

2003

Franchising in China: Legal Challenges When First Entering the Chinese Market

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FRANCHISING IN CHINA: LEGAL CHALLENGES WHEN FIRST ENTERING THE CHINESE MARKET

MICHELE LEE*

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“Two men look out through the same bars:
One sees the mud, and one the stars.”
- Frederick Langbridge¹

INTRODUCTION

The complicated and often inconsistent legal “bars” that face franchisors in China have not distracted these international investors from the glowing dollar signs.² While there are only about 1,000 franchisees in China operating approximately 100,000 outlets, they generate over eighty-five billion dollars in annual sales.³ The China Chainstore and Franchise Association predicts that franchising will comprise over thirty percent of retail sales by 2010.⁴

With China’s population gaining in affluence and maintaining a stronger middle-class base, U.S.-based franchises in China have found a receptive market.⁵ In the past few years, the franchise business model has grown from non-existent to an attractive business

1. The Quotations Page, Quotations by Author: Frederick Langbridge (1849-1923), at http://www.quotationspage.com/quotes/Frederick_Langbridge/ (last visited Feb. 29, 2004).

2. See *Steaming*, ECONOMIST, Nov. 13, 2003 (citing an estimate by the Bank Credit Analyst, a Canadian research firm, that China accounted for twenty-five percent of global growth in 1995-2003), http://www.economist.com/displayStory.cfm?story_id=2216039 (last visited Feb. 14, 2004). The rate of imports in China has risen forty percent in the past twelve months, while U.S. imports grew by only two percent. *Id.*

3. See *Franchising Becomes Popular*, SHANGHAI DAILY, Sep. 4, 2003 (detailing findings by the China Chainstore and Franchise Association, the largest trade organization in China, which compiles data on the retail and franchising industries), 2003 WL 62361045.

4. See *id.* (attributing the increasing popularity of the franchising format to the perception that franchises are “less risky, inexpensive and lucrative”).

5. See National Bureau of Statistics, People’s Republic of China, *Statistical Communiqué* 2002 (Feb. 28, 2003) (stating that the annual per capita disposable income of urban households in China has increased 13.4% this past year), http://www.stats.gov.cn/english/newrelease/statisticalreports/t20030312_70606.htm (last visited Feb. 15, 2004). With price factors taken into consideration, total retail sales of consumer goods increased 10.2% in the past year. *Id.*; see also *Franchising Becomes Popular*, *supra* note 3 (implying that because the United States is the world’s most developed country in the franchising business, expansion into China was inevitable). Several U.S. franchisors have already established stores in China, including KFC, Subway, Starbucks, and Athlete’s Foot. *Id.*

option; yet, even with the recent growth in popularity of the franchise format, the potential for future growth in China is tremendous.⁶ With U.S.-brand recognition currently at its peak, well-established franchisors seeking a less saturated market than the United States will find promising opportunities in the Chinese market.⁷

While the potential profit margin is enough for anyone to go East in search of striking gold, several problems bar the path to easy profits.⁸ China's accession into the World Trade Organization ("WTO") has done much to alleviate fears of foreign enterprise investors, with U.S. franchisors looking forward to greater market access through the relaxing of geographic restrictions, national treatment for foreign invested enterprises ("FEI"), and stricter intellectual property regulations.⁹ Despite the promised improvements, franchisors should be wary of the lax licensing

6. See *Franchising Becomes Popular*, *supra* note 3 (quoting Global Sources, a trade publisher, as stating that while franchise sales in developed countries account for over forty percent of total retail sales, franchise sales in China only account for two percent); see also *China Country Commercial Guide* (contending that there is still room for franchise development in numerous profitable markets), http://www.mac.doc.gov/Tcc/DATA/commerce_html/countries/Countries/China/CountryCommercial/2000/body.html#1 (last visited Feb. 15, 2004).

7. See *Kentucky Fried Chicken Tops International Brands in China*, PEOPLE'S DAILY, June 26, 2000 (citing an A.C. Nielson Co. survey which found that "as many as 45 percent of those surveyed [in China] said they had tasted Kentucky fried chicken at least once."), available at http://fpeng.peopledaily.com.cn/200006/26/eng20000626_43930.html (last visited Feb. 15, 2003).

8. See *Kentucky Fried Chicken China Earns U.S. \$250 MLN Per Year Since 1999*, ASIA PULSE, Nov. 29, 2001 (citing J. Samuel Su, president of Tricon China, a subsidiary of the U.S. based fast food corporation Tricon Global Restaurants, as stating that over ninety-nine percent of KFC stores in China have made a "handsome" profit), <http://www.siamfuture.com/asiannews/asiannewstxt.asp?aid=1981> (last visited Mar. 6, 2004). Since 1999, KFC's Chinese operations have garnered over \$250 million dollars each year. *Id.*

9. See generally *Protocol on the Accession of the People's Republic of China*, WT/L/432 (Nov. 23, 2001) (outlining the steps that China needed to take to accede to the WTO, including the development of transparency in laws and regulations relating to any foreign exchange, and the repeal of all laws inconsistent with WTO policies of national treatment), <http://docsonline.wto.org/DDFDocuments/t/WT/L/432.doc> (last visited Feb. 15, 2004).

regulations, vague laws, and weak intellectual property protection that could undermine the very identity of a franchise.¹⁰

This comment traces the development of franchise law in China and evaluates whether the evolution of the laws affecting foreign franchises in this country effectively provides protection for franchisors.¹¹ While there have been changes in both the rule of law and the laws themselves, this comment argues that the development in the laws are still not sufficient to provide adequate protection for franchises.¹² Because of this insufficient protection, foreign franchisors should take the additional protection of maintaining as much control over a franchise system as possible in its business ownership, intellectual property, and contractual agreements.¹³ Part I examines the different franchise structures in China and provides an overview of current regulations affecting franchises.¹⁴ Part II analyzes gaps in legal protection created by vague and inconsistent laws, a thin rule of law, and limited resources for legal enforcement in the Chinese legal system.¹⁵ Part III provides recommendations for

10. See *Franchising Becomes Popular*, *supra* note 3 (noting that Sha Yiwen, director of the Shanghai Trade Exhibition Office, has warned that China's lack of a legal framework for licensing and general ignorance of the franchise business structure are factors that could prove detrimental to the future of franchising in China).

11. See *infra* Part II.B (describing how the Chinese legal system's problems with corruption and the government's inability to enforce laws designed to prevent this corruption can pose significant hurdles for investors entering the Chinese market).

12. See *infra* Part II.B (analyzing how the legal framework in China has only created a thin rule of law that cannot support the rapidly growing international marketplace).

13. See *infra* Parts II.A, II.C (analyzing the pros and cons of each franchise structure and the laws that govern each structure, and concluding that steps must be taken to maintain as much control as possible over the franchise system).

14. See *infra* Part I (discussing different types of franchise structures that initial franchise outlets can take when first entering the Chinese market, the structure that the franchise system can take, and the intellectual property, contract, dispute resolution, and foreign investment laws that affect these businesses).

15. See *infra* Part II (presenting issues businesses should consider in developing enterprises and analyzing how these decisions relate to the problems in China's legal system and the problems with the laws themselves).

how franchisors can avoid legal pitfalls and take the necessary steps to franchise successfully in China.¹⁶

I. BACKGROUND

Since the start of communism, China has maintained its isolation and done little to interact with other countries.¹⁷ Partly as a result of this isolationist policy, the country declined in prosperity as it relied on a strictly controlled market that hinged on unsuccessful and corrupt state owned enterprises (“SOEs”).¹⁸ China’s history includes many unsuccessful government attempts to independently modernize China’s economy.¹⁹ Success in creating change arrived in 1978, when the Communist Party focused on economic development.²⁰ Despite the government’s focus on market development, China has continued its commitment to political socialism.²¹ The unique

16. See *infra* Part III (arguing that despite the problems with the Chinese legal system, the potential for growth is enormous, and that waiting to enter the Chinese market might place franchisors at a disadvantage later on).

17. See DANIEL C. K. CHOW, A PRIMER ON FOREIGN INVESTMENT ENTERPRISES AND PROTECTION OF INTELLECTUAL PROPERTY IN CHINA 15-29 (2002) (describing China’s history and the interaction between the political and economic roles of the government).

18. See *id.* (characterizing the time period of 1949-78 as defined by strong government market control where the State created and managed businesses that provided employment for the people).

19. See *id.* at 15-26 (tracing the history of China’s failed attempts to modernize the economy). The Great Leap Forward from 1958 to 1962 was one of the earliest failed attempts to modernize through encouraging the masses to increase crop productivity. *Id.* at 16. This attempt to modernize resulted in a disastrous famine that killed between twenty-five and thirty million people. *Id.* at 16. Another attempt, known as the Cultural Revolution, from 1966 to 1976, denounced bourgeoisie ideals and emphasized the importance of the masses. *Id.* Professionals and those attending universities were sent out into the rural areas of China to learn from the farmers. *Id.* This revolution created China’s ten year economic standstill. *Id.* at 16-17.

20. See CHOW, *supra* note 17, at 20 (discussing the revitalization of the economy through a focus on a “socialist market economy”). China has allowed for more market freedom in the private sector, but the market is still subject to the constraints of the state sector’s goals. *Id.* This is demonstrated by China’s continued ownership of all real property and means of production. *Id.*

21. See Patricia Pattison & Daniel Herron, *The Mountains are High and the Emperor is Far Away: Sanctity of Contract in China*, 40 AM. BUS. L.J. 459, 497 (2003) (concluding that the Chinese legal system “is explicitly meant to function as

atmosphere of a market oriented government in a strictly controlled political environment has forced foreign businesses to carefully adjust their business models to “fit” China’s political objectives and policies.²²

A. FRANCHISING DEFINED

The franchise structure originated in the United States,²³ and has since spread throughout the world.²⁴ A franchise exists when a franchisor grants to a franchisee the right to market goods and services following established marketing and distribution practices with the assistance of the franchisor.²⁵ In a franchise relationship, the

a ‘tool of the state’” (quoting Suzanne Ogden, CHINA’S UNRESOLVED ISSUES: POLITICS, DEVELOPMENT AND CULTURE, 188 (1989)); see also Peter Koveos, *Economies in Transition: Recent Performance*, 30 SYRACUSE J. INT’L. L. & COM. 287, 290-91 (2003) (asserting that political socialism in China has also been called “market socialism,” to describe the co-existence of a market economy and government controlled by a single party).

22. See Frank Horwitz, *There is an Art to Doing Business in China*, BUSINESS DAY (South Africa), Feb. 24, 2003, at 1 (identifying the need for an understanding of the Chinese culture as a key factor to success when doing business in China), 2003 WL 6967254; see also *Starbucks Brews Storm in China’s Forbidden City*, Dec. 11, 2000 (describing the outrage that Starbucks encountered when Meida Coffee Co., the Starbucks franchise for Northern China, first introduced a store in the Forbidden City), available at <http://www.cnn.com/2000/FOOD/news/12/11/china.starbucks.reut/> (last visited Feb. 15, 2004). The Chinese media lambasted Starbucks for “slapping China’s 1.2 billion people and 5,000-year traditional culture in the face.” *Id.*

23. See DAVID J. KAUFMANN, UNDERSTANDING FRANCHISING, BUSINESS & LEGAL ISSUES 13 (2001) (tracing the origin of franchise law to the 1850s, when the Singer Company set up a franchise network to sell sewing machines). Franchising, however, did not become widespread until the 1950s and 1960s, when currently popular chains like McDonald’s, Burger King, and Kentucky Fried Chicken first opened. *Id.*

24. See Richard C. Hoffman & John F. Preble, *Franchising into the Twenty-First Century*, BUSINESS HORIZONS, Nov.-Dec. 1999, 35, 39 (1993) (citing the International Franchise Association as having determined that more than eighty-three percent of U.S. franchisor’s outlets are located in Canada, Japan, Europe, Australia, and the United Kingdom).

25. See KAUFMANN, *supra* note 23, at 16-17 (defining the franchise relationship). Franchisors provide franchisees with information, techniques, and advice on how to operate a franchise outlet, and grant licenses to use the franchisor’s intellectual property marks. *Id.* at 16. Franchisors may also grant franchisees the right to develop stores in a particular geographic region. *Id.*

franchisor grants franchise identity rights to franchisees, either directly or indirectly.²⁶ Depending on their needs, parties to a franchise agreement can adopt different types of franchise structures.²⁷

1. Franchising — A New Concept in China

There is no Chinese word for “franchise,”²⁸ and for many years, franchising as it exists in the United States did not exist in China.²⁹ However, the Chinese government has begun to recognize the viability of franchising and chain stores as a business structure.³⁰ From the time that China opened its doors to foreign investment, the

Franchisees must pay for the limited license to use the franchise name and to obtain information to create the franchise outlet stores, and are obligated to continue paying royalty fees for these rights. *Id.* at 17.

26. See generally FUNDAMENTALS OF INTERNATIONAL FRANCHISING (Richard M. Asbill & Steven M. Goldman eds., 2001) (discussing franchising in several areas of law, including contracts, intellectual property, taxation, and dispute resolution).

27. See Andrew A. Coffey et al., *Structuring the Franchise Relationship*, in FUNDAMENTALS OF INTERNATIONAL FRANCHISING, *supra* note 26, at 41, 41-75 (explaining in depth the different types of franchising structures).

28. See Wilke English & Chin Xau, *Franchising in China: A 1994 Look at KFC and McDonald's in INTERNATIONAL FRANCHISING IN EMERGING MARKETS: CHINA, INDIA, AND OTHER ASIAN COUNTRIES* 37, 43 (Ian Alon & Dianne H.B. Welsh, eds. 2002) [hereinafter INTERNATIONAL FRANCHISING IN EMERGING MARKETS] (noting that there is no exact translation for franchise and that the closest is the term “chain store”).

29. See *id.* at 37 (explaining how because the franchise business format did not exist in China, McDonald's and KFC started out as joint ventures in partnership with the Chinese government).

30. See *China to Unveil New Rules for Franchisers*, CHINA DAILY, July 8, 2002 (demonstrating that the Chinese government has recognized the franchising business format through its decision to implement new regulations governing franchises in the near future), http://service.china.org.cn/link/wcm/Show_Text?info_id=36373&p_qry=franchise (last visited Feb. 15, 2004); see also *Asia's First Institute of Franchising Set up in China*, PEOPLE'S DAILY, June 6, 2003 (describing how the severe shortage of management talent spurred Beijing Normal University to set up the first institute of franchising in China's Guangdong province), http://english.peopledaily.com.cn/200306/06/eng20030606_117778.shtml (last visited Feb. 15, 2004).

country has been cautious in structuring its rules which govern foreign enterprises.³¹

While the November 1997 Measures for Administration of Commercial Franchise Operations promulgated by China's Ministry of Internal Trade Regulations, seem applicable only to China's domestic chain operations, the government has applied them to foreign operations.³² Article 5 of these measures recognizes two types of franchise structures: a direct franchise or a franchise that allows master franchisees to distribute the franchise out to sub-franchisees.³³

2. Direct Franchising

In direct franchising, the franchisor directly grants the right to operate individual or multiple franchise units in a particular location or area.³⁴ Direct franchising has proved to be a successful option for several foreign companies, including Kodak, which created a partnership with the Bank of China to provide financial aid for those seeking to open stores.³⁵ Under this structure, franchisors can directly

31. See Wholly Foreign-Owned Enterprise Law Implementing Rules, part 1, art. 5, translated in CHOW, *supra* note 17, App. I.F at 304-05 [hereinafter WFOE Rules] (listing reasons why applications for establishing a Wholly Foreign-Owned Enterprise would not be approved, which include harm to the public interest, state security, and sovereignty, or where the requirements of China's national economic development would not be met).

32. See Anna M. Han, *Legal Aspects of Franchising in China*, in INTERNATIONAL FRANCHISING IN EMERGING MARKETS, *supra* note 28, at 83, 85 (stating that while the measures are not expressly applicable to foreign industries because the measures are promulgated by the Ministry of Internal Trade, foreign franchisors should follow these regulations).

33. See *id.* at 85 (translating the Measures for the Administration of Commercial Franchise Operations as recognizing the direct franchising and sub-franchising formats).

34. See Catherine A. Riesterer, *Structuring the Contractual Relationship*, in FUNDAMENTALS OF INTERNATIONAL FRANCHISING, *supra* note 26, at 37, 41-44 (noting that with both direct and area franchising, the ability to purchase additional franchise units can be a strong incentive in franchise systems).

35. See *Kodak Aims to Take Lion Share of Chinese Digital Printing Market*, CHINA DAILY, May 27, 2003 (charting the rapid development of the digital photo industry in China, and noting that the partnership between the Bank of China and Kodak aids Chinese investors who do not have adequate funds to purchase the expensive digital printing equipment), <http://>

franchise from the business' country of origin or from a branch office in China.³⁶ Where a foreign entity completely owns a franchise system or an individual franchise outlet, China's laws on wholly foreign-owned enterprises ("WFOEs") regulate such a relationship.

a. The Wholly Foreign-Owned Enterprise

In the past, China has limited or banned completely the ability of foreign investors to operate WFOEs in certain industries.³⁷ However, China's entrance into the WTO led to the Amendments to the Implementation Rules of the Law on WFOEs.³⁸ Despite the changes, China attempts to retain control of the market by strongly encouraging the development of enterprises that are "beneficial to the development of China's national economy" and by maintaining absolute prohibitions over certain industries.³⁹

b. Development and Master Franchising Agreements

Franchisors can also introduce their franchise into China by working with a Chinese business.⁴⁰ With development agreements,

www1.chinadaily.com.cn/en/doc/2003-05/27/content_166648.htm (last visited Feb. 15, 2004).

36. See Alexander S. Konigsberg, *Practical Problems and Suggested Solutions Associated with International Franchising*, 7-SPG FRANCHISE L. J. 3, 3 (1988) (describing the different types of franchising structures and arguing that a franchisor should carefully examine the benefits and problems associated with each structure to avoid costly mistakes).

37. See Michael E. Burke, IV et al., *China Law*, 36 INT'L LAW. 815, 822 (2002) (noting that with the Amendments, WFOEs were "no longer required to adopt advanced technology or be export-oriented"). The Decision on Amendments also eliminated quotas for market sales and preferential treatment for domestic suppliers. *Id.*; see also WFOE Rules, *supra* note 31, part 1, art. 5 (stating that the Chinese government still retains the right to not approve a wholly owned enterprise if the enterprise would harm China's public interest).

38. See Burke, *supra* note 37, at 821 (determining that commitments made under the WTO accession led to the amendments in JV and WFOE laws).

39. See WFOE Rules, *supra* note 31, art. 3 (encouraging advanced technology, development of new products, and saving energy).

40. See UNIDROIT INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW, GUIDE TO INTERNATIONAL MASTER FRANCHISE ARRANGEMENTS 4 (1998) (explaining how franchisors who work with companies from the country in which they want to franchise have the advantages of investing less money to

franchisors can grant all development and ownership rights to a company to open franchise outlets in China.⁴¹ Franchisors can also grant master franchise agreements, which allow franchisees in China to develop and operate franchise stores and gives master franchisees the right to grant franchise rights to sub-franchisees.⁴² Another option of franchising is the creation of a joint venture, where a franchisor forms a company with a Chinese business, and this newly formed company creates franchise agreements for direct store ownership or sub-franchising rights.⁴³ Where a Chinese company and a foreign company join to develop a third, separate, business, China's Joint Venture ("JV") laws govern this third entity.⁴⁴

B. JOINT VENTURE STRUCTURES

The JV was the primary investment option in the 1980s in China because it allowed foreign enterprises to have a local Chinese partner who was familiar with the province where the business was located.⁴⁵ Because JVs were designed to be temporary business structures, approval of a JV's creation is often contingent on the establishment of a set term of years in which the JV will exist.⁴⁶ JVs fall into two

increase the size of the franchise network, and of understanding the local customs and conditions).

41. See Konigsberg, *supra* note 36, at 3 (clarifying that this type of franchising model allows a company to have direct control over all franchise stores, which further allows the implementation of changes in the franchise system to occur more quickly).

42. See Han, *supra* note 32, at 84 (stating that this type of agreement allows for rapid expansion). *But see* Riesterer, *supra* note 34, at 37, 50-51 (warning that problems might arise because master franchise agreements generally state that when the franchisee is terminated, these rights are automatically assigned to the sub-franchisee).

43. See Konigsberg, *supra* note 36, at 4 (stating that international franchisors typically do this when the franchisor does not have sufficient financial and human resources to successfully manage a franchise system in the foreign country).

44. See CHOW, *supra* note 17, at 40 (clarifying that the joint venture is a legal entity separate from the companies that formed it).

45. See *id.* at 41 (stating that the benefits of a local partner include the ability to navigate local bureaucracy and useful local business connections).

46. See WILLIAM B. GAMBLE, INVESTING IN CHINA: LEGAL, FINANCIAL AND REGULATORY RISK 156 (2002) (noting that while JVs are usually temporary arrangements, indefinite terms are available but not in service industries and land development projects).

categories: the equity joint venture (“EJV”) and the contractual joint venture (“CJV”).⁴⁷ The CJV is a company operating under a contract between two parties,⁴⁸ while the EJV is more structured by Chinese law.⁴⁹ In the past, foreign investors have predominantly used the EJV.⁵⁰

Despite the prevalence of U.S.-based businesses in China, the basic franchising structure, whereby franchise rights are directly granted from the franchisor to the franchisee, has been rare.⁵¹ Some U.S.-based companies have followed the traditional unit, area, and master franchising formats while doing business in China.⁵² Other corporations have opted to enter the market by maintaining direct ownership and control over stores as WFOEs or through JV

47. See CHOW, *supra* note 17, at 41-43 (comparing EJVs and CJVs to determine differences and similarities).

48. See *id.* at 41-42 (determining that CJVs are more flexible because they allow foreign investors to create contracts in which they recover their investments first, and the company does not need to have the status of a legal person); see also Ministry of Commerce of the People’s Republic of China: Detailed Rules for the Implementation of the Law on Sino-Foreign Cooperative Joint Ventures, ch. 4 (1995) (detailing investment and cooperation conditions), available at http://english.mofcom.gov.cn/article/200301/20030100062857_1.xml (last visited Feb. 12, 2004). Once parties invest cash or other property rights in a cooperative JV, the property is owned by both parties in a cooperative JV. *Id.* art. 19. If a party fails to make the promised investment set out in the contract or to follow the conditions of the contract, then that party is liable. *Id.* art. 21.

49. See Ministry of Commerce of the People’s Republic of China: Law on Sino-Foreign Equity Joint Ventures, art. 4 (1979) (defining the EJV as a limited liability company where the foreign partner’s capital cannot, in general, be less than twenty-five percent), http://english.mofcom.gov.cn/article/200301/20030100062855_1.xml (last visited Feb. 15, 2004). EJVs share profits and losses in proportion to the contribution of registered capital, and the partnership cannot be dissolved unless all parties approve. *Id.*

50. See CHOW, *supra* note 17, at 41 (stating that there has long been the impression that EJVs provide more stability under the law, but that CJVs actually have more flexibility).

51. See Dai Yan, *International Chain of Firms to Expand*, CHINA DAILY, July 8, 2002 (stating that all McDonald’s outlets in China were directly-run chains, and that McDonald’s would only be willing to begin franchising after the Chinese government defined relevant regulations and laws), http://www1.chinadaily.com.cn/en/doc/2002-07/08/content_126895.htm (last visited Feb. 12, 2004).

52. See *id.* (discussing how KFC’s first franchisee opened in 1993 in Xi’an).

development agreements.⁵³ Regardless of which investment vehicle investors select, franchisors must obtain approval from the Chinese government before any stores can open.⁵⁴

Even with Chinese laws specifying the different types of investment vehicles, foreign investors have a difficult time deciphering which regulations to follow in foreign investment.⁵⁵ Foreign investors have long found difficulty in navigating the complex, and often contradictory, rules and regulations governing foreign investment in China.⁵⁶

C. CHINA'S FRAMEWORK OF LAWS

In 1978, China lacked contract laws, corporate laws, intellectual property laws, security laws, and banking laws.⁵⁷ Since then, dramatic changes in the law and legal structure have occurred.⁵⁸ Since 1978, the government passed more than 350 laws and 6,000

53. See *id.* (discussing how McDonald's owns and operates all of its outlets).

54. See CHOW, *supra* note 17, at 54 (explaining how the examining committee that governs the particular industry that the JV is involved in must approve the JV). The State Development Planning Commission approves project proposals and the Ministry of Foreign Trade and Economic Cooperation approves JV contracts at the national level, while the provincial planning commissions approve projects at the local level. *Id.*

55. See RANDALL PEERENBOOM, CHINA'S LONG MARCH TOWARD RULE OF LAW 463 (2002) (describing the frustration of investors who were subject to laws and internal administrative regulations to which they did not have access).

56. See KUI HUA WANG, CHINESE COMMERCIAL LAW 44-46 (2000) (describing some criticisms of the Chinese legal system that provided the basis for foreigners' confusion). Critics argue that the law is a political tool in China; the laws and policies change too frequently, courts infrequently enforce judgments, the lack of stare decisis prevents adequate interpretation of laws, and that widespread corruption is a strong indicator of rampant disrespect for the laws. *Id.*

57. See *id.* at 11 (stating that from the late 1950s to the mid-1970s, several serious political movements interrupted the drafting of new legislation in China, eventually destroying the legal foundations created by the 1954 Constitution).

58. See Ministry of Commerce of the People's Republic of China: Law Digest (translating the text of recently enacted legislation, including the Contract Law, Secured Interest Law, Copyright Law, and Regulations on Joint Ventures), <http://english.mofcom.gov.cn/lawdigest.shtml> (last visited Feb. 12, 2004).

regulations.⁵⁹ Despite the influx in the number of laws, the political and legal structures do not satisfy the dramatically changing needs of an international business economy.⁶⁰

The Chinese legal system took a big step in 1997, when the 15th Congress of the Chinese Communist Party amended the Party's charter by adding that the Party would abide by "the Socialist Rule of law" as its goal by 2010.⁶¹ This amendment establishes, at least in theory, that high-ranking Communist Party members must abide by the rule of law.⁶²

While the "rule of law" exists in theory, China suffers from inconsistent interpretation of the laws and the Constitution.⁶³ Existing legislation contradicts the Chinese Constitution.⁶⁴ Another problem

59. See PEERENBOOM, *supra* note 55, at 239 (describing the National People's Congress' zealous efforts to create an institution of law that can support the market economy).

60. See JENNIFER CHANG & MICHAEL WANG, THE U.S. EMBASSY, BEIJING, CHINA COUNTRY COMMERCIAL GUIDE FY 2004: A GUIDE TO DOING BUSINESS IN CHINA AND INFORMATION ON CURRENT ECONOMIC CONDITIONS 6 (2004) (describing the Chinese government's difficulties in balancing its long term goal of opening up financial markets and attracting foreign investment with the need to retain strict control over its political power), at <http://www.usembassy-china.org.cn/fcs/pdf/ccg.pdf> (last visited Feb. 16, 2004).

61. See Jiang Zemin, Report to the 15th National Congress of the Chinese Communist Party, sec. VI (Sept. 12, 1997) (recognizing that the Party must adhere to the law institutionally and legally to guarantee political stability for the country), <http://www.fas.org/news/china/1997/970912-prc.htm> (last visited Feb. 12, 2004).

62. See Chris X. Lin, *A Quiet Revolution: An Overview of China's Judicial Reform*, 4 ASIAN-PAC. L. & POL'Y J. 9, 264 (2003) (translating and quoting comments by leading legal experts including Professor Jiang Ping who celebrated the policy as a major shift in the country's development strategy); see also PEERENBOOM, *supra* note 55, at 2 (explaining how the definition of "rule of law" is a contested concept). Peerenboom states that the basic definition is "a system in which law is able to impose meaningful restraints on the state and individual members of the ruling elite." *Id.*

63. See *id.* at 271 (stating that there are laws that conflict with the constitutional provisions that protect citizens from arrest without court orders, and that protect citizens from forced labor).

64. See PEERENBOOM, *supra* note 55, at 317 (noting that the authority of the courts often led to interpretations that were inconsistent with original legislation). One study estimated that in the mid-1980s in Hebei, Beijing, and Tianjin, about two-thirds of local regulations were inconsistent with the Constitution. *Id.* at 241-42. Compare ZHONGUA RENMIN GONGHEGUO XIANFA [Constitution of the

that plagues much of Chinese legislation is the vagueness that the legislation has built into the laws.⁶⁵ Vagueness leaves room for provinces to adjust the laws to suit their particular needs, but vagueness has often simply left room for corruption and inconsistent administration of laws.⁶⁶ When local governments can enact regulations that are not in line with the central government's regulations because of vagueness in the laws, complicated and overlapping government restrictions can impede the growth of the franchise structure.⁶⁷

Legal conflicts can be resolved in courts or through arbitration. The Chinese courts cannot actually interpret the laws because this right is reserved by the National People's Congress ("NPC") and the Standing Committee.⁶⁸ According to the Law on Legislation, only the

People's Republic of China] art. 36 (1982) [hereinafter XIANFA] ("No state organ, public organization or individual may compel citizens to believe in, or not believe in, any religion; nor may they discriminate against citizens who believe in, or do not believe in, any religion."), <http://www.hkhrm.org.hk/english/law/const03.html> (last visited Feb. 13, 2004), with Rupert Wingfield-Hayes, *China Tightens Laws Against Falun Gong*, BBC NEWS, June 11, 2001 (outlining the Communist Party's campaign efforts to eradicate Falun Gong activities), <http://news.bbc.co.uk/1/hi/world/asia-pacific/1383156.stm> (last visited Feb. 13, 2004). The Falun Gong faith is a nonviolent form of personal belief and practice, which the Chinese government has forbidden. See H.R. Con. Res. 188, 107th Cong. (2002) (enacted) (citing that the Chinese government has created an organization called "610," whose sole purpose is to get rid of the Falun Gong through brainwashing, torture, and murder).

65. See PEERENBOOM, *supra* note 55, at 251 (noting that the Confucian philosophy and socialist theory favor laws that are general principles rather than specific codes of law).

66. See *id.* at 475-92 (discussing the effect of rule of law on the different sectors of the economy); see also Illuminating China's Provinces, Municipalities & Autonomous Regions (listing the thirty-four different areas, and the geographic conditions, population and ethnic makeup, and economic conditions for each region), at <http://www.china.org.cn/english/features/43470.htm> (last visited Feb. 13, 2004).

67. See English & Xau, *supra* note 28, at 42 (stating that local governments and individual agencies each have separate procedures that companies must follow for setting up a business in a city).

68. See The Legislation Law of the People's Republic of China, art. 7 (2000) (establishing the lawmaking scope of the NPC), http://www.novexc.com/legislat_law_00.html (last visited Feb. 12, 2004).

legislature can interpret and repeal statutes.⁶⁹ Despite the Supreme People's Court's ability to handle disputes, the case decisions do not serve as precedent, as China has a civil law system.⁷⁰ In recent years, in response to the influx of more technical cases, subject area specific courts, like intellectual property courts, have been set up at the provincial level to handle specialized fields.⁷¹

Arbitration is the preferred means of dispute resolution in China.⁷² As China is a signatory to the New York Convention of 1958, it also recognizes and enforces foreign arbitral awards.⁷³ The New York Convention requires signatories to implement arbitration decisions from member states utilizing the arbitration procedures of the territory where the arbitration order was relied upon.⁷⁴ In ratifying

69. *See id.* arts. 42-47 (indicating that because the lawmaking power rests solely with the NPC, courts are not permitted to interpret the law).

70. *See* RONALD C. BROWN, UNDERSTANDING CHINESE COURTS AND LEGAL PROCESS: LAW WITH CHINESE CHARACTERISTICS 4 (1997) (explaining the legal process through which cases are heard). The highest court in China is the Supreme People's Court; below it at the provincial level are the High People's Courts; beneath that are the Intermediate People's Courts in the provinces, autonomous regions, and within centrally administered cities; and at the bottom are the Basic People's Courts. *Id.*

71. *See* PETER FENG, INTELLECTUAL PROPERTY IN CHINA 28 (2003) (noting that many courts in China have established a "chamber of intellectual property adjudication," staffed with younger, better-trained judges specializing in intellectual property cases).

72. *See* WANG, *supra* note 56, at 293 (suggesting that the amount of legislation involving arbitration reflects the preference for arbitration over litigation). Arbitration in China is governed by Chapter 28 of the Code of Civil Procedure of the People's Republic of China, The Arbitration Law of the People's Republic of China, the CIETAC Arbitration Rules, and the CMAC Arbitration Rules. *Id.*

73. *See* United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, (New York Convention of 1958), Jun. 7, 1959, art. 3, 21 U.S.T. 2517, 330 U.N.T.S. 3 (requiring signatory countries to recognize and enforce foreign arbitral awards), <http://www/uncitral.org/english/texts/arbitration/NY-conv.htm> (last visited Feb. 12, 2004).

74. *See id.* art. 5 (discussing when foreign arbitral awards are not enforceable). Awards are not enforceable when the agreement is not valid under the applicable law, or when the parties are legally incapacitated; the party was not given notice or was not allowed to present its case; the award went beyond the bounds of the terms submitted to arbitration; the parties had not agreed to the arbiters or the procedures, or absent agreement, were not in keeping with the country's arbitration procedures; or when the award has been set aside, suspended, or is not binding. *Id.* Member

the New York Convention, China reserved the right to only recognize contractual or non-contractual relationships that are recognized under Chinese law.⁷⁵ This reservation of power may make arbitration awards in private contractual agreements against the Chinese government and state owned enterprises unenforceable.⁷⁶

In both litigation and arbitration, there has been difficulty in the enforcement of decisions.⁷⁷ One frequently cited reason for this difficulty is China's "corruption culture."⁷⁸ China is set to implement new laws in 2004 targeting this corruption and attempting to eliminate much of the red tape that foreign enterprises must face.⁷⁹

states cannot impose "substantially more onerous conditions or higher fees or charges" for the recognition or enforcement of the foreign arbitration decision than conditions and fees placed upon domestic arbitration parties. *Id.* art. 3.

75. See John Shijian Mo, *Non-Judicial Means of Dispute Settlement*, in CHINESE LAW 757, 797 (Wang Guiguo & John Mo eds., 1999) (listing the two reservations that China made when ratifying the New York Convention in 1986). Besides this provision, China also will not enforce awards made in countries that do not enforce awards made in China. *Id.*

76. See *id.* (hypothesizing that non-commercial disputes and commercial business dispute settlements that the Chinese government participates in overseas may not be enforced in China).

77. See James V. Feinerman, *The Give and Take of Central-Local Relations*, CHINA BUS. REV., Jan. 1998 (citing an example where the Florida firm Revpower was unable to enforce an internationally recognized arbitration award), 1998 WL 10921709.

78. See *Chinese Judiciary and Legal Experts Meet to Discuss Curbing Corruption*, CHINA COURT, Aug. 14, 2003 (reporting on the public concern that has arisen over widespread government corruption), <http://en.chinacourt.org/public/detail.php?id=3205> (last visited Feb. 13, 2004). Since 1998, there were about 207,103 cases related to official bribery and malpractice with prosecution of 12,830 middle and high level officials. *Id.*

79. See *Majority of Corruption Cases in China Linked to Licensing: Official*, PEOPLE'S DAILY, Aug. 30, 2003 (reporting that the law will attempt to eliminate corrupt government practices through administrative regulations that will take effect on July 1, 2004), http://english.peopledaily.com.cn/200308/30/eng20030830_123408.shtml (last visited Feb. 28, 2003). The Standing Committee of the National People's Congress created the law because government officials were amassing profits by requiring several permits and collecting fees for these permits. *Id.*; see also *Chinese Judiciary and Legal Experts Meet to Discuss Curbing Corruption*, *supra* note 78 (describing the corrupt political environment in China).

These affirmative steps have helped to alleviate foreign investor concerns.⁸⁰

D. TRADEMARK REGULATIONS AND TRADE SECRET PROTECTIONS

1. Trademark Laws

The Chinese government allocates trademarks on a “first-to-register” system and franchisors do not need to provide evidence of prior use of the mark.⁸¹ One exception to this rule gives priority to those trademarks that are used on a commodity in a display at an international exhibition recognized or organized by the Chinese government.⁸² Another exception to the “first-to-register” system exists when the mark is “well-known.”⁸³ When a third party is using the same or similar well-known mark of an unregistered party in China, the owner of the well-known mark can then file a complaint with a local Administration for Industry and Commerce office

80. See John Zhengdong Huang, *China on the Horizon: Exploring Current Legal Issues: An Introduction to Foreign Investment Laws in the People's Republic of China*, 28 J. MARSHALL L. REV. 471, 494 (1995) (concluding that wide-scale economic and legal reforms have alleviated foreign investor concerns by providing a basic legal framework through which investors can seek protection).

81. See CHANG & WANG, *supra* note 60 (providing basic overview of trademark protections and determining that a “first-to-register” trademark system can make well-known foreign trademarks vulnerable to registration by third parties in China); see also Ministry of Commerce of the People's Republic of China: Trademark Law, ch. I, art. 3 & ch. VII, art. 51 (1982) (providing trademark registrants with the exclusive right to use the mark for approved goods and services), http://english.mofcom.gov.cn/article/200310/20030100063803_1.xml (last visited Feb. 12, 2003).

82. See *Trademark Law Amended to Better Protect Famous Brands*, BUSINESS ALERT-CHINA, Nov. 15, 2001 (describing changes in Chinese trademark law), at <http://www.tdctrade.com/alert/cba-e0111d.htm> (last visited Feb. 12, 2004); see also Trademark Law, ch. II, art. 25 (stating that an applicant attempting to claim this priority must file an application to register the mark within six months of the date of exhibition).

83. See JAMES M. ZIMMERMAN, CHINA LAW DESKBOOK: A LEGAL GUIDE FOR FOREIGN-INVESTED ENTERPRISES 320-21 (1999) (defining the procedures for foreign and domestic business to obtain “well-known” status for trademark protection in China). Certification for “well-known” status gives the owner of the mark three years in which others are barred from using or simulating the mark. *Id.*

(“AIC”).⁸⁴ The trademark does not need to be well-known in China if it is well-known internationally.⁸⁵ If the business is well-known internationally,⁸⁶ the Chinese Trademark Office can grant certification that the mark is well-known.⁸⁷

Trademark owners can seek administrative relief from the State Administration of Industry and Commerce (“SAIC”) if the owner believes that there has been an infringement of trademark rights.⁸⁸ Trademark holders can also seek relief from intermediate-level

84. See FENG, *supra* note 71, at 339 (stating that the AICs are responsible for handling domestic applications, renewals, assignments, and investigating infringement).

85. See News, CCPIT-Patent and Trademark Law Office: IKEA vs. CINET – First foreign related domain name case cited (describing a case involving Inter Ikea Systems B.V. and Beijing CINet Co. Ltd., where a domestic Chinese enterprise had registered the top level domain name “ikea.com.cn”). The Chinese enterprise argued that at the time of infringement when the trademark was registered, “Ikea” could not have been a well-known name because it had not been used in China. *Id.* However, the court determined that Ikea was a well-known mark internationally and as such deserved protection. *Id.*

86. See Ministry of Commerce of the People’s Republic of China: Trademark Law, art. 14 (stating that business can submit, as evidence, information to prove that they are well known, including: the duration of the publicity of the mark, data supporting the amount of public recognition of the mark in the particular commercial area, and economic ranking of the business versus other competitors); see also Edward Eugene Lehman et al., *Well-Known Trademark Protection in the People’s Republic of China—Evolution of the System*, 26 *FORDHAM INT’L L.J.* 257, 259 (2003) (stating that Pizza Hut was the first company to achieve well-known status in China, when it proved its well-known status through evidence of the mark’s registration in over forty countries). In this case, an Australian company applied for registration of the trademark “Pizza Hut” for cake and powder products in China, but the application was rejected and it was determined that the Pizza Hut trademark was well-known. *Id.*

87. See Lehman, *supra* note 86, at 260 (stating that no foreign trademark has been granted well-known mark certification outside of the standard registration process).

88. See ZIMMERMAN, *supra* note 83, at 322-23 (stating that the SAIC has authority to issue cease and desist orders, to destroy products containing the infringing trademark, to impose fines up to fifty percent of the total sales of the infringing goods or up to five times the profit garnered from the infringement provided that the fine is up to RMB 10,000 (about U.S. \$1,208), and to order trademark infringers to compensate rightful owners).

people's courts that specialize in intellectual property law.⁸⁹ Chinese lawmakers intended that trademark protections in China protect the trademark holder's right to use a trademark, with a focus on protecting consumer interests.⁹⁰ In registering a trademark, the users of this trademark are responsible for the quality of the goods sold under the trademark.⁹¹

2. Trade Secret Protection

Franchises can protect their trade secrets through contractual agreement⁹² and the Anti-Unfair Competition law.⁹³ "Unfair competition" is defined as activities that might damage the legal rights and interests of others, and "disturb the order of [the] social economy."⁹⁴ Under the law, businesses are prohibited from stealing business secrets, disclosing business secrets, allowing others to use trade secrets, or violating trade secret contracts.⁹⁵ However, these trade secrets are only protected if they fall under the requirements of the statute; business information not listed in the law is not

89. See FENG, *supra* note 71, at 25-26 (listing the level of courts in the People's Court system, of which the intermediate courts preside over issues at the municipal level).

90. See Ministry of Commerce of the People's Republic of China: Trademark Law, art. 1 (describing the general purpose of Chinese trademark law).

91. See *id.* art. 7 (discussing the responsibility that trademark owners have for the quality of the goods sold under their mark).

92. See SHANGHAI ZHONGYI LAW FIRM, FRANCHISE AND LEGAL SERVICE OF FRANCHISE 8 (2003) [hereinafter SHANGHAI ZHONGYI] (determining that a franchisor can create and enter into a trade secret agreement that requires the franchisee to keep the trade secrets and not disclose or transfer the secrets), <http://www.ccfa.org.cn/end.jsp?id=4777> (last visited Feb. 10, 2004).

93. See Anti-Unfair Competition Law of the People's Republic of China, art. 10 (1993) (prohibiting business practices that might impede the development of the social market economy), *available at* <http://en.chinacourt.org/public/detail.php?id=3306> (last visited Feb. 10, 2004). Managers cannot steal another's business secrets, nor can they disclose, use, or permit others to use these business secrets. *Id.* The article stipulates that these business secrets must be maintained as secrets by the legal owners to gain protection. *Id.*

94. *Id.* art. 2.

95. See *id.* (imposing legal obligations on managers to "abide by the principle of voluntariness, equality, impartiality, honesty and good faith," and to maintain a "public commercial morale").

guaranteed protection.⁹⁶ Many corporations have chosen to take the additional step of protecting intellectual property through contractual agreements.⁹⁷

E. CONTRACT LAW IN CHINA

Generally, contractual agreements are beneficial because they help to limit a party's risk.⁹⁸ The Uniform Contract Law primarily governs contracts in China, but commercial contracts also fall under the General Principles of Civil Law of the People's Republic of China and the Secured Interest Law of the People's Republic of China.⁹⁹ Prior to the recent enactment of China's Uniform Contract Law, contracts suffered from an emphasis on procedural formalities¹⁰⁰ and inconsistencies between different codes that governed contracts.¹⁰¹

96. See Anti-Unfair Competition Law of the People's Republic of China, art. 10 (protecting trade secrets only where the information is not known to the public, where the information can provide economic benefit to the owner and has practical applicability, and finally, where the owner has taken steps to keep the information confidential).

97. See SHANGHAI ZHONGYI, *supra* note 92, at 7 (advising franchisors that they should create trade secret agreements with franchisees and employees).

98. See GAMBLE, *supra* note 46, at 7 (limiting a contractor's risk in two ways: first, the contract helps to record the terms of a deal for future reference, and second, the contract helps to provide a legal framework in case of unforeseen contingencies).

99. See James M. Zimmerman et al., *People's Republic of China*, 34 INT'L L. 883, 883-84 (2000) (describing how the Civil Law, the Secured Interests Law, and the Uniform Contract Law, supersede the Economic Contract Law, the Foreign Economic Contract Law, the Technology Contract Law, and the Technology Import Contract Regulations, which formerly governed contracts).

100. Compare James C. Hitchingham, *Recent Development: Stepping Up to the Needs of the International Market Place: An Analysis of the 1999 "Uniform" Contract Law of the People's Republic of China*, 1 ASIAN-PAC. L. & POL'Y J. 8, 7 (2000) (discussing how, according to the 1999 "Uniform" Contract Law, contracts can now be "written, oral, or 'in another form'"), with General Principles of the Civil Law of the People's Republic of China, arts. 56-57 (1987), <http://www.cietac-sz.org.cn/cietac/English/Convention/Gpoc12.htm> (last visited Feb. 11, 2004), The Economic Contract Law of the People's Republic of China, art. 3 (1981), http://www.novexcn.com/economic_contract.html (last visited Feb. 11, 2004), and Foreign Economic Contract Law, art. 7, *translated in* 24 I.L.M. 797, 799 (1985) (noting that under previous contract laws, contracts with foreign parties had to be written while contracts among Chinese parties could be oral); see also Feng Chen, *The New Era of Chinese Contract Law: History, Development and a Comparative Analysis*, 27 BROOK. J. INT'L L. 153, 162 (2001) (explaining

The new contract law might seem familiar to Westerners because it borrows both terminology and provisions from civil and common law.¹⁰² The Uniform Contract Law emphasizes the protection of the rights and duties of the parties.¹⁰³ However, unlike the traditional contract laws at common law, Chinese contract law distinguishes between the different types of contractual relationships.¹⁰⁴ Chinese contract law places strong emphasis on good faith dealing, which underlies the Uniform Contract Law and other Chinese laws.¹⁰⁵ During and even after a contract terminates, the law imposes an obligation upon parties to perform duties of “notice, assistance, confidentiality etc. conforming to the principle of good faith and in accordance with trade usage.”¹⁰⁶ While the law permits standard contract provisions, the party providing these provisions “shall ascertain the rights and duties of the parties pursuant to the principle of fairness.”¹⁰⁷ Similarly, the party using these boilerplate provisions

that under the former Economic Contract Law, contracts that failed to include certain specific terms were void).

101. See Chen, *supra* note 100, at 154 (arguing that the different requirements of the previous system of three different contract laws reflected a need for a less chaotic and uniform system of contract law).

102. See WANG, *supra* note 56, at 76 (stating that while the contract law borrows language from common law jurisdictions, the definitional and contextual meanings are not the same).

103. See Ministry of Commerce of the People’s Republic of China: Contract Law, arts. 2-3, 5-6 (2003) [hereinafter Contract Law] (stating that parties to a contract are of equal status, that they must determine rights and duties based upon principles of fairness, and that the parties must perform their duties in good faith), available at http://english.mofcom.gov.cn/article/200301/20030100064766_1.xml (last visited Feb. 11, 2004). Contractual agreements consist of offer and acceptance, but the Contract Law does not include a requirement for consideration. *Id.* art. 13.

104. See *generally id.* chs. 9, 12, 13, 15, 18, 19, 22, & 23 (creating separate regulations for twenty-one different types of commercial transactions including: sales contracts, contracts for loan, contracts for lease, contracts for work, contracts for technology, contracts for deposit, contracts for commission, and contracts for brokerage).

105. See *id.* art. 6 (requiring that “parties shall exercise their rights and perform their duties in accordance with the principle of good faith.”); see also *id.* art. 7 (stating that parties must respect “social morality” and cannot harm the public interest).

106. *Id.* arts. 92-93.

107. *Id.* ch. 2, art. 39.

must draw attention to provisions that might exclude or restrict liability.¹⁰⁸

The most significant change the Uniform Contract Law effectuated was the elimination of the requirement that contracting parties be economic organizations.¹⁰⁹ Now, under the Uniform Contract Law, individuals are permitted to contract with foreign entities.¹¹⁰ Under the changes in contract law, franchisors can franchise directly to Chinese individual franchisees while still obtaining contractual protections.¹¹¹

Another significant change includes the transformation from the old law, which had different requirements for domestic, foreign, and technology contracts, to the new Contract Law, which governs all contracts.¹¹² Foreign parties to a contract may choose which law to apply in contractual disputes.¹¹³ In JVs, however, the laws of the

108. *See id.* (requiring that when contracts have standard clauses, a party must bring the other party's attention to clauses that create or limit the obligations of parties and, where necessary, provide explanations).

109. *See Foreign Economic Contract Law*, art. 2, *translated in* 24 I.L.M. 797, 799 (1985) (stating that under Chinese contract law, individuals could not contract with foreign enterprises).

110. *See* Ministry of Commerce of the People's Republic of China: *Contract Law*, art. 2 (noting that contractual relationships can exist between "natural persons, legal persons or other associations that are subjects of equal status").

111. *See* ZIMMERMAN, *supra* note 83, at 113 (determining that China has developed contract law from a paternalistic approach to a more open approach that recognizes freedom of contract for individuals).

112. *See* Zhao Yuhong, *Law of Contract*, in CHINESE LAW, *supra* note 75, at 217, 222-25 (describing the triplet contract legislation that included the Economic Contract Law, the Foreign Economic Contract Law, and the Technology Contract Law). The Foreign Economic Contract Law governed contracts with foreign entities and was supplemented by other laws, including the Joint Equity Ventures Law and the Joint Co-operative Ventures Law. *Id.* at 223. The Economic Contract Law governed legal persons and clarified domestic parties' rights and obligations. *Id.* at 222.

113. *See* Luo Junming, *Choice of Law for Contracts in China: A Proposal for the Objectivization of Standards and Their Use in Conflicts of Law*, 6 IND. INT'L & COMP. L. REV. 439, 441-42 (1996) (interpreting the Supreme Court of the People's Republic of China as providing that parties can agree upon a choice of law clause in their contracts).

People's Republic of China will apply.¹¹⁴ Contracts can also determine the means of dispute resolution.¹¹⁵ Parties in China typically consult and mediate prior to litigation or arbitration.¹¹⁶

II. ANALYSIS

Doing business under the rule of law in China poses significant opportunities for financial gain. Franchise investors must be fully aware of the legal risks under Chinese law and the legal structure when considering franchising in China.¹¹⁷ In planning, franchisors should carefully consider the legal implications of each type of foreign investment structure.¹¹⁸ After selecting a structure, franchisors should then carefully examine relevant laws and the level of legal enforcement typically provided by intellectual property, contract, and dispute resolution laws.¹¹⁹ Based on the laws and

114. See Ministry of Commerce of the People's Republic of China: Contract Law, art. 126 (mandating that when a choice of law provision is not included, the law of the country most closely connected with the contract will be used).

115. See generally Erik B. Wulff, *Dispute Resolution: Choice of Law and Forum*, in *FUNDAMENTALS OF INTERNATIONAL FRANCHISING*, *supra* note 26, at 305, 307 (discussing the significance of the choice of law and forum agreements).

116. See WANG, *supra* note 56, at 282 (noting that the practice of "joint conciliation" has become common). In this process, the Chinese party will apply to an arbitration commission or conciliation center, and the foreign party will apply to an arbitration or conciliation organization from its own country. *Id.* Then these institutions form a joint committee to settle the matter. *Id.*

117. See U.S. COMMERCIAL SERVICE-CHINA, CONTACT CHINA: A RESOURCE GUIDE FOR DOING BUSINESS IN THE PEOPLE'S REPUBLIC OF CHINA 9-10 (2002) (discussing some of the problems that foreign investors ought to be aware of when entering the Chinese business market, including: lack of predictability in the business environment, bureaucratic local protectionism, remnants of the state planned economy, and general over-enthusiasm), <http://www.business.gov/busadv/frame.cfm?urltest=http://www.mac.doc.gov/china/chinagateway.html&catid=94&urlplace=maincat.cfm> (last visited Feb. 11, 2004).

118. See UNIDROIT, *supra* note 40, at 2-5 (advising franchisors to carefully consider the legal environment, such as what type of control the sub-franchisor will have in the master franchise agreement).

119. See *supra* note 25 and accompanying text (identifying the many other laws that govern franchising including taxation, labor, and real property laws).

accompanying levels of protection, businesses can determine the best means of maintaining control and protecting the franchise system.¹²⁰

A. DEVELOPING A BUSINESS STRUCTURE

Many franchisors are attempting to enter or further their business in the Chinese market.¹²¹ Without proof of success in the Chinese market, a franchise business is unlikely to attract quality franchisee applicants.¹²² Because the franchise structure does not have a long history under Chinese law, potential franchisees may not understand the value of the franchise brand name and the support that a franchise system can provide.¹²³ Franchisees may be reluctant to pay the high costs of franchising and the royalty fees involved.¹²⁴ Therefore, proof of success in China may be necessary before franchisees are willing to bypass opening up their own small businesses in favor of a franchise.¹²⁵

120. See Riesterer, *supra* note 34, at 54 (noting that ceding control over selection of sub-franchisees, training, and marketing can put the franchise system at a disadvantage, however, master franchise agreements remain extremely popular and successful strategies).

121. See Review on the 4th China Franchise Convention & Exhibition (citing statistics compiled by the China Chain Store and Franchise Association that by the first half of 2002, there were over 1000 franchisors in over forty business categories), at http://www.cffa.org.cn/5th/2003_e4.htm (last visited Feb. 16, 2003).

122. See *Asia's First Institute of Franchising Set Up in China*, *supra* note 30 (stating that the rapid growth in franchising created a severe shortage in qualified personnel which poses an additional challenge for potential business entrepreneurs).

123. See Mark Spitalnik, *Can Franchising Work in the PRC?*, CHINA BUS. REV., Sept.-Oct. 2003 (determining that potential business owners would rather spend money on tangible goods like machinery and technology, rather than pay franchise fees and royalties), <http://www.chinabusinessreview.com/public/0309/franchising.html> (last visited Feb. 12, 2004).

124. See *id.* (concluding that the potential franchisees felt that their money was better spent on starting their own small businesses, rather than a franchise).

125. See *id.* (arguing that where a franchise has successful company-owned stores in China, potential franchisees would see the value of a franchise and be more willing to pay franchise and royalty fees).

1. Initial Entry into the Chinese Market

Successful U.S. franchisors entering the Chinese market have often tested out their franchise with company-owned stores prior to granting rights to franchisees.¹²⁶ When franchisors begin to open and operate their own test stores, they can determine what modifications to the business model are necessary to build a consumer base in China.¹²⁷ Immediately granting legal franchise rights to a franchisee or even a master franchisee without first testing out the viability of the franchise within China could depreciate the quality of the trademark and franchise globally.¹²⁸

When first opening an outlet, franchisors can open the store as a WFOE, a CJV, or an EJV.¹²⁹ All three business formats have pros and cons, and the decision of how to begin franchising in China depends upon availability of resources, financial capital, human capital, and notoriety of the franchise.¹³⁰

126. See Yan, *supra* note 51 (stating that McDonald's has not yet entered the franchise market, and has opted to maintain direct control over stores, but has, nevertheless, initiated the franchising process in China); see also ANDREW J. SHERMAN, *FRANCHISING & LICENSING: TWO POWERFUL WAYS TO GROW YOUR BUSINESS IN ANY ECONOMY* 13-15 (2004) (citing a proven prototype location and proven methods of operation and management, among several other factors, as essential to the creation of a responsible franchise foundation).

127. See, e.g., *Dunkin' Donuts*, *FOOD AND DRINK WEEKLY*, Mar. 13, 2000 (noting that Dunkin' Donuts stores in China closed down because the sweet American pastries did not fit the Chinese palate), available at http://www.findarticles.com/cf_dls/m0EUUY/10_6/60596905/p1/article.jhtml (last visited Feb. 12 2004).

128. See Jia Hepeng, *Hoteliers Up Rivalry by Franchising*, *BUSINESS WEEKLY*, July 2, 2002 (quoting Jerry Huang, deputy president of the China Development Department of Six Continents, the largest hotel group in the world, as stating that franchise expansion in China could endanger the group brand if the franchisees do not meet the brand's strict standards), http://www1.chinadaily.com.cn/en/doc/2002-07/02/content_127156.htm (last visited February 12, 2004).

129. See *supra* notes 40-50 and accompanying text (describing the unique characteristics of each of these foreign investment enterprises).

130. See Kenneth S. Kaplan, *Deciding to Go International: Organizational and Business Considerations*, in *FUNDAMENTALS OF INTERNATIONAL FRANCHISING*, *supra* note 26, at 14, 16 (urging franchisors to seriously consider the pros and cons of expanding the franchise internationally). Financial resources are needed to retain experienced local counsel, registration for licenses and intellectual property

a. The WFOE as the Test Outlet

The WFOE allows the foreign investor to have direct control over operations, but may cause substantial difficulties in navigating local laws and establishing localized business relationships.¹³¹ Various benefits that attach to the WFOE include a greater ability to protect intellectual property and the ability to select favorable choice of law provisions and dispute resolution mechanisms.¹³² However, problems that can arise with the WFOE include a company's inability to understand local laws and regional business practices.¹³³ Lack of legal and cultural understanding on the part of companies, coupled with China's historical bias against foreigners and large corporations, can prove to be heavy burdens for a company entering the Chinese market to establish a franchise.¹³⁴ Similarly, regional interpretations of national laws and the corruption that the vague laws engender can prove to be unexpected challenges even for those individuals well-versed in the national Chinese legal structure.¹³⁵

rights, recruiting skills management professionals, investing in the initial site, and translation of the franchise operation materials. *Id.* at 17-19.

131. See generally Anyuan Yuan, *Foreign Direct Investments in China--Practical Problems of Complying with China's Company Law and Laws for Foreign-Invested Enterprises*, 20 NW. J. INT'L L. & BUS. 475 (2000) (describing the practical problems and difficulties WFOEs face in unraveling the intricacies and inconsistencies of Chinese law).

132. See WFOE Rules, *supra* note 31, part 13, art. 81 (stating that when a WFOE signs a contract with another entity, the contract law of China will apply).

133. See KONG QINGJIANG, *CHINA AND THE WORLD TRADE ORGANIZATION: A LEGAL PERSPECTIVE* 34-35 (2002) (stating that one reason WTO compliance will be difficult is because transparency of laws is required on all levels, and there is no official compilation for laws and regulations on a local and national level in China).

134. See WANG, *supra* note 56, at 97-98 (noting that a key advantage to establishing a JV, rather than a WFOE, is that there is lower financial contribution needed, which lessens risk, and Chinese partners may be in a better position to know the procedures for obtaining permits and licenses).

135. See *infra* notes 184-199 and accompanying text (describing how there are contradictions between laws and regulations, and how vagueness in the laws can be interpreted in dramatically different ways in each region).

b. The Joint Venture as the Test Outlet

The Chinese government intended the JV to be a short-term business structure that would bring new technology and business skills to the country.¹³⁶ Accordingly, companies should think carefully about long-term business goals prior to creating a JV.¹³⁷ Historically, JVs have not been very successful in China because the objectives of the parties are often different.¹³⁸

JVs do have the advantage of providing corporations with a local liaison who is familiar with regional business practices.¹³⁹ Besides the liaison's factual knowledge, the value of the liaison's understanding of regional cultural mores should not be underestimated.¹⁴⁰ The combination of local cultural awareness and an understanding of common business practices, allows the foreign investor's JV to reduce the risk of overlooking critical steps in business development.¹⁴¹ Risk is similarly reduced because if the

136. See *supra* note 46 and accompanying text (explaining how the Chinese government views the JV as a short term venture, designed to stay with the Chinese counterpart eventually).

137. See WANG, *supra* note 56, at 98 (citing disadvantages to a JV including problems that arise when there are different management styles, when partners who obtain access to business secrets later become competitors, and when Chinese nationals are in control of part of the company and the Chinese government has more control over daily operations as a result).

138. See GAMBLE, *supra* note 46, at 157 (attributing the lack of success to the fact that foreign partners may have long-term development goals with several JVs, while Chinese partners are more concerned with short-term profits of the particular JV).

139. See Riesterer, *supra* note 34, at 54 (suggesting that JVs have several advantages including better access to natural and human resources, and knowledge of business customs, as well as the structural advantage of sharing profits and losses to minimize the risk involved in the venture).

140. See Spitalnik, *supra* note 123 (describing a case study of an international sign and banner franchise with successful franchisees in over twenty countries that was unable to successfully franchise in China). The franchise soon discovered that Chinese consumers were less willing to pay higher prices for more durable signs from one location when there were cheaper alternatives they could obtain from shopping around. *Id.*

141. See Kaplan, *supra* note 130, at 27-33 (enumerating several factors that foreign investors would be unfamiliar with, including local zoning codes, taxations, restrictions on hiring, legal codes, etc.).

enterprise fails, the financial burdens of the failure will be evenly distributed amongst the parties.¹⁴²

2. *Developing the Franchise System*

After creating initial stores and gauging the success of these stores in the Chinese markets, franchisors should consider the development and ownership of a franchise system.¹⁴³ Long term considerations should guide the initial introduction of the franchise system.¹⁴⁴ Franchisors who franchise directly have similar advantages to a WFOE because of the direct control over the franchise's operations.¹⁴⁵ Similarly, direct franchising forces foreign investors to take on the full costs associated with creating a franchise system.¹⁴⁶

Where franchisors decide to engage in master and development franchising, there are several benefits to master, development, and JV agreements.¹⁴⁷ Similarly, these agreements allow the franchisor to have the resources of a Chinese company that is more familiar with

142. See China Council for the Promotion of International Trade & China Chamber of International Commerce, *Foreign Investment* (describing how key characteristics of JVs have attracted foreign investment to China at a 16.72% rate of increase), <http://app.ccpit.org/vhosts/english/IV.htm> (last visited Feb. 12, 2004). JVs invest, manage, and share risks together proportionally. *Id.*

143. See Kaplan, *supra* note 130, at 20 (advising the franchisor to consider how to compromise the franchise's existing structure with efforts towards building an international franchise system). Franchisors should consider whether there will be offices in these other countries, and examine whether these offices will have taxation and labor relations implications. *Id.* at 20-21.

144. See *supra* notes 52-54 and accompanying text (explaining that foreign investors need to consider both the size and scope of business operations, as well as long-term business goals, to comport with China's goals for the JV in general).

145. See *supra* notes 132-133 and accompanying text (describing the various advantages that a WFOE has when doing business in China as compared to other business structures).

146. See Konigsberg, *supra* note 36, at 3 (alluding to the expensive costs of opening an initial franchise outlet because of the additional financial and human resources necessary to assist the outlet with conforming the franchise system to the differences in language, culture, and customs).

147. See *id.* at 27 (arguing that while costs for master and development franchising are lower, franchisors who have adequate financial and human resources should select direct franchising because it minimizes the risk that a third party will damage the future of the franchise system).

the regional business practices in China.¹⁴⁸ Problems in master development and JV agreements can arise if a franchisor selects a poor franchise developer or sub-franchisor.¹⁴⁹ Substantial problems can arise in a working relationship which involves two or more parties that have separate and sometimes conflicting business interests.¹⁵⁰

Initially, these types of franchise agreements require research into suitable partners and China does not have simple means, like a basic national credit system, to screen potential business partners.¹⁵¹ Even after parties select suitable partners, problems in the working relationship can arise.¹⁵² One more recent and significant problem involved with the JV is the failure of JV parties to submit their promised shares of capital.¹⁵³ Similarly, business partners may improperly take advantage of the relationships.¹⁵⁴ Besides potential

148. See UNIDROIT, *supra* note 40, at 16 (noting that cultural considerations can have implications as to the willingness of individuals to be franchisees, and as to whether particular products or services will be well-received).

149. See Konigsberg, *supra* note 36, at 27 (stating that the best sub-franchisors and developers are those with similar business philosophies and management styles as the chief executive officer of the franchise system, and who have an entrepreneurial ability that is balanced by an ability to work within the pre-existing franchise system).

150. See Z.Y. James Fang & David K.Y. Tang, *The Wholly Foreign-Owned Enterprise Law: Defining the Legislative History and Interpreting the Statute*, 2 J. CHINESE L. 153, 155 (1988) (discussing how problems in a partnership can arise in China because there is no well-developed information network to research potential partners, and that after a partner is selected, there are often differences in managerial style and ideology).

151. See Christopher M. Vaughn, *Venture Capital in China: Developing a Regulatory Framework*, 16 COLUM. J. ASIAN L. 227, 235-36 (2002) (displaying the need for venture capital to overcome a pattern of insufficient self-financing). The lack of screening procedures and information to distinguish between promising and problematic bank loan applicants often creates difficulties for small businesses attempting to finance their debt. *Id.* at 236.

152. See Fang & Tang, *supra* note 150, at 155 (stating that cultural differences can prove to be a hurdle in the working relationship).

153. See CHOW, *supra* note 17, at 69 (recommending that foreign investment enterprises establish a schedule of payment to help solve this problem).

154. See *id.* at 79 (determining that the foreign investor can be at a serious disadvantage in these situations because the local Chinese party typically controls the supply of utilities to the JV). Even when the details of the relationship are established in a contract, and contractual provisions preclude competition between

working relationship problems with partners, the franchisor will also have to share profits from franchising fees with the other parties.¹⁵⁵ When developing a business structure, franchises should also pay close attention to the legal system and the sometimes overlapping and contradictory laws that govern foreign investments in China.¹⁵⁶

B. NAVIGATING PROBLEMS WITHIN CHINA'S FRAMEWORK OF LAWS

China has eagerly pursued a stronger legal system and stronger legal protections.¹⁵⁷ China wants to provide a stronger legal framework to entice foreign investors and to gain legitimacy internationally.¹⁵⁸ The sheer amount of legislative work that China has undertaken indicates that the government is serious about developing the socialist market economy through WTO compliance.¹⁵⁹ However, passage of these laws has not solved all of

the parties, there have been cases where these anti-competition agreements have not prevented Chinese business partners from copying marketing strategies, management techniques and even product development methods to improve their own products. *Id.* at 78. When these anti-competition issues arise, litigation of these issues can be time-consuming and will likely destroy the working relationship. *Id.* at 79.

155. See Riesterer, *supra* note 34, at 44 (explaining the method of franchisors in developing area agreements among multiple franchisees).

156. See Peter Howard Corne, *Creation and Application of the Law in the PRC*, 50 AM. J. COMP. L. 369, 374 (2002) (characterizing the laws as problematic because of undefined terms, vagueness, omissions, and "catch all" clauses).

157. See Paul Gerwitz, *The U.S.-China Rule of Law Initiative*, 11 WM. & MARY BILL RTS. J. 603, 604 (2003) (listing some factors that reflect the changes in China's legal environment). While there were only two law schools and fewer than 3000 lawyers in 1979, there are now more than 200 law schools and over 100,000 lawyers. *Id.*

158. See Huang, *supra* note 80, at 471-72 (noting that one step the government has taken to attract foreign investors is to establish Shenzhen, Shantou, Xiamen, Zhuhai, Hainan Island, Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nanton, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjian, and Beihai as areas where foreign investors can receive preferential treatment in their economic activities).

159. See Donald C. Clarke, *China's Legal System and the WTO: Prospects for Compliance*, 2 WASH. U. GLOBAL STUD. L. REV. 97, 104 (2003) (stating that the Ministry of Foreign Trade and Economic Cooperation reviewed over 1,400 laws and regulations, while the State Council reviewed over 2,300 laws and regulations to prepare for WTO membership).

the problems that currently exist in China's legal framework that can threaten the quality and success of a franchise.¹⁶⁰

1. Lack of Transparency and Corruption

The change to a "rule of law" system may not be fully implemented for many years; however, the change recognizes the correlation between economic growth and the rule of law through the strengthening of institutions and transparency of laws.¹⁶¹ This change is consistent with China's entrance into the WTO, which requires that member nations have laws that are executed in a "uniform, impartial and reasonable manner."¹⁶² Also consistent with China's WTO accession, China's Supreme Court has requested that courts make decisions public which, while not legally binding, can serve as a guide to potential litigants on how judges may rule.¹⁶³

Vagueness in the law gives judges, administrators, local government officials, and other persons in power the latitude to construe laws in ways that serve their own interests.¹⁶⁴ One notable characteristic of Chinese laws is the vagueness inherent in the

160. See PEERENBOOM, *supra* note 55, at 268 (arguing that China has a thin rule of law because the regulatory framework and the legal institution itself need further development).

161. See THE WORLD BANK, WORLD DEVELOPMENT REPORT 2003: SUSTAINABLE DEVELOPMENT IN A DYNAMIC WORLD, TRANSFORMING INSTITUTIONS, GROWTH, AND QUALITY OF LIFE 194 (2003) (recommending that developing countries strengthen the rule of law and good governance to increase consumer and investor confidence), available at http://econ.worldbank.org/files/17960_WDR_2003_chp_9_web.pdf (last visited Feb. 28, 2004); see also PEERENBOOM, *supra* note 55, at 452-53 (explaining economic historian Douglass North's theory that enforceable property and competition rules are important for entrepreneurs to reap the benefits of their labor, which encourages further economic growth and development).

162. General Agreement on Tariffs and Trade, Oct. 30, 1947, art. 10, 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194.

163. See Cao Jianming, *WTO and the Rule of Law in China*, 16 TEMP. INT'L & COMP. L.J. 379, 388 (2002) (describing how publication of judicial decisions is a significant step towards transparency in laws). Cao Jianming is the Justice and Vice President of the Supreme People's Court of the People's Republic of China. *Id.* at 390.

164. See PEERENBOOM, *supra* note 55, at 251 (stating that wide latitude in interpretation prevents the law from being predictable and stable).

wording.¹⁶⁵ In the Chinese contract law, there are concepts like “reasonableness,”¹⁶⁶ “fair dealing,” and “good faith.”¹⁶⁷ While these terms might seem familiar to foreign franchisors, the terms are not defined in Chinese jurisprudence.¹⁶⁸ Analysts have argued that this vagueness was necessary because it allowed local officials to adapt national laws to their regional needs.¹⁶⁹ However, vagueness is particularly problematic in contract law because several provisions refer to vague concepts like principles of fairness.¹⁷⁰ This vagueness is replicated in several laws.¹⁷¹ With these vague concepts of fairness, judges have wide latitude to use their own discretion, which sets the framework for corruption.¹⁷²

Corruption can exist when lower level government officials are unwilling to enforce laws promulgated by the central government.¹⁷³

165. See *id.* (noting the factors that favor general principles of law that can be adapted to the vastly different needs of the various regions).

166. See Ministry of Commerce of the People’s Republic of China: Contract Law, art. 19 (2003) [hereinafter Contract Law] (making an offer irrevocable when the offeree could reasonably rely upon the offer as being irrevocable), http://english.mofcom.gov.cn/article/200301/20030100064766_1.xml (last visited Feb. 11, 2004). The offeree has a “reasonable” amount of time in which to accept a non-oral offer. *Id.* art. 23.

167. See Anti-Unfair Competition Law of the People’s Republic of China, art. 2 (1993) (“Business operator[s] . . . shall follow the principles of voluntariness, equality, fairness, honesty and credibility and observe the generally recognized business ethics.”), available at <http://en.chinacourt.org/public/detail.php?id=3306> (last visited Feb. 10, 2004).

168. See Hitchingham, *supra* note 100, at 4 (arguing that one of the predominant problems with the Uniform Contract law is that the law adopted many undefined foreign legal standards).

169. See PEERENBOOM, *supra* note 55, at 251 (explaining how the vastly different regions of China have dramatically different needs).

170. See Ministry of Commerce of the People’s Republic of China: Contract Law, arts. 5-7 (referring to principles of fairness, good faith, and public interest).

171. See Sino-Foreign Equity Joint Venture Law, July 1, 1979, art. 1 (mandating that equity JVs be based on “principles of equality and mutual benefit”), <http://www.qis.net/chinalaw/prclaw11.htm> (last visited Feb. 15, 2004).

172. See GAMBLE, *supra* note 46, at 16 (suggesting that the concept of fairness can be interpreted in a manner that suits the judge’s individual agenda).

173. See XIANFA, *supra* note 64, art. 100 (“The people’s congresses of provinces and municipalities directly under the Central Government and their standing

Because government officials have substantial power to influence economic transactions, they also have the power to exact “tea money,” or bribes.¹⁷⁴ Even when the laws condemn monetary bribes, those involved in the practice of gift giving often condone the activity as *guanxi*, a Chinese term which can be loosely translated as “personal relationships.”¹⁷⁵ This makes the corruption even more difficult to weed out.¹⁷⁶ Even though there are several reasons for the prevalence of corruption, the solutions for the problem are difficult to find.¹⁷⁷

The most frequently cited reason for corruption lies in the nexus between the government and the Communist Party.¹⁷⁸ While Article 5 of the Constitution states that no one is above the law, in practice,

committees may adopt local regulations, which must not contravene the Constitution and the [national] law”).

174. See STANLEY B. LUBMAN, *BIRD IN A CAGE: LEGAL REFORM IN CHINA AFTER MAO* 120 (1999) (stating that some of the powers that government officials have include granting licenses, providing access to utilities, allowing tax-breaks, and granting loans); see also Gregory C. Ott, *China's Accession into the WTO: The Practice of International Bribery and the Issues It Presents for American Counsel Whose Clients Are Doing Business Within the Confines of the Great Wall*, 15 TEMP. INT'L & COMP. L.J. 147, 151 (2001) (attributing widespread bribery and corruption to China's historical aversion to a rule of law, and the general reliance on personal relationships to do business).

175. See Kate Hutchings & Georgina Murray, *Family, Face, and Favours: Do Australians Adjust to Accepted Business Conventions in China?*, 25 SING. MGMT. REV. (2003) (noting that laws now exist that specifically prohibit corruption but that corruption can still exist outside the constraints of these laws), 2003 WL 15844431.

176. See *id.* at 29 (stating that the distinction between legal and illegal gifts are based on arbitrary cultural standards that make enforcement of anti-corruption laws difficult).

177. See WANG, *supra* note 56, at 30 n.107 (citing reasons for the prevalence of corruption, including: the low pay that government employees receive as compared to private employees, poorly drafted laws, nepotism, and the close relationship between the Communist Party and the government).

178. See Peter K. Yu, *The Harmonization Game: What Basketball Can Teach About Intellectual Property and International Trade*, 26 FORDHAM INT'L L.J. 218, 240-41 (2003) (citing the intertwined relationship between the judicial branch and the Communist Party as a reason for courts' ineffectiveness at settling intellectual property disputes).

the will of the Communist Party prevails over the rule of law.¹⁷⁹ High level members within the Party, as well as relatives of these members, enjoy special treatment.¹⁸⁰ The disconnection between central and local government, which has provided local officials with the latitude to normalize the business professional's expectation of paying bribes and kickbacks, has furthered the problem of corruption.¹⁸¹

2. Decentralization of Government

There is growing decentralization of government in China.¹⁸² Poorer provinces often do not have the financial resources to purchase books that state the new laws and regulations.¹⁸³ Even when local governments have access to national laws and regulations, poorly drafted laws have widened the gap between the intent of drafters and implementation of laws.¹⁸⁴ Particularly when the NPC or the legislators fail to issue interpretations of the laws, regional governments are left confused about the intent behind the

179. See WANG, *supra* note 56, at 41 (noting that in spite of Article 5, the fact that China is under one party rule and has been since 1949 means that the will of the Party prevails).

180. See Hutchings & Murray, *supra* note 175, at 34-35 (quoting an interviewee as stating that *gaoganzidi*, the children of high level officials, have distinct political and financial advantages).

181. See *id.* (arguing that while the Chinese government has made significant efforts to end corruption, the central government's ability to fix the kickbacks and favors given on a lower level are questionable).

182. See Feinerman, *supra* note 77 (outlining the structure of the Chinese central government and the reasons for the disconnect between the central government and provinces); see also Li Yahong, *The Law-Making Law: A Solution to the Problems in the Chinese Legislative System?*, 30 HONG KONG L.J. 120, 124 (arguing that decentralization of the government has created local protectionism where provinces discriminate against outsiders). One example of this protectionism is the "Battle of the Cars." *Id.* In June 1999, the Shanghai government imposed a license plate fee for cars that were purchased from anyone other than Shang Ta Na, a Shanghainese/German joint venture. *Id.* at 140 n.22. The Hubei government retaliated by issuing a similar regulation that imposed a large fee on those who purchased a Shang Ta Nas car in the Hubei province. *Id.*

183. See FENG, *supra* note 71, at 28 (mentioning that courts in poorer areas cannot afford collections of updated laws).

184. See PEERENBOOM, *supra* note 55, at 251 (concluding that vagueness in legislation undermines the predictability of laws).

legislation.¹⁸⁵ The government has put little effort into eliminating this problem, and has characterized the contradictions as “natural phenomena.”¹⁸⁶ The government has downplayed the conflicts between local and national government as inconsequential because the Legislation Law states that the national law is the controlling law.¹⁸⁷ However, when resolving conflict of law issues, judges themselves are sometimes unsure of whether to apply national or local regulations.¹⁸⁸

Local government is also often unwilling to enforce laws promulgated by the central government because of local

185. See *id.* at 257 (using the 1997 State Council bankruptcy notice to demonstrate that lower level regulations can be developed that are inconsistent with national legislation). This legislation removes rights from creditors that are guaranteed under superior legislation. *Id.*; see also Yahong, *supra* note 182, at 123-24 (2000) (discussing how there have been reports where the NPC’s jurisdiction has been usurped by the Standing Committee of the National People’s Congress of China (NPCSC), or where the NPC and the NPCSC have been usurped by the State Council and local legislatures).

186. See Corne, *supra* note 156, at 412 (quoting Chinese administrative law scholars Ying Songnian and Dong Hao’s argument that as long as there is no contradiction between laws, regulations, and the constitution, differences in the local and national laws are “normal phenomena”). Legal scholars have argued that these contradictions are acceptable as long they conform to the “spirit” of the law. *Id.* This argument is problematic because reliance upon the “spirit” of the law constitutes reliance upon an ambiguous concept that can be easily shaped by party leaders. See PEERENBOOM, *supra* note 55, at 65 (defining principles of the “rule of law” as encompassing clear, accessible, consistent, and enforced laws). Reliance upon the “spirit” of the law, rather on the “letter” of the law, strongly suggests that in practice, China may be operating a political system closer to the “rule of man” rather than the “rule of law.” *Id.* at 56. While the “rule of man” proponents advocate that law is insufficient to govern and must be supplemented by party leadership, “rule of law” proponents argue that the laws provide stability and properly subject party members to the constraints of the law. *Id.*

187. See The Legislation Law of the People’s Republic of China, art. 64 (2000) (“Where a national law or administrative regulation enacted by the state has come into force, any provision in the local decree which contravenes it shall be invalid.”), http://www.novexc.com/legislat_law_00.html (last visited Feb. 12, 2004).

188. See Corne, *supra* note 156, at 418-19 (citing statistics indicating that when faced with a conflict between local and national legislation, 64.5% of judges would use central law and disregard local law, while 27.9% said they would seek the help of higher state institutions, and 5.4% said they would apply local laws over national laws).

protectionism.¹⁸⁹ Structurally, local legislation usually includes only a general statement noting that its formation is in accordance with relevant laws.¹⁹⁰ The generality of this statement provides wide latitude through which local governments can provide benefits for favored local businesses.¹⁹¹ Often, favoritism shown to local businesses is shrouded under the concept of *guanxi*.¹⁹² Because local legislatures allocate judicial resources, the judiciary has a strong interest in maintaining positive relationships with local businesses and officials.¹⁹³

The disconnect between national legislation and regional implementation of the legislation has been the main source of China's inability to fulfill international treaty obligations.¹⁹⁴ China often does not enforce provisions agreed to in these treaties at the regional level because local officials can gain financially from the furtherance of illegal activity.¹⁹⁵ However, particularly in the area of

189. See Feinerman, *supra* note 77 (determining that the national government has been unable to live up to promises to foreign corporations because of local government inaction).

190. See Corne, *supra* note 156, at 390 (contrasting this general statement with the specificity with which national regulations cite the enacting laws and regulations that they are based upon).

191. See *id.* (suggesting, once again, that vagueness in law provides room for corruption).

192. See Hutchings & Murray, *supra* note 175, at 27 (noting that China's business culture is often cited as being rooted in strong family and cultural ties, or *guanxi*).

193. See Margaret Y. K. Woo, *Law and Discretion in Contemporary Chinese Courts* in THE LIMITS OF THE RULE OF LAW IN CHINA 163, 170 (Karen G. Turner et al. eds., 2000) (arguing that self interest forces judges to issue rulings that are favorable to local residents, or to ignore rulings by other courts that are unfavorable to local residents).

194. See generally Clarke, *supra* note 159, at 97-98 (arguing that reforms agreed to in international treaties may not get enacted because the Chinese central government has difficulty enacting change). The author notes, however, that this change is unlikely to be effectuated by international pressures, but will likely be developed through China's internal legal developments. *Id.*

195. See, e.g., GAMBLE, *supra* note 46, at 204 (describing the creative ways in which local governments have shifted funds to avoid paying taxes, thereby keeping a larger portion of tax money for themselves). Often, illegal copyright and trademark activity can be quite profitable, and when these industries pay taxes, local officials have much to gain in turning a blind eye. See Connie Ling, *Everybody Does It: Protests and Crackdowns Haven't Diminished Asian*

intellectual property, the future state of enforcement is promising as Chinese courts have, in some cases, prioritized applying international treaties.¹⁹⁶ While this suggests greater protection for franchisers, it does not promise to solve the problem, as China is generally a civil law system and judicial decisions are not normally precedent setting.¹⁹⁷

3. Promising Signs for a Stronger Framework of Laws and Legal Enforcement

Despite problems with the rule of law, the government has enacted several pieces of legislation that have, at least, set the framework for reform in China.¹⁹⁸ Recent development and adoption of the Administrative Litigation Law provides citizens with the ability to sue government officials who violate laws.¹⁹⁹ The Administrative

Consumers' Appetite for Pirated VCDs, ASIAN WALL ST. J., Mar. 29, 1999, at S3 (describing the pervasive nature of video compact disk piracy in Asia).

196. See IMPLEMENTATION OF LAW IN THE PEOPLE'S REPUBLIC OF CHINA 205 (Jianfu Chen et al. eds., 2002) (citing cases in which courts applied principles that were stated in international treaties). In *Twentieth Century Fox Film Corporation v. Beijing Art and Literature Publishing House Recording and Videotape Great World*, the First Intermediate People's Court of Beijing determined that unauthorized film copies sold with the permission of the Ministry of Culture were still illegal because China was a signatory to the Memorandum of Understanding for the Protection of Intellectual Property Rights and was a member of the Berne Convention for the Protection to Literary and Artistic Works. *Id.*

197. See Wang Guiguo, *The Legal System of China*, in CHINESE LAW, *supra* note 75, at 1, 19 (stating that under the civil law system, the court has the power to implement and not to actually interpret laws). This inability to actually interpret laws has prevented case decisions from experienced judges to serve as guides for lower court judges, and has prevented uniform application of the laws. See WANG, *supra* note 56, at 45 (stating that the lack of stare decisis in the Chinese legal system means that no system exists to ensure uniformity in legal interpretation and application). *But see* Lin, *supra* note 62, at 225-26 (describing how in the city of Zhengzhou, the District Court has developed a precedent system that allows holdings to be established as precedent). In creating this system, Presiding Judge Li Guanghu argued that this would help to minimize the problems with the civil law system, while still following the currently existing laws. *Id.*

198. See *supra* notes 79-80 and accompanying text (discussing some of the changes in Chinese laws that respond to problems with corruption and enforcement of laws).

199. See Administrative Procedure Law of the People's Republic of China, Apr. 4, 1989, art. 2 ("If a citizen, a legal person or any other organization considers that his or its lawful rights and interests have been infringed upon by a specific

Licensing Law similarly improves government accountability by taking the right to grant franchises and licenses away from the ministries and commissions and giving this power to industrial associations and other intermediate agencies.²⁰⁰ This law limits the restrictions on obtaining franchising rights.²⁰¹

One promising sign of improvement in the judiciary is the “Judges Law,” which was passed to lessen the grip that the government has on judges, and to make the judiciary more independent.²⁰² Under this law, administrative organs or other individuals cannot interfere with the judiciary, and cannot remove judges unless there is a statutory basis.²⁰³ While this is a positive change in that it allows judges to act outside the approval of the Party, the effect of this law is limited

administrative act of an administrative organ or its personnel, he or it shall have the right to bring a suit before a people’s court in accordance with this Law.”), http://www.law-lib.com/law/law_view.asp?id=5641 (last visited Feb. 15, 2004); see also Susan Finder, *Like Throwing an Egg Against a Stone? Administrative Litigation in the People’s Republic of China*, 3 J. CHINESE L. 1, 7-8 (1989) (describing how economic reforms and the increasing number of foreign investors have created a larger base of people with financial interests in challenging administrative body decisions). *But see Officials Forced to Appear in Court*, CHINA DAILY, July 19, 2003 (noting that officials and heads of administrative bodies who are sued rarely appear in court), http://www1.chinadaily.com.cn/en/doc/2003-07/19/content_246390.htm (last visited Feb. 1, 2004). Only 0.1% of administrative directors ever appeared in court, allowing lower officials to avoid legal scrutiny and accountability. *Id.*

200. See *Lawmakers to Discuss Crucial Law*, CHINA DAILY, Aug. 16, 2003 (detailing how there are many levels of administrative licensing that prevent a more open market economy because this over-licensing creates inefficiency and inequity in how licenses are granted), http://www1.chinadaily.com.cn/en/doc/2003-08/16/content_255391.htm (last visited Feb. 15, 2004). Currently, there are about 4,100 items that require administrative licenses. *Id.*

201. See *id.* (stating that enterprises seeking licenses to start up businesses will likely need to go to fewer government agencies for approval because, in 2001, the government eliminated approximately 1,200 government licenses).

202. See *China Adopts Amendments to Laws on Judges, Prosecutors*, PEOPLE’S DAILY, July 1, 2001 (quoting Li Peng, chairman of the NPC Standing Committee, as stating that the revisions would help in “strengthening the caliber of the country’s judiciary and ensuring that justice be served”), http://fpeng.peopledaily.com.cn/200107/01/eng20010701_73890.html (last visited Feb. 15, 2004).

203. See *Judges Law of the People’s Republic of China*, art. 8 (1995) (stating that judges cannot be removed, demoted or sanctioned unless statutory procedures are followed), available at <http://www.accci.com.au/judges-law.htm> (last visited Feb. 25, 2004).

because courts are expressly prohibited from determining the validity of legislation.²⁰⁴ Also, the law is problematic in that it provides the appearance of legitimacy, even though judges will likely continue to act according to Party wishes because they generally are loyal members of the Communist Party.²⁰⁵ Corruption in the past few years has recently received greater attention.²⁰⁶ Investigations into the corrupt practices of high level government officials have lent credibility to China's evolution into a "rule of law" system.²⁰⁷

Ambiguity in the law translates into higher costs and less efficiency because businesses must spend time and money to determine the proper governing regulations.²⁰⁸ Besides the government's lack of efficiency, the disconnect between the central government and local government can place businesses in the difficult position of choosing which laws govern their particular business practice.²⁰⁹ Similarly, the corruption that festers in this disconnect forces businesses to choose between conforming with, or

204. See *supra* note 70 and accompanying text (discussing limitations on the implications of court decisions).

205. See LUBMAN, *supra* note 174, at 256 (determining that local party organizations have final say over all judicial appointments).

206. See Hutchings & Murray, *supra* note 175, at 29 (noting that the use of bribery, at least in theory, has been condemned through the development of anti-corruption laws).

207. See *China Fires Official Amid Corruption Reports*, THE ASIAN WALL ST. J., Oct. 29, 2003 (stating that the Land and Resources Minister was fired and under investigation), 2003 WL-WSJA 65016557. This investigation is the highest level government official investigation since 2001, when a deputy chairman was executed for accepting bribes. *Id.*

208. See Feinerman, *supra* note 77 (mentioning that the uneven application of laws on a local level has left foreign investors confused).

209. See *supra* notes 184-199 and accompanying text (analyzing how the plethora of vague laws can result in inconsistent local implementation, which puts businesses in the difficult position of determining which laws they need to follow).

refusing to succumb to, corruption.²¹⁰ This choice can ultimately mean the choice between business success or failure in China.²¹¹

Another source of concern is a business' lack of awareness of corrupt practices.²¹² When Chinese businesses introduce fees to foreign businesses as standard costs, lack of awareness of regional business practices will likely result in ignorance of what constitutes reasonable fees.²¹³ Similarly, even for those businesses that are well-versed in business laws, the regulations and procedures can change dramatically based on the region.²¹⁴ Because national and regional regulations undergo dramatic changes quite frequently, businesses may not be aware of the changing standards for what constitutes bribery and kickbacks.²¹⁵ Also, businesses may not be well-versed in local business culture.²¹⁶ While local businesses frown upon bribes, gifts may or may not be acceptable.²¹⁷ While foreign investors might

210. See Hutchings & Murray, *supra* note 175, at 33 (listing results of a survey about business practices in China). One respondent said that there was a difficult quandary, because it was important to follow the ethical practices appropriate for an international company, but failing to adopt the cultural practice of favor granting would likely result in business failure in China. *Id.*

211. See *id.* (quoting a manager of a large multi-national corporation who said that by not engaging in corruption, his company lost large amounts of business).

212. See generally Anti-Unfair Competition Law of the People's Republic of China (1993) (failing to include good faith or lack of awareness as a defense to charges of unfair business practices), available at <http://en.chinacourt.org/public/detail.php?id=3306> (last visited Feb. 10, 2004).

213. See Hutchings & Murray, *supra* note 175, 41 (noting that in Chinese business, favors, or *renqing*, are important, but that there is a fine line between these favors and illegal bribery).

214. See Carolita L. Oliveros, *International Distribution Issues: Contract Materials*, 2003 A.L.I.-A.B.A. CONTINUING LEGAL EDUC. 675, 737 (warning attorneys that Chinese government policies are "mercurial" and "subject to change without notice").

215. See Yuan, *supra* note 131, at 483 (citing reasons why businesses may be unaware of changing regulations and laws).

216. See CHOW, *supra* note 17, at 49 (stating that the foreign investor is often at a disadvantage because of difficulties with obtaining information about government structures and transaction procedures).

217. See *id.* (noting that in the past investors have accepted unfavorable conditions and circumstances, which has led many Chinese business operators to expect special treatment from foreign investors).

have the best of intentions, the Anti-Unfair Competition Law does not make allowances for those who unintentionally break the law.²¹⁸

The potential for fully developing a “rule of law” system in China is promising.²¹⁹ The government has taken affirmative steps to address the above problems.²²⁰ One key example of this occurred when the Chinese government noted that much of the corruption was rooted in licensing laws and responded by passing the Administrative Licensing Law.²²¹ Despite the progress towards uniformity and transparency of laws, there are several problems in the laws themselves that can still impede franchising.²²²

C. NAVIGATING THE PROBLEMS INHERENT IN THE LAWS

1. Trademark Protection Falls Short

Vigilant intellectual property protection is vital to the operation and longevity of a franchise.²²³ Trademarks are private property and

218. See generally Anti-Unfair Competition Law of the People's Republic of China (1993) (failing to mention lack of intent to accept or give bribes as obviating possibility of prosecution), available at <http://en.chinacourt.org/public/detail.php?id=3306> (last visited Feb. 10, 2004).

219. See Eric W. Orts, *The Rule of Law in China*, 34 VAND. J. TRANSNAT'L L. 43, 106 (2001) (discussing the progress towards rule of law through more reliable laws that help to create stronger stability in a market economy).

220. See *id.* (arguing that while laws have developed to provide foreign corporations with more security in the development of businesses, the Chinese Communist Party has maintained a strong resistance to political reform).

221. See *Majority of Corruption Cases in China Linked to Licensing: Official*, PEOPLE'S DAILY, Aug. 30, 2003 (quoting Wang Yongquing as stating that the administrative licensing law would help to combat the corruption arising from the lack of restrictions and transparency in operations), http://english.peopledaily.com.cn/200308/30/eng20030830_123408.shtml (last visited Feb. 13, 2004).

222. See S.R. Nair, *Franchising Opportunities in China from the Perspective of a Franchisee*, in INTERNATIONAL FRANCHISING IN EMERGING MARKETS, *supra* note 28, at 109, 116 (arguing that new franchise regulations, and the disconnect between the regulations themselves and the implementation of the regulations, is a significant challenge to investors seeking to franchise in China).

223. See William A. Finkelstein, *Protecting Trademarks and Related Intellectual Property Rights*, in FUNDAMENTALS OF INTERNATIONAL FRANCHISING, *supra* note 26, at 59, 61 (arguing that franchising concepts consist of marks,

are in and of themselves “commoditized products.”²²⁴ Any misuse of a franchise’s trademark can result in the depreciation of the quality of goods or services associated with the franchise, not just within China, but for the franchise chain internationally.²²⁵ While China has revised its trademark regulations to conform to the Trade Related Intellectual Property Protection Agreement (“TRIPS”) and WTO provisions, the Chinese trademark regulations at this point do not provide the same level of enforced protection that franchisors enjoy in the United States or Europe.²²⁶

Despite the fact that the legislative framework is in place to provide trademark protection, Chinese trademark law has fallen short for a few reasons.²²⁷ First, courts often do not protect trademark owners when different product or service lines copy the trademarks.²²⁸ Many small businesses seek to take advantage of the positive image associated with well-known corporations.²²⁹ Under the current law, where these businesses use a registered trademark for a product or service line that is different from the original

symbols, trade dress, and particular ways of doing business). These elements are often the basis for the inherent value of the franchise. *Id.*

224. See FENG, *supra* note 71, at 243 (stating that the value of a commodity lies in the selling power of the product).

225. See Han, *supra* note 32, at 88 (describing how intellectual property protection is probably the most important property that a franchisor owns).

226. See *Trademark Law Amended to Better Protect Famous Brands*, *supra* note 82 (describing the protections created by the Standing Committee of the National People’s Congress with the passage of the amended Trademark Law on October 27, 2001). While previously only words received protection, the new regulations protect visual marks, including symbols and color combinations. *Id.*

227. See Ministry of Commerce of the People’s Republic of China: Trademark Law, art. 1 (1982) [hereinafter Trademark Law] (stating that the intent of the trademark law is to protect consumer expectations and to encourage producers to guarantee the quality of their goods), http://english.mofcom.gov.cn/article/200310/20030100063803_1.xml (last visited Feb. 12, 2003).

228. See CHAOWU JIN & WEI LUO, *COMPETITION LAW IN CHINA* 127 (Chinese Law Series Vol. 6, 2002) (arguing that the goodwill associated with the names and trademarks of large, well-known companies will likely extend to businesses in a completely different line of business).

229. See *id.* (stating that businesses can unfairly benefit when they attach the name of another company to their own product).

trademark's intention, the business has not committed trademark infringement.²³⁰

Second, the trademark law fails to make trademark dilution illegal.²³¹ This could pose a serious problem for franchises, because trademark identity constitutes a large part of franchises.²³² The trademark law fails to enumerate dilution as a type of infringement.²³³ The threat of dilution is strong, as businesses often realize the potential benefits of manipulating the public perception associated with a business' goodwill.²³⁴ When laws and courts fail to prevent this dilution, a franchise can suffer substantial harm to its credibility.²³⁵ Where consumers are unable to associate products with a particular franchise, consumers cannot associate the goodwill and good quality, which is the primary benefit of owning a franchise.²³⁶

230. *See id.* at 126 (defining the concept of "conceptual connection," whereby companies can capitalize on the goodwill associated with trademark or business name in another industry).

231. *See id.* at 123 (noting the trademark law's failure to provide business operators protection from trademark dilution).

232. *See* KAUFMANN, *supra* note 23, at 14 (citing the trademark as an element of the franchise that helps to convey authenticity and exclusivity).

233. *See generally* Ministry of Commerce of the People's Republic of China: Trademark Law, art. 1 (1982) [hereinafter Trademark Law] (failing to provide recourse for trademark dilution cases), http://english.mofcom.gov.cn/article/200310/20030100063803_1.xml (last visited Feb. 12, 2003); *see also* JIN & LUO, *supra* note 228, at 123 (defining dilution as when the business associated with a strong mark is unable to distinguish clearly their goods from competitor's goods).

234. *See* JIN & LUO, *supra* note 228, at 126 (noting that this may constitute an unfair business practice).

235. *See* Han, *supra* note 32, at 88 (discussing the importance of protecting intellectual property in a franchise). In one case in the Sichuan Province, a brewery had properly registered its mark only to find that another brewery in the Guizhou Province was using a name, design, and even coloration of mark that was similar to the Sichuan Brewery's registered mark; *see also* JIN & LUO, *supra* note 228, at 124 (describing the extent of the similarities between the two products). For four years, the Sichuan brewery attempted to stop the Guizhou brewery's production and unauthorized usage of the registered trademark before it finally brought suit in court. *Id.* The duration of the trademark disputes created widespread consumer confusion, to the extent that consumers contacted their local AIC offices for clarification. *Id.*

236. *See* DELI YANG, INTELLECTUAL PROPERTY AND DOING BUSINESS IN CHINA 61 (Pervez N. Ghauri, series ed., 2003) (describing the importance of "intellectual

Also, if products or services use trademarks illegally, and the products or services are deficient, this negative stigma can attach to the trademark itself.²³⁷

Third, penalties issued are often not severe enough to deter future trademark infringers.²³⁸ Penalties imposed by the SAIC's administrative action in the past have often failed to provide adequate relief, and as a result, have not served as a strong deterrent for criminals or corporations seeking to turn a profit.²³⁹ For example, when a Chinese enterprise infringed the Disney trademark by using the Mickey Mouse character, the SAIC fined the company ninety-one dollars.²⁴⁰ When the government-affiliated Shenzhen University Research Institute counterfeited the Microsoft trademark and sold illegal copies of programs, the SAIC fined the infringers \$260.²⁴¹

While the laws themselves now impose harsher penalties, the enforcement of the laws and the ensuing penalties has proven problematic.²⁴² Despite the problems with enforcement, a recent landmark court decision has "give[n] teeth to its claims of rule of

capital," which is the sum of the company's technology, management processes, and overall knowledge that translates into profits).

237. See *id.* at 64 (urging companies to not make the common mistake of underestimating the value of intellectual property as a company's intangible asset).

238. See Lisa Movius, *Imitation Nation*, SALON.COM, Jul. 8, 2003 (quoting the Chinese proverb, "if everyone does wrong, no one will be punished," to describe the lack of intellectual property rights enforcement), at http://archive.salon.com/tech/feature/2002/07/08/imitation_nation/index1.html (last visited Feb. 10, 2004).

239. See *id.* (noting that with the demise of the state owned enterprises, unemployed individuals are more willing to engage in selling illegal trademark infringing products, even if the punishment entails fines).

240. See Linus Chua, *China Steps up Enforcement of Piracy Laws*, L.A. TIMES, Apr. 4, 1994, at D3 (observing that the case award would have been much higher in the United States).

241. See Ruth Youngblood, *China Fights Trademark Abuse*, UPI, Apr. 12, 1994 (noting the lax punishment given for illegal trademark use); see also Harriet King, *Microsoft Nails Some Pirates*, N.Y. TIMES, May 10, 1992, § 3, at 7 (estimating that the software industry alone loses fourteen billion dollars a year to piracy).

242. See King, *supra* note 241 (discussing the difficulty that companies face in attempting to enforce piracy laws in China).

law.”²⁴³ Educational Testing Services, a U.S.-based company that owns the TOEFL, GRE, and GMAT tests and trademarks, accused New Oriental Education Group, a Chinese private language training institute of copyright and trademark infringement and sought \$3.63 million in compensation.²⁴⁴ The Beijing No. 1 Intermediate court ordered the New Oriental Education Group to hand over all illegal test copies, to publish an apology, and to pay \$1.21 million dollars in compensation.²⁴⁵ While this payment was unprecedented, experts estimate that this fine was much less than what New Oriental earned from the infringement.²⁴⁶ It remains to be seen whether this case is indicative of stricter intellectual property controls, or whether it is merely an anomaly.²⁴⁷

Finally, the anti-unfair competition law does not provide solid protection for all franchise trade secrets.²⁴⁸ While the law exists, it does not provide mechanisms for enforcement.²⁴⁹ Even if there were sufficient enforcement mechanisms, business information that does

243. See *Copyright Infringement Fine Sparks Debate*, CHINA DAILY, Oct. 2, 2003 (describing the events of the Educational Testing Service case), <http://www.china.org.cn/english/2003/Oct/76561.htm> (last visited Feb. 10, 2003).

244. See *Court Rules against English Language School in Copyright Lawsuit*, CHINA COURT, Sept. 28, 2003 (discussing the details of the case), <http://en.chinacourt.org/public/detail.php?id=3350> (last visited Feb. 10, 2003).

245. See *id.* (noting the punishment imposed in this case).

246. See *Copyright Infringement Fine Sparks Debate*, *supra* note 243 (arguing that that this fine was not high at all because the company earned much more from the infringement than it was ordered to pay).

247. See *Chinese Firm to Appeal Verdict in Copyright Case Won by U.S. Education Groups*, AGENCE FRANCE PRESSE, Sept. 29, 2003 (stating that the court's award was unusual because foreign entities rarely win copyright infringement cases and when they do, they are only awarded nominal compensation), 2003 WL 71371165.

248. See *Anti-Unfair Competition Law of the People's Republic of China*, art. 10 (1993) (protecting business operators by prohibiting third parties from “obtaining, using or disclosing” secrets that the party knows or should know constitutes an illegal act), available at <http://en.chinacourt.org/public/detail.php?id=3306> (last visited Feb. 10, 2004).

249. See Kang Rui & Feng Xiaoju, *A Challenge to Emerging Economies: New Competition Patterns Required in the Telecommunications Industry – The Case of China After Its Entry into the WTO*, 36 INT'L LAW. 1173, 1179 (2002) (stating that enforcement is assigned to authorities above the country level, but that there are no entities that “monitor, interpret or enforce the provisions of the law”).

not fall inside the definition of a trade secret may not obtain protection.²⁵⁰ Accordingly, trade secret information should further be protected through contractual agreement with all those who come into contact with information associated with the franchise's business structure, methods of operation, and any secrets involved in products and services.²⁵¹ The Contract Law also proves helpful in the protection of trade secrets because it mandates that when another party learns trade secrets in the course of developing a contract, even if the contract does not ultimately come to fruition, the party learning the secret is to keep the information secret.²⁵² This law helps to protect franchisors who have divulged information to a franchisee expected to sign a contract, but the contract then fails to form or becomes void.²⁵³ Besides creating these additional layers of protection, contracts can also help to satisfy the requirement that the trade secret owner take affirmative steps to prevent the public from knowing about the secret.²⁵⁴

D. EFFECTIVENESS OF CONTRACTS IN CIRCUMVENTING PROBLEMS IN THE LEGAL SYSTEM AND THE LAWS THEMSELVES

The developments in contract law signal the Chinese government's willingness to develop greater freedom in

250. See JIN & LUO, *supra* note 228, at 132 (questioning the vagaries involved in determining whether business information constitutes a trade secret).

251. See Finkelstein, *supra* note 223, at 93 (recommending that franchisors create contractual remedies for trade secret breaches because trade secrets are extremely difficult to protect).

252. See Ministry of Commerce of the People's Republic of China: Contract Law, art. 43 (2003) (stating that when other parties disclose trade secrets that they have learned in the course of formulating a contract, they shall be liable for the losses that result from the disclosure), http://english.mofcom.gov.cn/article/200301/20030100064766_1.xml (last visited Feb. 11, 2004).

253. See Peter J. Klarfeld, *Introduction*, in COVENANTS AGAINST COMPETITION IN FRANCHISE AGREEMENTS xi (Peter J. Klarfeld ed., 1992) (noting that one of the most significant characteristics of a franchise is the transfer of confidential business information that could make the other person a more effective competitor).

254. See JIN & LUO, *supra* note 228, at 137 (translating a SAIC provision stating that confidentiality agreements and rules can help a trade secret holder to show that steps were taken to keep the information confidential).

contracting.²⁵⁵ The Uniform Contract Law states that parties “enjoy the legal right to voluntarily conclude contracts, and no work unit or individual may illegally intervene” in the contractual relationship.²⁵⁶ Permitting Chinese individuals and foreign persons to be able to contract together is a significant step in developing a market-driven economy.²⁵⁷ Relaxation of regulations over who can contract and the regulations governing contracts should improve the economy by allowing more contractual relationships to develop.²⁵⁸

Well-drafted contracts can provide a significant layer of protection for franchises against China’s weak legal structure.²⁵⁹ To create strong contracts, foreign investors must anticipate and draft protections against even those scenarios that seem unlikely.²⁶⁰ Weak drafting can be the basis for substantial financial and legal burdens.²⁶¹

255. See Chen, *supra* note 100, at 154 (stating that China has changed its legal system and adopted Western legal concepts to meet the WTO requirements).

256. See Ministry of Commerce of the People’s Republic of China: Contract Law, art. 60 (discussing the scope of legal rights that contracting parties have, including mutual duties of “notification, assistance, and confidentiality”).

257. See Chen, *supra* note 100, at 170 (discussing how the limitations on who could form contracts was a violation of the Chinese constitution).

258. See Hitchingham, *supra* note 100, at 3-4 (determining that the relaxation of regulations will be beneficial to the economy because under the Uniform Contract Law, contracts can still be valid even if there are missing or disputed terms).

259. See Ministry of Commerce of the People’s Republic of China: Contract Law, art. 12 (recommending that contracts include names of parties and residence, subject matter of contract, quantity, quality, price, time limit, place and method of contract performance, liabilities involved for breach of contract, and methods of dispute settlement).

260. See GAMBLE, *supra* note 46, at 15-16 (stating that while the purpose of a contract law is to help prevent opportunistic behavior, two specific problems with the law limit the effectiveness of the law in protecting parties). Gamble argues that the contract law itself is too ambiguous and the fact that the law allows for state supervision can be problematic where foreign investors are involved in business dealings with state run enterprises. *Id.* at 16.

261. See *id.* at 5-6 (discussing an example of General Motors’ (“GM”) problems when its contract failed to protect it from joint venture problems). In 2000, GM re-entered the Chinese market after an unsuccessful first attempt through a joint venture with FAW Jinbei Automotive in an equal partnership. *Id.* Problems arose when the parent company of FAW transferred forty-six percent of ownership shares to the local Shenyang government and this local government in turn sold shares in the joint venture to China Brilliance. *Id.* While GM started off with one

Another key component of effective drafting is overcoming the language barrier.²⁶² Translations often do not fully capture the minutiae involved in languages.²⁶³ Foreign enterprises must be prepared to hire counsel to draft a contract in English, but also to hire counsel well-versed in Chinese contract law to draft a Chinese version.²⁶⁴ Particularly for those contracts involving protection of intellectual property and trade secrets, there must be well-drafted Chinese contracts.²⁶⁵ While translations are important to provide understanding for other parties involved in the contract, they are absolutely critical to provide clear direction to the courts in the event that dispute resolution becomes necessary.²⁶⁶

partner, it ended up with three partners, with the original company FAW holding 28.59%, the Shenyang government with 4.6%, and Brilliance with 33.12%. *Id.* However, because China's contract law mandates that parties must still perform their duties even when there is a change in the legal representatives or persons in charge, GM was forced to honor the original agreement. *Id.*; see also *GM Faces Challenging Road Ahead with New China JV*, DOW JONES INT'L NEWS, Dec. 19, 2000 (mentioning a previous failed JV in Shenyang and the re-entrance into the market). Because FAW was a subsidiary of a state-owned enterprise, the joint venture was ultimately a relationship with the Chinese government, which the company believed was favorable for relationship building. *Id.*; see also David Blumenthal, "Reform" or "Opening"? Reform of China's State-Owned Enterprises and WTO Accession—the Dilemma of Applying GATT to Marketizing Economies, 16 UCLA PAC. BASIN L.J. 198, 201 (1998) (noting that state-owned enterprises have enjoyed preferential treatment).

262. See R. Randle Edwards, *Legal Training for China Ventures*, in LEGAL ASPECTS OF DOING BUSINESS IN CHINA 1985 295, 298 (Com. L. & Prac., Course Handbook Series No. 349, 1985) (suggesting that joint legal training efforts between the United States and China are the best way to ensure that the negotiations and contract developments reflect a meeting of the minds).

263. See *id.* at 297 (stating that there is always a substantial risk for misunderstanding due to legal and cultural differences, and that companies should retain local foreign counsel to reduce that risk).

264. See Jonathan Reuvid, *Identification and Selection of Partners*, in DOING BUSINESS WITH CHINA 213, 223 (Jonathan Reuvid & Li Yong eds., 2d ed. 1998) (noting that documents submitted to the approval authorities must be written in Chinese, but that documents can be drafted simultaneously in a language to which the parties agree).

265. See *supra* text accompanying note 258-261 (examining the reasons that contractual agreements to protect trade secrets are important).

266. See Peter K. Yu, *From Pirates to Partners: Protecting Intellectual Property in China in the Twenty-First Century*, 50 AM. U. L. REV. 131, 214 (2000) (stating that many Chinese judges lack experience, expertise, and formal

While investment of capital in a joint venture is a form of ownership one cannot transfer freely and only through approval by government authorities, when foreign investors contract with government authorities in a JV, the conditions of a business enterprise can change dramatically.²⁶⁷ Failing to consider this scenario in any partnership based contractual agreement can set the stage for a confusing business relationship that is detrimental to a company's long-term business strategy.²⁶⁸ Specifically, franchisors should be wary of the glaring problem with the Uniform Contract Law which gives Chinese government officials the right to supervise contracts.²⁶⁹ Reservation of power over contracts allows China to influence the outcome of contracts in which it has an interest.²⁷⁰ This may prevent the non-governmental party in a contract from being able to resolve a dispute in a neutral forum.²⁷¹

III. RECOMMENDATIONS

A. RESEARCH LOCAL CULTURAL AND BUSINESS PRACTICES, AND ADJUST THE FRANCHISE ACCORDING TO REGIONAL PREFERENCES

Franchise success in China has often hinged upon adapting business models to suit Chinese consumers and establishing

education, which can hinder their ability to interpret the many laws and regulations that might govern).

267. See CHOW, *supra* note 17, at 54 (explaining that the laws and regulations involve a variety of government entities that range from the State Development Planning Commission at the central government level, which examines and approves project proposals and feasibility studies, to local provincial or municipal planning authorities). A JV entity only exists once all the proper governmental approvals and licenses have been obtained. *Id.* at 55.

268. See Hitchingham, *supra* note 100, at 14-16 (discussing some of the possible problems that arise when a change of partner scenario is not considered in the contract).

269. See *id.* at 23-24 (stating that the state can create contractual procedures that are beneficial to government agencies, and that under the Uniform Contract Law, they have the discretion to interpret and replace terms in a contract).

270. See *id.* (discussing the implications of the government reservation of power in the Contract Law).

271. See *id.* at 24 (stating that the wide discretion held by courts, and the power of administrative review can prevent parties from having their disputes fairly resolved).

successful stores to attract qualified franchisees.²⁷² While there has been much analysis about the concept of *guanxi*, personal relationship building in China is as important as relationship building in other countries.²⁷³ Similarly, businesses that fail to consider the regional differences that distinguish the provinces of China are also likely to fail.²⁷⁴

From the management perspective, businesses should carefully research regional businesses practices.²⁷⁵ Lack of awareness of local norms and customs can alienate employees, potential franchisees, and government officials.²⁷⁶ Franchises that take the time to develop their businesses with their target clients and employees in mind will have a stronger chance of business success in China.²⁷⁷

272. See *supra* notes 122-126 and accompanying text (positing that the shortage of management puts franchisors in the position of having to compete for qualified franchisee applicants); see also English & Xau, *supra* note 28, at 46-47 (noting the success of franchisors who modify products for their target markets).

273. See CHOW, *supra* note 17, at 48 (suggesting that the importance of *guanxi* in China has been exaggerated).

274. See *supra* notes 166-199 and accompanying text (suggesting reasons for the differences in law, and the disparity in enforcement between the regions of China).

275. See CHOW, *supra* note 17, at 48 (advising foreign investors to find knowledgeable local assistants or spend time thoroughly researching the proposed transaction, the business matter, the background of possible partners, and the applicable political and legal systems).

276. See Gordon Chen, *Relationships Build Success in China*, AUSTL. FIN. REV. 53 (Aug. 15, 2003) (advising companies to take time to learn about China's "cultural nuances"), 2003 WL 61012419. Some of the differences Chen highlights include: where people say "yes" in China, they do not necessarily mean to agree, but simply to demonstrate that they have heard the words; that there is a different conception of payment, as payment for goods can extend over months; and that the Chinese place a great emphasis on an individual's "good name". *Id.*

277. See English & Xau, *supra* note 28, at 50 (describing how McDonald's has worked hard to adapt its "food culture" to China and has become one of the most prestigious places to work).

B. FRANCHISING DIRECTLY, PRIOR TO TESTING THE VIABILITY OF THE FRANCHISE IN CHINA, COULD PROVE DETRIMENTAL TO THE FRANCHISE INTERNATIONALLY

Businesses unwilling to modify their products and services to suit the palates of Chinese consumers are unlikely to be successful.²⁷⁸ Opening up company-owned stores to conduct research provides the best means of figuring out which products appeal the most to the region.²⁷⁹ Initially, rapid area development for franchising can lead to problems with protecting intellectual property.²⁸⁰ Coupled with the lack of qualified management applicants for franchising structures, area development can lead to poor management and an overall depreciation of franchise quality.²⁸¹ Opening up a successful company-owned store will allow businesses to test the market for the product or service, and experiment with developing successful management structures.²⁸²

278. See *id.* at 47 (noting that McDonald's has successfully adapted its menu to suit local tastes in sixty-six countries); see also Ramoncito dela Cruz, *Taco Bell Goes to China, But No Fast-Food Style*, DOW JONES INT'L NEWS, Apr. 15, 2003 (stating that one of the reasons that KFC has been so successful is that it incorporates local food tastes, like a Peking Duck burrito):

279. See English & Xau, *supra* note 28, at 47 (describing how McDonald's, in realizing that there was a shortage of management talent, opened a "Hamburger University" to train employees).

280. See *supra* text accompanying notes 95-97, 155 (noting that when trade secrets are divulged in a JV, the franchisor loses the ability to fully prevent the "secret" and management structures from being used in competitive businesses).

281. See Daniel C.K. Chow, *Reorganization and Conversion of a Joint Venture into a Wholly Foreign-Owned Enterprise in the People's Republic of China*, 73 TUL. L. REV. 619, 627 (1998) (stating that the old inefficient state-driven economy has prevented individuals with managerial experience from developing the technological, financial, and management skills that are necessary to compete in the new economy).

282. See *supra* notes 125-126 and accompanying text (describing the positive experience of international franchisors who opened up company-owned stores in China prior to franchising).

C. WHEN FINANCIAL RESOURCES ARE ADEQUATE, FRANCHISORS SHOULD SEEK TO MAKE THEIR FIRST STORE AND THE FRANCHISE CHAIN A WFOE BECAUSE OF STRONGER LEGAL PROTECTIONS

Franchisors with available resources should open their first stores and the ensuing franchise system in China as a WFOE.²⁸³ China has made it more difficult to gain permission for WFOEs than for JVs because the government cannot supervise WFOE operations.²⁸⁴ While the approval process is difficult, the benefits far outweigh the time and costs of obtaining approval, and thus it is not uncommon for China to grant approval.²⁸⁵

During initial forays into the Chinese market, foreign investors traditionally relied upon the joint venture model because there was a belief that a Chinese partner would be well-connected and have the requisite *guanxi* for business success.²⁸⁶ With a well-connected Chinese partner, the foreign investor hoped to avoid navigating an undeveloped legal system and political channels.²⁸⁷ However, because the government now places an emphasis on developing a “rule of law,” the role that personal relationships play in business development in terms of obtaining the necessary permits and licenses will likely lessen.²⁸⁸ Similarly, greater transparency in the laws, as

283. See *supra* text accompanying note 133 (discussing the advantages associated with the WFOE, particularly the ability to maintain tight control over intellectual property).

284. See WANG, *supra* note 56, at 132 (stating that foreign investors must receive preliminary approval from the local government, and then receive formal approval from Ministry of Foreign Trade and Economic Co-operation). After approval, the foreign enterprise must register and obtain a business license. *Id.* at 134.

285. See *id.* at 131 (citing a Xinhua News Agency statistic that in 1997, forty-five percent of the newly approved foreign investment companies were WFOEs).

286. See PEERENBOOM, *supra* note 55; at 476 (stating that businessmen in China used to believe that success was contingent upon a well-connected Chinese business partner).

287. See *id.* (detailing how foreign investors relied heavily upon their Chinese partners to have social and political clout).

288. See *id.* at 476-77 (determining that one of the reasons that corporations have been so vocal in calling for rule of law is because it provides security for business owners who are concerned about how to structure their businesses). Without transparency of laws, there is much room for corruption and inconsistent administration of rules. *Id.*

required by WTO accession, can provide a clearer understanding of procedures that foreign franchisors need to follow when establishing their first stores.²⁸⁹ Strong evidence exists to demonstrate both the government's commitment to developing a rule of law and growing support from the general population for this rule of law.²⁹⁰

D. INTELLECTUAL PROPERTY SHOULD BE RECOGNIZED AS ONE OF
A FRANCHISE'S MOST VALUED ASSETS, AND STEPS MUST BE
TAKEN TO ENSURE PROTECTION

Wholly owned enterprises have a distinct advantage because they allow franchisors to have more control over the trademark identity of the franchise.²⁹¹ Full ownership of the enterprise allows the franchise to shape and develop the trademark, the advertising, and the products associated with the mark.²⁹² Franchisors may also circumvent the problem in the trademark laws that only protect the mark in the

289. See Peter H. Koehn, *The Shanghai Outlook on the WTO: Local Bureaucrats and Accession-Related Reforms*, 75 PAC. AFF. 399, 408-09 (2002) (quoting the Minister of Foreign Trade and Economic Cooperation Shi Guangsheng as stating that China will "reinforce its legal system and establish a more unified, standardized and transparent system of foreign trade and economic relations" that will "protect the legitimate rights and interests of foreign investors"), available at 2002 WL 24263690.

290. See PEERENBOOM, *supra* note 55, at 481-82 (drawing parallels between foreign investment and farming in determining that social connections are not an adequate substitute for the rule of law). While the rural farmers used to rely upon personal relationships at the expense of defined property rights, the resulting illegal taxes and misappropriation of village funds created problems. *Id.* at 483. Villager appeals to higher party officials have proved unsuccessful, and villagers have increasingly turned to the legal system for redress. *Id.* at 483-84.

291. See *supra* text accompanying note 133 (noting the benefits that the WFOE has in intellectual property protection).

292. See Ministry of Commerce of the People's Republic of China: Trademark Law, art. 1 (1982) [hereinafter Trademark Law] (conferring upon trademark registrants the exclusive right to use the mark in the line of goods for which the mark is registered), http://english.mofcom.gov.cn/article/200310/20030100063803_1.xml (last visited Feb. 12, 2003).

product line for which it is registered by attempting to register the mark for several different types of goods and services.²⁹³

With long-term growth in mind, franchisors can similarly set the framework for the future by maintaining direct control over the content of contractual agreements.²⁹⁴ In considering the substantial costs of maintaining joint venture relationships, the decreasing need to rely upon these relationships to enforce the law, and the importance of maintaining strict control over the quality of the franchise itself, the cost-benefit calculation clearly favors the wholly owned foreign enterprise.²⁹⁵

E. DEVOTE RESOURCES TO OVERCOME LANGUAGE BARRIERS

Bad translations can subject a franchise to legal liability and depreciate the value of the franchise image.²⁹⁶ As such, it is critical that franchisors take into consideration all the possible meanings of a word.²⁹⁷ Because the English and Chinese languages are so different, businesses may want to consider a Chinese name to provide consumers with a name that they can easily pronounce.²⁹⁸ When registering for trademark protection, businesses should register both their Chinese and English names, along with any graphical

293. See Finkelstein, *supra* note 223, at 75-76 (noting that while this often involves greater costs and higher legal fees, the protections afforded to the trademark by registering in several categories is worth the cost).

294. See CHOW, *supra* note 17, at 187 (implying that contractual agreements are helpful because reliance upon trademark laws alone may not be effective since more enforcement resources are devoted to prosecuting counterfeiting than trademark infringement).

295. See *supra* text accompanying notes 130-143 (weighing the advantages and disadvantages of WFOEs and JVs and concluding that the WFOE is a better business vehicle for protecting intellectual property).

296. See Finkelstein, *supra* note 223, at 70 (citing a classic example of linguistic misunderstanding: after the Chevrolet Nova automobile was introduced in Latin American countries, the company discovered that Nova was interpreted as "no va," meaning "does not go" in Spanish).

297. See *id.* (discussing the Purdue slogan "[i]t takes a strong man to make a tender chicken," which was translated into Spanish as "[i]t takes an aroused man to make chicken affectionate").

298. See English & Xau, *supra* note 28, at 47 (describing how McDonald's changed the pronunciation of its name to "Maidanglao" because it was easier to pronounce for Chinese consumers).

representations of their logo in either language.²⁹⁹ Often, English products can acquire a "street name" which, if proven unfavorable, can only work to devalue the product and the franchise as a whole.³⁰⁰

Language considerations are also critical in contractual agreements.³⁰¹ Particularly because China's Contract Law borrows so many terms from Western laws which have no history of interpretation in China, clear definitions are critical to establish duties and responsibilities in a contract.³⁰²

F. ACTING UNETHICALLY, EVEN IF THE BEHAVIOR IS
TECHNICALLY LEGAL, MAY PROVIDE EFFECTIVE SHORT TERM
SOLUTIONS, BUT WILL BE DETRIMENTAL TO THE ENTIRE
FRANCHISE IN THE LONG TERM

At this point, corruption is so widespread that enterprises may have no recourse against corrupt government officials.³⁰³ While

299. See Kaplan, *supra* note 130, at 31 (advising businesses to obtain professional counsel when registering their trademarks to ensure that all translations are accurate and have no unintended meanings).

300. See David A. Victor, *Cross-Cultural Awareness*, in THE ABA GUIDE TO INTERNATIONAL BUSINESS NEGOTIATIONS: A COMPARISON OF CROSS-CULTURAL ISSUES AND SUCCESSFUL APPROACHES 15, 16 (James R. Silkenat & Jeffrey M. Aresty eds., 1994) (noting how translations are inexact, and that phrases often have connotations which cannot be understood through literal translations).

301. See *supra* notes 264-268 and accompanying text (stressing the importance of using clearly worded, well-drafted contracts in order to provide courts with clear direction in arbitration or litigation).

302. See *supra* notes 166-174 and accompanying text (discussing how the terminology which serves as the basis for some of China's newer laws does not have a history of interpretation and widens the latitude that judges and arbiters have in interpreting these terms).

303. See Evelyn Iritani, *I Need Help; When a Group of Stanford Business School Grads Got an E-mail from an Alum Imprisoned in Shanghai, They Sprang into Action*, L.A. TIMES, Sept. 11, 2003, at A1 (detailing how a Chinese graduate of the Stanford Business School was arrested by Shanghai officials after refusing to pay tax auditors 500,000 yuan, or \$60,000, to stop a "special tax audit" of his newly formed medical equipment business), 2003 WL 2433716. While Jude Shao continued to meet with tax officials, he continued to refuse to pay off the tax officials. *Id.* After he was arrested in April 1998, his family was told by someone claiming to represent the Shanghai police that they would release him if the family paid 300,000 yuan or about \$36,000. *Id.* The family refused and he was arrested and convicted in Shanghai No. 1 People's Intermediate Court for not paying taxes and creating false invoices. *Id.* Contrary to Chinese judicial law, Shao was not able

WFOEs offer more control over the franchise and are better in the long run, JVs do provide for the possibility that the local partner will be more familiar with local government corruption and can navigate it accordingly.³⁰⁴ While it may be tempting for businesses to circumvent the corruption by acquiescing to the officials' demands for kickbacks, this route is not advisable, as it is illegal and can only harm public perception of the enterprise.³⁰⁵ Even if a course of action seems unethical, rather than illegal, foreign investors should avoid this behavior.³⁰⁶ Besides having ramifications for the franchise internationally, there is the possibility that the broadly worded "good faith" provisions in Chinese law can be applied.³⁰⁷

CONCLUSION

Large franchisors with adequate financial resources would be hard-pressed to find adequate justification for failing to enter the Chinese market.³⁰⁸ While the legal barriers are substantial, waiting to

to see a lawyer until shortly before trial. *Id.*; see also Karby Leggett, *Expert Legal Reviews Gain Prominence in China's Courts*, WALL ST. J., May 29, 2003 (reporting that Jude Shao, a naturalized U.S. citizen, is still imprisoned, even though a panel of six prominent Chinese legal scholars, including a former official of China's Supreme People's Court, determined that his conviction was "absent of sufficient evidence"), http://www.freejudeshao.com/articles/article_WSJ_052903.shtml (last visited Feb. 13, 2004).

304. See *supra* notes 140-143 and accompanying text (citing some of the advantages of having an enterprise with a Chinese partner).

305. See *Localization Trap – Multinationals Hit by Corruption Scandals*, CHINA ONLINE, Mar. 28, 2002 (describing the scandals Unilever faced when counterfeit products almost identical to its own were produced in the market, suggesting that there was internal collaboration with the trademark infringers), 2002 WL 10273519. The company believes that the scandal will prove detrimental to the product's image. *Id.*

306. See Hutchings & Murray, *supra* note 175, 43 (quoting interviewees of multi-national corporations who place a strong emphasis on acting ethically to preserve the international image, even if it means short-term financial losses in China).

307. See *supra* notes 166-174 and accompanying text (discussing vague provisions in Chinese law, which provide administrators with broad powers of interpretation).

308. See *supra* notes 1-9 and accompanying text (describing the favorable conditions, and the receptive consumers that foreign investors have found when entering the Chinese market).

enter the Chinese market will allow competitors who entered the market earlier to gain a strong competitive advantage.³⁰⁹ Establishment of a successful franchise entails development of “goodwill” behind the brand.³¹⁰ Even when franchises are well known internationally, to achieve success in China it is invaluable to develop a loyal consumer base and attract potential franchisees.³¹¹

Franchisors should prepare themselves to enter the Chinese market by developing a strong understanding of the cultural norms and business practices of the regions in which they wish to do business.³¹² This type of understanding can only be gained through the practical experience that comes with developing an initial company-owned store.³¹³ After establishing a franchise, it is critical that franchisors place a premium on protecting the trademark and trade secrets of the franchise through strict contracts with employees and joint owners.³¹⁴

While the Chinese laws and legal structure are only beginning to reflect the “rule of law,” corporations that draft effective contractual agreements and vigilantly police intellectual property will establish a strong start in long term franchise development.³¹⁵ As an old Chinese

309. See Richard McGregor, *KFC Leads China's New Appetite for Fast Food*, FIN. TIMES, Jan. 19, 2003 (describing the success of KFC, the first foreign fast food franchise to open in China), available at 2003 WL 3916874. By the end of this year, KFC will have double the number of stores of its biggest rival in China, McDonald's. *Id.*

310. See *supra* notes 225-227 and accompanying text (providing reasons why trademark protection is important to a franchise).

311. See Phelim Kyne, *McDonald's China Aims to Fix Marketing Errors*, DOW JONES INT'L NEWS, Sept. 25, 2003 (discussing McDonald's focus on branding as a way to expand consumer loyalty to McDonald's stores).

312. See *supra* notes 274-279 and accompanying text (recommending that foreign investors take the time to understand consumer tastes, and to better understand regional business practices).

313. See *supra* notes 122-129 and accompanying text (suggesting some of the benefits that foreign investors have if they establish company owned stores prior to franchising directly).

314. See *supra* notes 225-228 and accompanying text (explaining the serious problems that can arise where international franchisors fail to protect their intellectual property in China).

315. See *supra* notes 158-199 and accompanying text (describing the vagueness, contradictions, and enforcement problems that have prevented a strong rule of

proverb states, “Hao de kai shi shi cheng gong de yi ban,” a good start is halfway on the path to success.³¹⁶

law); *see also supra* text accompanying notes 257-273 (describing how contracts can provide a layer of legal protection).

316. Interview with Carole Lee, Author’s Mother, in East Hanover, N.J. (Nov. 23, 2003).