrictions. The only general restriction is that the Chinese authorities likely will not approve a joint venture or contract that provides for unreasonably high franchise fees and royalties. A practical limitation is the amount of foreign exchange the enterprise can generate because fees and royalties may only be repatriated in hard currency.

2. Franchise Term and Termination

An always thorny problem for franchisers is how to deal with a franchise unit that fails. China does not have a franchise law per se and therefore does not specifically regulate the dissolution of franchises. However, the Chinese laws that franchisors should be aware of with regard to terms and terminations are the joint venture law and the technology contract import law.

Under Chinese law, every joint venture must have a specified term that is set forth in the JV contract and approved by the authorities. The term can be extended prior to expiration by the parties subject to government approval.[179] Chinese law also sets forth the circumstances under which a joint venture may be dissolved. These circumstances are: 1) Expiration of duration;

[175] *See* Tariff Nomenclature of the PRC, effective March 10, 1985.

[176] *See* Procedure for Administration and Supervision of the Quality of the Import Commodities issued jointly by the State Administration on Commodity Inspection, the State Economic Commission, MOFERT and General Administration of Customs of the PRC on Sept. 8, 1987.

[177] *See* Provisional Rules on Examination of Export Technology issued on Dec. 26, 1989.

[178] Of course, if a foreign owned enterprise owns 100% of an enterprise, then it will be wholly foreign owned and will no longer be a joint venture.

[179] Joint Venture Law, art. 12.

2) business failure due to heavy losses; 3) business failure due to one of the contracting parties failing to fulfill its obligations; 4) business failure due to force majeure; 5) inability to obtain the desired objectives of the enterprise; and 6) other grounds for dissolution as described by the contract and articles of association.[180] The Chinese authorities must approve the dissolution.

An important term limitation that franchisors should be aware of is the ten year limit placed on technology import contracts by article 8 of the Regulations. This article states that "[t]he duration of the contract shall conform to the time needed by the recipient to assimilate the technology provided and, unless specially approved by the approving authority, shall not exceed ten years." Should a franchisor desire to franchise through technology import contracts and want to retain the rights to its technology, article 8 can be a significant problem.

3. Subfranchisees

The question often arises whether a master franchiser in a country has the right to enter into contracts with other individuals or businesses which then become subfranchisees. There is no prohibition against this form of organization in China. As a practical matter, a Chinese-foreign joint venture could act as a master franchiser and enter into subfranchise contracts with other Chinese enterprises. The prohibition against Chinese individuals and small private enterprises entering into contracts with foreigners would no longer be applicable because the joint venture is a Chinese legal person. The Economic Contract Law, as opposed to the Foreign Economic Contract Law, would apply to these subfranchise contracts.

4. Foreign Equity Participation Requirements

Some countries impose a maximum and minimum equity participation requirement on foreign investors. There are no such requirements in China.

5. Antitrust Laws

Due to the degree of control that a franchiser attempts to exert over a franchisee, questions of antitrust often arise. China does not as yet have any antitrust laws. However, the prohibitions against undue licensor control contained in the technology import contract regulations serve much the same purpose as antitrust laws in the franchising context.

6. Notification Requirements

Countries with developed franchising laws will usually impose notification requirements on franchisers that are attempting to convince potential franchisees to open a franchise. China does not have any notification requirements in large part because it has no franchising laws. However, the strong degree of government involvement and the requirement of a feasibility study probably renders such notification requirements unnecessary.

VI. Franchise Strategy

A. Practical Approach

In light of all the legal, political, and cultural barriers which still exist in China, a successful franchise venture will require a creative and integrated approach. The primary obstacles to consider are technological requirements, product demand, and the need to generate foreign exchange. Franchisors should consider using the following comprehensive strategy to franchise in Mainland China:

[180] Joint Venture Regulations, art. 102.

Step One: Develop franchise operations in Taiwan, Hong Kong and Japan. These countries are currently much more receptive to U.S. franchisers than the People's Republic of China.[181] Although the domestic markets in these countries are not nearly as big as China's, opening these franchises will give franchisors experience in the Pacific Rim and a preview of China.

Step Two: Begin marketing in mainland China from the franchises established in Taiwan and Hong Kong. Mainland China receives television and radio broadcasts from Hong Kong.[182] Franchisors could begin to establish product recognition by advertising through mass media which reaches the mainland. Television commercials could be supplemented by print advertising in China.

Step Three: Begin designing the franchising operations in Japan, Hong Kong, and Taiwan to use raw materials that are available in China. The raw materials would include food, paper products, building materials, and any other item that would be appropriate to process or produce the franchised product or service.

Step Four: Once a franchisor has the ability to use Chinese raw materials in its other Pacific Rim franchising operations, it should begin searching for an appropriate Chinese partner. Franchisors should strongly consider forming either an equity or contractual joint venture with the chosen partner because it will need the partner's assistance with the feasibility study report and in dealing with the Chinese authorities. A state owned enterprise should be the first choice for a partner because it has the strongest political and financial connections. Although franchisors will be forced to relinquish the usual franchiser control when forming a joint venture with a state owned enterprise, the loss in power should be more than offset by added benefits.

Step Five: During the feasibility study report phase, franchisors should emphasize their ability to use Chinese raw materials in its other Pacific Rim franchising operations. If franchisors can structure their overall Pacific Rim franchising operations to use Chinese raw materials whenever possible, it can generate a tremendous amount of foreign exchange. This will, in turn, give franchisors a great deal of negotiating leverage with the Chinese officials when the officials are reviewing the potential franchises for technological content.[183]

Step Six: Assuming that a franchisor can successfully form a joint venture with another Chinese enterprise, then the joint venture can begin enlisting Chinese individuals and small private companies to become subfranchisees throughout mainland China.

B. Products and Industries

As a general rule, the franchises that would be most appropriate for the Chinese market are those which can generate foreign exchange and which deal in technologically advanced products. Any franchise which delivers products and services to foreign visitors will generate foreign exchange. These franchises include hotels, motels and any businesses located in or near hotels,

[181] *See Franchising in the Pacific Rim*, 58 Antitrust Law Journal (1990).

[182] *See Hong Kong: Franchising Continues to Work Wonders*, South China Morning Post at 1 (September 27, 1992).

[183] This type of strategy is apparently being successfully pursued by McDonald's Corp. in China. As reported in a recent November article in the Dallas Morning News, McDonald's is generating foreign exchange by exporting beef and bread from China to its other franchise locations in the Pacific Rim Area.

motels, airports and seaports. The franchises that could deliver technologically advanced products are those dealing in computers, office equipment, pharmaceuticals and general electronic products such as Radio Shack.

Should a franchisor decide to follow the proposed franchising strategy outlined above, then it should be free to franchise in a wider variety of areas. The franchise companies which are currently succeeding in the Pacific Rim area are providing products and services that are unique, not otherwise available, and for which there is a growing need.[184] Examples include high quality services for the elderly, home delivery systems, convenience stores and services, health and natural foods, sports and leisure facilities, toys, home appliances, auto accessories, and western style clothing and food.[185]

VIII. Conclusion

Mainland China is the largest potential franchising market in the world. Although this great and ancient country isolated itself from the rest of the world for thirty years, it now is making efforts to rejoin the world business community. Foreign investors have been encouraged and assisted by China's ambitious campaign to create a structure of commercial laws and regulations.

Despite the new legal structure, franchising is still a difficult and risky business in China. This is because the laws are designed primarily to assist China in reaching its goals of economic and technological modernization, rather than to assist foreigners in exploiting the Chinese domestic consumer markets. But for the patient and innovative franchiser, opportunities do exist. U.S. franchisers such as McDonald's, Kentucky Fried Chicken and Avon Cosmetics have managed to overcome the obstacles and are in the process of establishing successful Chinese franchises.

It should be well worth a potential franchisor's investment of time, money and effort to investigate and experiment with franchise opportunities in China. In light of China's current overwhelming success with its free market revolution, the future of Sino-foreign business enterprise looks bright. Domestic economic success may well eventually lead to further legal reforms such as a comprehensive franchise law, the relaxing of technology requirements, and a convertible currency. The pioneering franchises now willing to brave China's evolving economic, political, and cultural landscape should be well positioned to reap tremendous rewards when China's door finally swings wide open to the rest of the world.

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[184] *See Japan - Franchising Industry*, 1992 National Trade Data Bank Market Reports at 8 (May 19, 1992).
[185] *Id.*