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**A STUDY ON FRANCHISEE PROTECTION UNDER THE  
FRANCHISING REGULATION IN CHINA**



**HUANG XINBO**

**DOCTOR OF PHILOSOPHY  
UNIVERSITI UTARA MALAYSIA  
2025**

**A STUDY ON FRANCHISEE PROTECTION UNDER THE  
FRANCHISING REGULATION IN CHINA**



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**A thesis submitted to the Ghazalie Shafie Graduate School of Government in  
fulfilment of the requirement for the Doctor of Philosophy  
Universiti Utara Malaysia**



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## ABSTRACT

Since the early 1990s, franchising in China has experienced rapid growth, but concerns about misuse and fraud have been raised among regulators. This study examines the legal and regulatory framework governing the franchising sector to evaluate whether the current framework adequately protects franchisees. The objectives are to: (1) study the current franchising regulation in China, (2) analyse the existing protection for franchisees in China, (3) examine the practices of franchisee protection with specific reference to the United States, Australia and Malaysia, and (4) propose recommendations for improving the franchising regulation for a better protection of franchisees. This study adopts a doctrinal legal approach, supplemented by qualitative interviews with 21 respondents, including potential franchisees, franchisees, franchisors, lawyers and regulators. Data collected through library research and interviews are analysed using content analysis, thematic and critical methods. The findings indicate that the current franchising regulation protects franchisees' interests through mandatory disclosure, post-registration requirements and contractual mechanisms. However, interview findings reveal that the current regulatory framework offers limited protection for franchisees, with unclear disclosure, weak enforcement of registration and imbalanced contracts. A critical analysis of regulatory practices in the United States, Australia and Malaysia highlights the need for clearer disclosure, stronger enforcement of registration and fairer contractual safeguards to better protect franchisees. This study recommends clarifying disclosure requirements, strengthening registration and enhancing contractual safeguards to create a fairer franchising environment.

**Keywords:** Franchising Regulation, Franchisee Protection, Disclosure, Contract, China.

## ABSTRAK

Sejak awal 1990-an, francais di China mengalami perkembangan pesat, namun isu seperti penyalahgunaan dan penipuan telah menimbulkan kebimbangan dalam kalangan pengawal selia. Kajian ini meneliti rangka kerja perundangan dan peraturan yang mengawal selia sektor francais untuk menilai sama ada rangka kerja sedia ada melindungi francais dengan secukupnya. Objektif kajian adalah untuk: (1) mengkaji perundangan semasa francais di China, (2) menganalisis perlindungan sedia ada bagi francais di China, (3) mengkaji amalan perlindungan francais dengan rujukan khusus kepada Amerika Syarikat, Australia dan Malaysia, serta (4) mencadangkan penambahbaikan terhadap perundangan francais di China bagi menjamin perlindungan yang lebih baik kepada francais. Kajian ini menggunakan pendekatan perundangan doktrinal, di samping temu bual kualitatif bersama 21 responden, termasuk bakal francais, francais, francaisor, peguam dan hakim. Pengumpulan data melalui kajian perpustakaan dan temu bual dianalisis menggunakan analisis kandungan, kaedah tematik dan kritikal. Dapatan menunjukkan bahawa perundangan francais di China melindungi kepentingan francais melalui pendedahan mandatori, keperluan selepas pendaftaran serta mekanisme kontrak. Walau bagaimanapun, penemuan temu bual mendedahkan bahawa rangka kerja kawal selia semasa menawarkan perlindungan yang terhad untuk francais, pendedahan yang tidak jelas, penguatkuasaan pendaftaran yang lemah, juga kontrak yang tidak seimbang. Analisis kritikal terhadap amalan kawal selia di Amerika Syarikat, Australia dan Malaysia menunjukkan keperluan untuk pendedahan yang lebih jelas, penguatkuasaan pendaftaran yang lebih kukuh serta perlindungan kontrak yang lebih adil untuk memastikan perlindungan yang lebih baik terhadap francais. Kajian ini mengesyorkan keperluan terhadap penjelasan pendedahan, pengukuhan pendaftaran termasuk mempertingkatkan perlindungan kontrak untuk mewujudkan persekitaran francais yang lebih adil.

**Kata Kunci:** Peraturan Francais, Perlindungan Francaisi, Pendedahan, Kontrak, China.

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## LIST OF ABBREVIATIONS

<b>ACCC</b>	Australian Competition and Consumer Commission
<b>ADR</b>	Alternative Dispute Resolution
<b>CCFA</b>	China Chain Store & Franchise Association
<b>CFAR 2007</b>	Commercial Franchising Administration Regulation 2007
<b>CFAM 2004</b>	Commercial Franchise Administrative Measures 2004
<b>CFIDAM 2012</b>	Commercial Franchise Information Disclosure Administrative Measures 2012
<b>CFRAM 2011</b>	Commercial Franchise Registration Administrative Measures 2011
<b>CFAM 1997</b>	Commercial Franchises Administration Measures 1997
<b>FDD</b>	Franchise Disclosure Document
<b>FTC</b>	Federal Trade Commission
<b>GDP</b>	Gross Domestic Product
<b>IFA</b>	International Franchise Association
<b>MOC</b>	Ministry of Commerce
<b>NASAA</b>	North American Securities Administrators Association
<b>NPC</b>	National People's Congress
<b>RPM</b>	Resale Price Maintenance

**UFOC**

Uniform Franchise Offering Circular

**USA**

United States of America

**WTO**

World Trade Organization



# CHAPTER ONE

## INTRODUCTION

### 1.1 Research Background

Franchising has become one of the most dynamic and widely adopted business models in China, with a profound impact on the economy. It can be found in catering (KFC, McDonald's, Subway), retail (Walmart, Yonghui supermarket, Miniso), convenience store (7-Eleven, Meijia), clothing (UniQlo, Heilan Home), home furniture (Red Star Cameron, IKEA) and other industries. Franchising is a business arrangement in which the franchisor provides its trademark and marketing plan to franchisees, who pay fees and operate under the franchisor's control.<sup>1</sup> Under this business model, the franchisor is able to achieve low-cost and high-efficiency expansion of its business by licensing its franchise resources to the franchisee, while the franchisee is able to reduce the costs and risks of starting a business and directly use the franchisor's goodwill, market and experience to realize its business dreams.<sup>2</sup>

Franchising first emerged in the United States of America (hereinafter referred to as "USA") in 1863, when the American Seiko Sewing Machine Company first used franchising to establish a marketing network and achieved great success.<sup>3</sup> The first

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<sup>1</sup> Elizabeth Crawford Spencer, "An Exploration of the Legal Meaning of Franchising," *Journal of Marketing Channels* 20, no. 1-2 (2013): 36, <https://doi.org/10.1080/1046669X.2013.747858>.

<sup>2</sup> Robert W. Emerson, "Franchise Contract Interpretation: A Two-Standard Approach," *Michigan State Law Review* (2013): 641.

<sup>3</sup> Roger D. Blair and Francine Lafontaine, *The Economics of Franchising* (Cambridge: Cambridge University Press, 2005).

generation of franchising was based on product and trademark franchising, in which Seiko Sewing Machine and Coca-Cola were licensed through products and trademarks, and the franchising mode based on product distribution developed rapidly in Europe and the USA. The second generation of franchising, also known as business format franchising, exemplified by McDonald's standardized restaurant model, has rapidly expanded in the catering, retail, and service industries due to the international growth of multinational enterprises.<sup>4</sup>

Chinese franchising started in the 1980s, when McDonald's and 7-Eleven were first introduced to China. At that time, foreign franchise companies entered China in the form of joint ventures. However, due to policy restrictions, it has been operating in the form of a joint venture or a direct chain operation. Until 2004, to fulfill China's commitments upon accession to the World Trade Organization (hereinafter referred to as "WTO"), the restrictions on foreign investment entering China's franchise industry were lifted.<sup>5</sup> As a successful business model proven internationally, franchising has grown rapidly in China. According to the latest statistics from the Ministry of Commerce<sup>6</sup> (hereinafter referred to as "MOC"), it can be found that as of July 12, 2023, the total number of commercial franchise registration enterprises in the country reached 9549, an increase of more than 2 times compared with 3,341 in 2017.<sup>7</sup>

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<sup>4</sup> Marko Grunhagen and Robert A. Mittelstaedt, "Franchising from the Franchisee's Perspective: A Review of the Multi-Unit Franchising Paradox," *The International Journal of Entrepreneurship and Innovation* 2, no. 2 (2001): 74.

<sup>5</sup> MQ Zang, "The WTO Contingent Trade Instruments Against China: What Does Accession Bring?" *International and Comparative Law Quarterly* 58, no. 2 (2009): 321, <https://doi.org/10.1017/S0020589309001018>.

<sup>6</sup> The MOC is the executive department of the State Council, which can interpret and implement administrative regulations.

<sup>7</sup> "Business Franchise Information Management," Ministry of Commerce (MOC), accessed July 19, 2023, <http://txjy.sygggs.mofcom.gov.cn/index.do?method=tjxx/>.

With the continuous growth of the Gross Domestic Product (hereinafter referred to as "GDP"), China has become the second largest economy in the world since 2010. According to the forecast of the International Monetary Fund, China may surpass the largest economy of the USA in 2030.<sup>8</sup> China represents one of the most promising franchising markets, driven by its vast population of nearly 1.4 billion and a rapidly growing middle-income group exceeding 400 million individuals, creating significant opportunities for market expansion and consumer demand.<sup>9</sup> According to the China Chain Store & Franchise Association (hereinafter referred to as "CCFA"), the sales of the top 100 franchise companies alone reached USD 284 million in 2023, representing an increase of 4.6% compared with the previous year.<sup>10</sup> In the USA, the franchise industry totaled USD 827 billion in sales and accounting for 3 percent of GDP.<sup>11</sup> Australia has more than 1,000 franchise systems, with sales of up to USD 170 billion and a share of 10 % of Australia's GDP.<sup>12</sup> Malaysia is one of the fastest-growing franchise markets in Southeast Asia. With 2% of GDP, the franchise sector is among the top three contributors to Malaysia's economy.<sup>13</sup> Compared with these countries, China's franchise market still offers substantial growth potential.

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<sup>8</sup> "China's Economic Outlook in Six Charts," *International Monetary Fund*, last modified July 25, 2018, accessed July 19, 2023, <https://www.imf.org/en/News/Articles/2018/07/25/na072618-chinas-economic-outlook-in-six-charts/>.

<sup>9</sup> Arthur R. Kroeber, *China's Economy: What Everyone Needs to Know*® (Oxford: Oxford University Press, 2020).

<sup>10</sup> "2023 China Chain TOP100 Released," *China Chain Franchise Association*, June 6, 2024, <http://www.ccfa.org.cn/portal/cn/xiangxi.jsp?id=445745&type=10003>.

<sup>11</sup> Mary Kay Rickard and L. Brooke Conaway, "Franchising Variation across US States," *Competitiveness Review: An International Business Journal* 33, no. 6 (2023): 1069.

<sup>12</sup> "Franchising in Australia: Market Size, Industry Analysis, Trends and Forecasts (2024-2029)," *IBISWorld*, accessed September 14, 2023, <https://www.ibisworld.com/au/industry/franchising/1902/>.

<sup>13</sup> Nor Hafiza Othman et al., "Franchise Industry: A Systematic Review of Business Survival," *Remittances Review* 8, no. 4 (2023): 3818, <https://doi.org/10.33182/rr.v8i4.263>.

Franchising regulation has been a critical factor in the development of franchising in China.<sup>14</sup> Notable progress was achieved with the introduction of China's first formal regulation of franchise activities: the *Trial Commercial Franchises Administration Measures* (hereinafter referred to as "CFAM 1997"), issued by the former Ministry of Domestic Trade in 1997. It sends a signal to the market that the Chinese government supports and encourages franchising activities. At that time, franchise management is mainly based on industry self-regulation.<sup>15</sup> The rapid expansion of franchising has led to increasing instances of misuse, including unfair practices and commercial fraud, prompting heightened regulatory scrutiny and intervention. To preventing franchise fraud, the *Commercial Franchise Administrative Measures* (hereinafter referred to as "CFAM 2004"), issued by the MOC, introduced a regulatory framework that emphasised registration management.

In 2007, the State Council issued the *Commercial Franchising Administration Regulation* (hereinafter referred to as "CFAR 2007"), which replaced the *CFAM 2004*.<sup>16</sup> This regulatory shift focused on franchise information disclosure, aligning with international standards to better prevent franchisor misconduct and protect vulnerable franchisees. This framework was further strengthened with the issuance of the *Commercial Franchise Registration Administrative Measures* (hereinafter referred to as "CFRAM 2011") and the *Commercial Franchise Information Disclosure Administrative Measures* (hereinafter referred to as "CFIDAM 2012"), both

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<sup>14</sup> Richard C. Hoffman, Jonathan Munemo, and Sharon Watson, "International Franchise Expansion: The Role of Institutions and Transaction Costs," *Journal of International Management* 22, no. 2 (2016): 101, <https://doi.org/10.1016/j.intman.2016.01.003>.

<sup>15</sup> Jaochuan Wang, "Speech at the National Meeting on Implementing the Commercial Franchise Administrative Regulation," *Ministry of Commerce*, June 2007, <https://m.mofcom.gov.cn/article/zcjd/jdgnmy/200706/20070604820167.shtml>.

<sup>16</sup> *Commercial Franchising Administration Regulation*, Decree No. 485 of the State Council of the People's Republic of China, released by the State Council in February 2007 and effective May 2007.

implemented by the MOC.<sup>17</sup> Since the introduction of the first franchise law in California in the 1970s, subsequent franchise-specific regulations have increasingly focused on protecting franchisees, with information disclosure becoming a pivotal regulatory tool.<sup>18</sup> In addition to these specific regulations, general principles of contract law, as outlined in the *Civil Code*, provide important legal interpretations for franchise agreements.

Although regulatory measures have been implemented to address and mitigate the widespread abuse of franchising for commercial fraud in China, these efforts have not completely resolved the underlying issues. In October 2023, Shanghai authorities uncovered a major milk tea investment fraud case, where criminals exploited fictitious brand authorizations and fabricated business performance to create deceptive franchise opportunities. This scam defrauded over 5,800 franchisees nationwide, resulting in substantial financial losses from franchise fees.<sup>19</sup> This case, which attracted widespread attention, highlighted the vulnerabilities in franchise practices and the need for stricter regulatory oversight.

Fraud in the franchise market, stemming from imbalances in franchise relationships, are pressing issues that require attention.<sup>20</sup> Given the prevalence of unfair practices and fraudulent behaviors in China's rapidly expanding franchise market, an assessment

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<sup>17</sup> *Commercial Franchise Registration Administrative Measures*, Decree No. 5 of the MOC of the People's Republic of China. Released by the MOC in December 2011 and effective February 2012; *Commercial Franchise Information Disclosure Administrative Measures*, Decree No. 2 of the MOC of the People's Republic of China. Released by the MOC in February 2012, effective April 2012.

<sup>18</sup> Ann Hurwitz, "Managing the Proliferation of Global Franchise Regulation," *Franchise Law Journal* 40, no. 1 (2020): 43, <https://www.jstor.org/stable/27184576>.

<sup>19</sup> "Shanghai Broke 700 Million Yuan Milk Tea Franchise Fraud Case: Gangs Hire People to Queue Up, Cheating Franchisees' Trust," *Surge News*, May 13, 2021, [https://m.thepaper.cn/wifiKey\\_detail.jsp?contid=12655103&from=wifiKey#](https://m.thepaper.cn/wifiKey_detail.jsp?contid=12655103&from=wifiKey#).

<sup>20</sup> Peter C. Lagarias and Robert S. Boulter, "Modern Reality of the Controlling Franchisor: The Case for More, Not Less, Franchisee Protections," *Franchise Law Journal* 29, no. 3 (2009): 139.

of the current regulatory environment is essential. This study reviews the existing regulatory framework for franchising in China and provides recommendations to address these malpractices, with the aim of enhancing the protection of franchisees.

## **1.2 Problem Statement**

Franchising has played a crucial role in driving China's economic growth. However, the regulation of franchising remains a controversial issue. As Andrew Terry observed,

The search for an appropriate form of regulation which protects the interests of both parties in a manner that does not curtail the entrepreneurial nature of franchising or threaten its development is difficult but significant.<sup>21</sup>

The relationship between a franchisor and a franchisee is governed by their contract and is typically characterized by an imbalance of rights and obligations. This study was motivated by following three key issues:

- i. Lack of clear legal protection for franchisees
- ii. Unbalanced franchise relationship in contract
- iii. Unfair practice in franchising enforcement

### **1.2.1 Lack of Clear Legal Protection for Franchisees**

*CFAR 2007* is a crucial piece of legislation in the franchising sector. However, its primary focus on administrative regulation overlooks the fundamental nature of franchise contractual relationships. This oversight leads to a lack of clarity regarding key aspects of franchise agreements, such as the rights and responsibilities of the

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<sup>21</sup> Andrew Terry, *A Census of International Franchise Regulation* (paper presented at the 21st Annual International Society of Franchising Conference, Las Vegas, NV, USA, February 24–25, 2007).

parties involved.<sup>22</sup> The National People's Congress (hereinafter referred to as "NPC"), China's top legislative body, did not enact a specific franchise law. Although franchise contracts were included in the draft of the *Civil Code* in August 2017, they were ultimately omitted from the final version. Moreover, as an administrative regulation issued by the State Council, it does not carry the legislative authority of the NPC, limiting its effectiveness in regulating franchise contractual relationships.

While franchise relationships are governed by general contract provisions under the *Civil Code*, the absence of specific regulations for franchise contracts means that only broad principles or analogous contract rules can be applied. The *Civil Code* offers general contractual principles, such as good faith, but lacks clear, tailored provisions addressing the unique dynamics of franchising. Its guidelines on performance, termination, and breach of contract liability are designed for typical civil contracts, without accounting for the specific complexities inherent in franchise relationships.<sup>23</sup> The absence of clear, specific regulations for franchise contracts in both *CFAR 2007* and the *Civil Code* exposes franchisees to potential risks and uncertainties, especially given their weaker bargaining position in contract negotiations.

Moreover, the ambiguity of the relevant provisions has brought about confusion in judicial decisions.<sup>24</sup> As a civil law country, China relies on codified laws as the primary basis for judicial rulings, limiting judges' ability to interpret beyond what is

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<sup>22</sup> Shaokun Fang, and Peiying Liu, "Determination of the Effectiveness of Commercial Franchise Contracts and Ideas for Correction," *Journal of Shandong University (Philosophy and Social Sciences)* 2 (2021): 110-118.

<sup>23</sup> Andrew Terry, Carmen Di Lernia, and Rozenn Perrigot, "The Obligation of Good Faith and Its Role in Franchise Regulation," in *Handbook of Research on Franchising*, ed. Frank Hoy, Rozenn Perrigot, and Andrew Terry (Cheltenham: Edward Elgar Publishing, 2017), 169-190.

<sup>24</sup> Colin Hawes, "How Chinese Judges Deal with Ambiguity in Corporate Law: Suggestions for Improving the Chinese Case Precedent System," *Australian Journal of Asian Law* 19, no. 1 (2018): 1.

explicitly stated in the law. In cases where a franchisor infringes on the franchisee's exclusive right of operation, courts typically rely on the exclusive franchise clause within the contract to reach a decision.<sup>25</sup> However, not all franchise agreements include such provisions. It is difficult for the court to find a direct contractual legal basis to resolve such franchise disputes. In the absence of specific regulations to guide decisions, judges may interpret franchise contract disputes inconsistently, resulting in varying outcomes and legal uncertainties for both franchisees and franchisors.<sup>26</sup>

The lack of clear legal provisions and standards has led to inconsistent judgments in similar cases. For example, Article 12 of *CFAR 2007* provides the franchisee's right of repentance, that is, the franchisee can unilaterally terminate the contract without any reason within a reasonable period. Courts hold varying opinions on what constitutes a reasonable cooling-off period. Some argue that the cooling-off period should be explicitly defined in franchise agreements,<sup>27</sup> while others believe it should be left to the court's discretion.<sup>28</sup> Indeed, due to the lack of legislative clarity on the return of franchise fees after contract termination, there is significant variation in how courts handle refunds. In Hangzhou, courts typically limit refunds to 20% to 50% of the fees, whereas in similar cases, courts in Nanjing and Shanghai often require refunds of 70% to 80%, and sometimes even the full amount.<sup>29</sup>

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<sup>25</sup> Haitao Hu, "Analysis and Improvement of Commercial Franchise Cooling-off Period System," *Journal of Graduate School of Chinese Academy of Social Sciences* 2 (2016).

<sup>26</sup> Huanmin Lin, "The Necessity of Adding a Chapter on Commercial Franchise Contracts to the Contract Part of the Civil Code and Its System Points," *Journal of Beijing University of Aeronautics and Astronautics (Social Science Edition)* 32, no. 2 (2019): 19, <https://doi.org/10.13766/j.bhsk.1008-2204.2019.0044>.

<sup>27</sup> Shanghai Qingpu District People's Court, First Instance Civil Judgment No. 34415, 2023.

<sup>28</sup> Guangzhou Panyu District People's Court, First Instance Civil Judgment No. 5399, 2023.

<sup>29</sup> "The Termination of Commercial Franchise Contracts and the Disposal of Franchise Fees," *Intermediate People's Court of Kunming*, accessed September 15, 2023, <https://www.capitallaw.com.cn/article/default.asp?id=12880>.

In addition, *Civil Code* and *CFAR 2007* have uncertain provisions on the same matter. For example, Article 148 of *Civil Code* provides that legal acts committed by fraudulent means may be cancelled. However, Article 23 of *CFAR 2007* clearly stipulates that under such circumstances, the franchisee may terminate the contract. It is illustrated by *Ding Lianzheng (franchisee) v. Spliced Road Restaurant Management Co., Ltd.(franchisor)*.<sup>30</sup> In this case, the franchisor concealed the unregistered trademark of "Perverted Potato" and falsely advertised that "Perverted Potato" originated from the Netherlands. The Supreme Court held that franchisor's conduct constituted fraud. It is noteworthy that the franchisee in this case claimed the right of cancellation based on the Article 54 of the *Contract Law 1999*<sup>31</sup>, while the Supreme People's Court applied Article 23 of *CFAR 2007* to terminate the contract. Rescinding a contract is different from terminating a contract. In the *Civil Code*, rescission involves canceling the contract entirely, treating it as though it never existed, often due to misrepresentation, fraud, or mutual mistake. Termination, on the other hand, ends the contract moving forward, but the terms and actions performed prior to termination remain valid.<sup>32</sup> The legislation needs further interpretation to reduce uncertainty.

### **1.2.2 Unbalanced Franchise Relationship in Contract**

In franchise contracts, the unbalanced relationship between franchisors and franchisees is a significant issue. The franchisor often uses its dominant position to impose unreasonable restrictions on the franchisee's rights or to increase the franchisee's liabilities, which raises public concerns about the adequacy of franchisee protection.<sup>33</sup> As Beijing court noted that,

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<sup>30</sup> Beijing Supreme People's Court, Civil Final Judgment No. 2427, 2015.

<sup>31</sup> The same provision is made in Article 148 of the Civil Code.

<sup>32</sup> Article 157 and Article 566 of the Civil Code.

<sup>33</sup> Fanhong Chen, "Alienation of Regulation: A Study on the Imbalance of Rights and Obligations in

Some franchise contracts disproportionately favor the franchisor, with more provisions outlining the franchisor's rights and fewer or vague agreements on the franchisee's rights, creating an unfair imbalance.<sup>34</sup>

The franchising relationship inherently involves power imbalances. The franchisor typically possesses specialized expertise, extensive business experience and stronger bargaining power, whereas the franchisee often lacks substantial business experience. As a result, franchisees are usually in a weaker position.<sup>35</sup> Shanghai court summarizes the characteristics of the franchise cases as follows,

Franchisees are more frequently involved in legal disputes. In the conclusion and performance of franchise contracts, the franchisee is in a weak position in terms of contracting ability, business experience and market value judgment, and most of the disputes arise from the irregularities of the franchisor. Out of 316 cases accepted by the court, 16.46% were initiated by franchisors, while 83.54% were initiated by franchisees.<sup>36</sup>

Moreover, the information asymmetry in the franchise relationship puts franchisees at risk of deception and exploitation. Franchisors often have access to more comprehensive information about the business, which can create vulnerabilities for franchisees who may not fully understand or be aware of critical details.<sup>37</sup> Franchisors

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Commercial Franchise Contracts," *Journal of China University of Political Science and Law* 5 (2020): 86.

<sup>34</sup> Beijing Haidian District Court, *White Paper on Trial of Franchise Contract Dispute Cases 2013-2019*, (2019).

<sup>35</sup> Barry Quinn and Anne Marie Doherty, "Power and Control in International Retail Franchising – Evidence from Theory and Practice," *International Marketing Review* 17, no. 4/5 (2000): 354, <https://doi.org/10.1108/02651330010339897>.

<sup>36</sup> Shanghai Yangpu District Court, *White Paper on Trials of Franchise Contract Disputes 2017-2019*, (2020).

<sup>37</sup> Christopher Von Koch, Martin Ludvigsson-Wallete, and Ola Nilsson, "In Search of Corporate

may delay, withhold, or falsify relevant information, often making misleading claims and exaggerating facts to lure franchisees into high-risk ventures.<sup>38</sup> Given their disadvantaged position, franchisees heavily rely on the information provided by franchisors for decision-making, and any errors in judgment can lead to significant financial losses.<sup>39</sup> Tianjin court makes a similar point,

In 92.86% of the cases, the plaintiff was the franchisee, which contrasts sharply with other types of contract disputes. In the franchise relationship, the information between the parties is asymmetrical, the franchisee is in a relatively weak position, and it is easy for them to make wrong judgments under the misleading guidance of the franchisor with ulterior motives.<sup>40</sup>

Furthermore, franchisors often exercise excessive and ongoing control over franchisees. Despite the appearance of contractual freedom, an inherent inequality exists between the franchisor and franchisee. This disparity allows franchisors to impose unreasonable operational restrictions through standardized contracts. In such relationships characterized by significant control, the franchisee's legitimate rights and interests are more susceptible to infringement.<sup>41</sup> For example, franchisors may exert control over the supply of raw materials to ensure business reputation and product quality. However, this control can lead to inflated prices for these materials compared

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Governance in Franchising," *Journal of Marketing Channels* 26, no. 3 (2020): 178-193.

<sup>38</sup> Richard Craswell, "Taking Information Seriously: Misrepresentation and Nondisclosure in Contract Law and Elsewhere," *Virginia Law Review* 92 (2006): 565.

<sup>39</sup> Shuwen Wang, "Information Disclosure Obligations in the Formation of Business Franchise Contracts from the Perspective of Collaborative Obligations," *Journal of Northeast Normal University (Philosophy and Social Sciences Edition)* 302, no. 6 (2019): 184. <https://doi.org/10.16164/j.cnki.22-1062/c.2019.06.028>.

<sup>40</sup> Tianjin First Intermediate Court, *White Paper on Franchise Cases Trials 2018-2020*, (2021).

<sup>41</sup> Alan Felstead, *The Corporate Paradox: Power and Control in the Business Franchise* (London: Taylor & Francis, 2024)

to market rates. Additionally, franchisors often implement non-compete clauses under the guise of safeguarding intellectual property, which can effectively restrict market competition and limit the franchisee's operational flexibility.<sup>42</sup>

In addition, franchise agreements are typically form contracts, allowing franchisors to unilaterally dictate terms that prioritize their interests. This lack of negotiation power for franchisees results in agreements that disproportionately favor the franchisor, exacerbating the inherent power asymmetry within the franchising relationship. It increases the risk of exploitation in franchise agreements.<sup>43</sup> Almost all clauses in franchise agreements impose obligations solely on the franchisee, creating an imbalance in the franchising relationship.<sup>44</sup> Franchisors use form contracts to minimize their liability and effectively avoid risk, while franchisees face significantly increased risks. Although franchisors may encourage franchisees to review the agreement and raise questions, any request for modifications is often met with strong resistance.<sup>45</sup>

Moreover, these agreements often contain restrictive clauses that severely disadvantage the franchisee. For example, franchisors may stipulate that arbitration, or litigation occurs at their head office, impose unreasonable time or geographic limits on non-compete obligations, and enforce restrictive tying clauses, fixed resale prices, or sales territory restrictions.<sup>46</sup>

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<sup>42</sup> Orly Lobel, "Enforceability TBD: From Status to Contract Intellectual Property Law," *Boston University Law Review* 96 (2016): 869.

<sup>43</sup> Mark AP Davies et al., "A Model of Trust and Compliance in Franchise Relationships," *Journal of Business Venturing* 26, no. 3 (2011): 322.

<sup>44</sup> Jeff Giddings et al., "Understanding the Dynamics of Conflict within Business Franchise Systems," *Australian Dispute Resolution Journal* 20, no. 24 (2009): 25.

<sup>45</sup> Jenny Buchan, "Consumer Protection for Franchisees of Failed Franchisors: Is There a Need for Statutory Intervention," *Law and Justice Journal* 9, no. 2 (2009): 233.

<sup>46</sup> *China Judgements Online*, accessed February 25,

### 1.2.3 Unfair Practice in Franchising Enforcement

The regulation of franchising in China has evolved over more than 20 years since the introduction of the first formal regulation of franchise activities, the *CFAM 1997*. However, the enforcement of franchising raises significant concerns about the effectiveness of the current regulatory framework in protecting the rights of franchisees and ensuring fair practices within the franchising sector.<sup>47</sup> Data from Wolters Kluwer's case database shows a dramatic increase in franchising disputes, with 58,310 judicial cases recorded by May 31, 2024.<sup>48</sup> Figure 1.1 illustrates this growth, with franchise disputes cases reaching a peak in 2020, followed by a sharp decline. The growing number of franchise disputes suggests that violations of franchising regulations are prevalent.

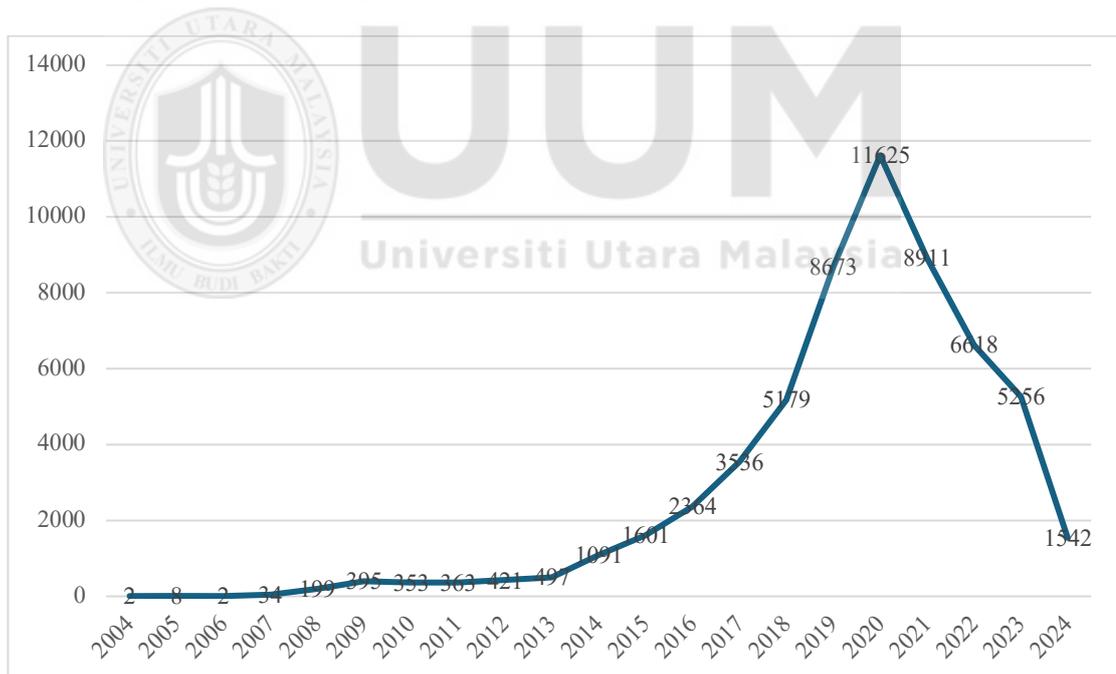


Figure 1.1: The Number of Franchise Court Cases in China from 2004 to 2024

2023, <https://wenshu.court.gov.cn/website/wenshu/181029CR4M5A62CH/index.html>.

<sup>47</sup> Marie Doherty, A., Chen, X., and Alexander, N. "The Franchise Relationship in China: Agency and Institutional Theory Perspectives," *European Journal of Marketing* 48, no. 9/10 (2014): 1664-1689. <https://doi.org/10.1108/EJM-04-2012-0199>.

<sup>48</sup> "Wolters Kluwer," accessed May 31, 2024, <https://law.wkinfo.com.cn>.

Most of these disputes typically involve issues related to *Contract Law* (now superseded by *Civil Code*) and *CFAR 2007*. As shown in Figure 1.2 below, the frequent application of specific provisions from the *Contract Law* and *CFAR 2007* highlights critical areas of concern in franchising disputes. Franchise disputes cover a range of issues, including general contract matters such as good faith (Article 60), performance (Article 94) termination (Article 97), and breach of contract (Article 107 and Article 8). They also involve specific franchising concerns, such as franchisor's violation of information disclosure obligations (Articles 22 and 23), non-compliance with franchise registration requirements (Article 3 and Article 7), and disputes related to the termination during the cooling-off period (Article 12).

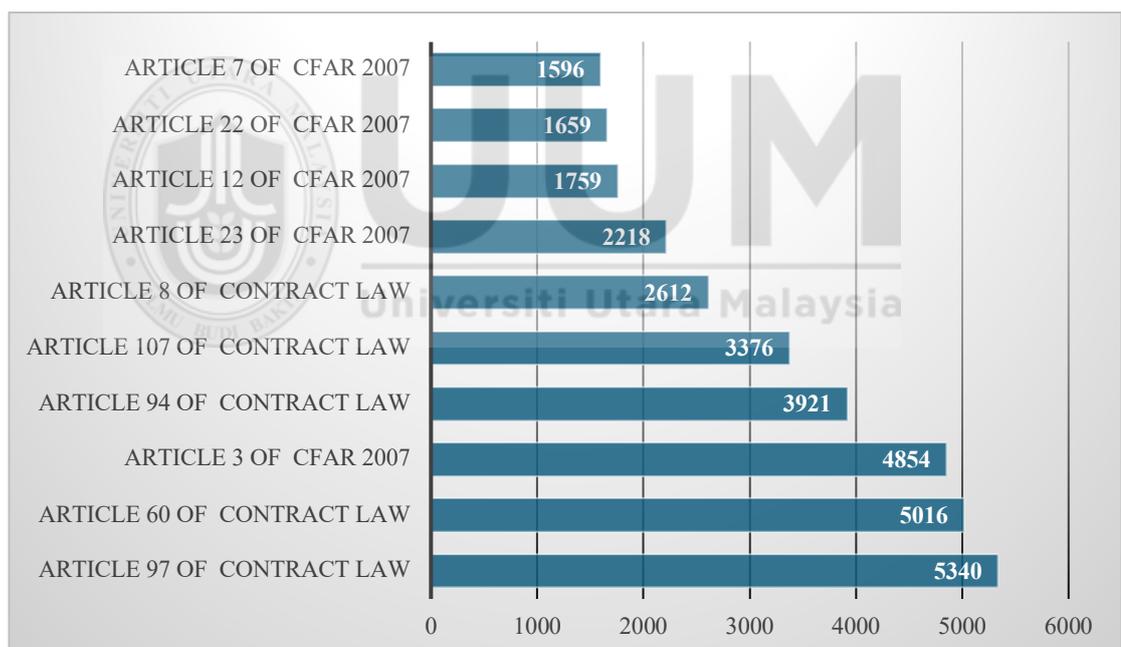


Figure 1.2: High-frequency Laws and Regulations Invoked in Franchise Court Cases

The high citation rates of these articles, which address issues related to contracts, registration, and disclosure, further indicate that these three aspects are critical components of franchise regulation and are also where violations most frequently occur.

Investigations indicate that disputes arising from franchisors' failure to meet their disclosure obligations are the most prevalent, comprising nearly 30% of all franchise-related conflicts.<sup>49</sup> There are two common types of non-compliance with disclosure obligations, one is to conceal relevant information, the other is to provide false information. Even worse, franchisors do not disclose information at all. In practice, franchisees often face inadequate information disclosure or even outright fraud, a common issue in rapidly expanding franchise markets.<sup>50</sup> This problem was also prevalent in the USA during the rapid growth of franchising in the 1960s and 1970s. A study found that 37% of franchisors mislead potential franchisees by overstating projected revenue, contributing to the significant prevalence of disclosure-related disputes in the franchising sector.<sup>51</sup>

The enforcement of franchise registration in China is a common issue. The MOC reported a total of 9,955 registered enterprises engaged in franchising, far below the actual number of franchised brands in the market.<sup>52</sup> Franchisor registration requires only basic information submitted through the official website of MOC, lacking comprehensive disclosure of essential franchise-related details. Although franchisors are required to register with governments under the franchising regulation, many enterprises view this regulatory scrutiny as an unnecessary constraint and resist compliance. This lack of robust enforcement leaves franchisees exposed to increased

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<sup>49</sup> Jiansheng Feng, "Formulization of Commercial Franchise Contracts from the Perspective of Civil Code Compilation," *Law and Business Research* 36, no.4 (2019): 16.

<sup>50</sup> Chenghao Zhao, "Research on Commercial Franchise System from the Perspective of Anti-Monopoly Law," *Open Journal of Legal Science* 11 (2023): 1414.

<sup>51</sup> Shelby D. Hunt and John R. Nevin, "Full Disclosure Laws in Franchising: An Empirical Investigation: What Effects Have the Full Disclosure Laws Had on the Franchise System of Distribution?" *Journal of Marketing* 40, no. 2 (1976): 53.

<sup>52</sup> "Business Franchise Information Management," Ministry of Commerce (MOC), accessed July 19, 2023, <http://txjy.sygggs.mofcom.gov.cn/index.do?method=tjxx/>.

risks, as insufficient information and limited regulatory oversight hinder their ability to make informed decisions.

Additionally, the unfair practice in China's franchising sector poses significant challenges, often directly harming franchisee interests. Although franchising aims to create mutually beneficial business relationships, many franchisors view franchising as a means to expand their business and collect fees, neglecting their contractual obligations to provide operational support.<sup>53</sup> The lack of commitment leaves franchisees without essential guidance, increasing their business risks. When franchisors ignore contract obligations, they not only harm their own reputation but also threaten the long-term success of the franchise. Even worse, some companies falsely present themselves as qualified franchisors to deceive potential franchisees, revealing major issues in contract compliance and integrity.<sup>54</sup> This self-centered behavior by franchisors highlights a lack of effective contract enforcement, increasing the risks faced by franchisees and affecting the overall franchise market.

Overall, the above discussion suggests the need for further research on franchising regulation in China, particularly in terms of franchisee protection. Key factors driving this research include the lack of clear legal protection for franchisees, the imbalance of franchise relationship in terms of contract and the unfair practice in franchising enforcement. Addressing these areas is essential to ensure fair and effective regulatory

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<sup>53</sup> SooCheong Shawn Jang and Kwangmin Park, "A Sustainable Franchisor-Franchisee Relationship Model: Toward the Franchise Win-Win Theory," *International Journal of Hospitality Management* 76 (2019): 13-24, <https://doi.org/10.1016/j.ijhm.2018.06.004>.

<sup>54</sup> Paul Steinberg and Gerald Lescatre, "Beguiling Heresy: Regulating the Franchise Relationship," *Penn State Law Review* 109 (2004): 105.

mechanisms that support franchisee rights and improve the overall stability of the franchising sector.

### **1.3 Research Questions**

Based on the issues related to franchisee protection under the franchising regulation, this research develops the following research questions:

- (1) What is the current franchising regulation in China?
- (2) To what extent does China's current regulatory framework effectively protect franchisees?
- (3) How can China learn from the USA, Australia and Malaysia to enhance franchisee protection?
- (4) How should China improve its franchising regulation to better protect franchisees?

### **1.4 Research Objectives**

This research aims to achieve the following objectives:

- (1) To study the current franchising regulation in China.
- (2) To analyse the current protection for franchisees in China.
- (3) To examine the practices of franchisee protection with specific reference to the USA, Australia and Malaysia.
- (4) To propose recommendations for improving the franchising regulation to better protect franchisees.

### **1.5 Significance of Study**

This study critically examines the franchisee protection under the franchising regulation in China, contributing to both practice and theory. It helps stakeholders

understand the role of current franchising regulation, identify gaps, and consider potential improvements. By examining the current franchising regulation in China, especially the practices of franchisee protection, this study also makes theoretical contributions.

First, this study provides valuable insights for regulators to refine the current franchising legal framework. It encourages regulators to recognize and address legal loopholes to provide better protection for vulnerable franchisees under China's franchising regulations. By examining current franchising legislation such as *CFAR 2007* and the *Civil Code*, more detailed and clear proposals are put forward to create a more transparent and fair franchising regulatory environment. Also, this study offers guidance for judicial practice, providing courts with a comprehensive and clear legal framework to address franchise disputes effectively.

Moreover, this research benefits existing and potential franchisees and franchisors, as well as other stakeholders. The findings benefit franchisees and potential investors by offering comprehensive and clear guidelines in terms of franchising regulation. This helps them identify risks and understand their legal protections more clearly. Additionally, this study clarifies the requirements for various aspects of franchise regulation, helping franchisors fully understand legal requirements and ensure compliance in their operations. By promoting fair trade practices and reducing franchise business risks, the study supports a healthier franchise environment.

This study provides a franchisee perspective on China's franchise regulatory experience and enriches the franchising research literature in emerging markets.

Through the analysis of legal documents related to franchising regulation and the analysis of interview data, this research has made significant contributions in many aspects. It begins by examining the current legal and regulatory framework for franchising in China, providing detailed insights into the legislative development and regulatory environment for franchising in China. Secondly, through the analysis of qualitative interview data, the research indicates the legal loopholes existing in the current protections for franchisees under the China's franchising regulation. For example, lack of clarity in disclosure terms, weak registration implementation, and franchise contracts exacerbate the imbalance in franchise relationships. In addition, the practice of franchisee protection in the USA, Australia and Malaysia is used for reference and relevant improvement suggestions are put forward.

The current research on franchising is mostly from the perspective of franchisors, ignoring the group of franchisees. This study focuses on the importance of franchisee protection to the long-term development of franchising and emphasizes the balance of the franchising relationship. Therefore, this study can provide a new perspective for the analysis of China's franchise regulatory framework and make up for the relevant theoretical gaps in the study of franchisee protection. This study provides insight into how to meet regulatory requirements for disclosure, registration and contracts, which ultimately have a concrete impact on franchise regulatory reform in China.

## **1.6 Research Methodology**

To achieve the objectives of this study, this section discusses the research methodology, research design, research scope, data types, data collection method and data analysis.

### 1.6.1 Research Design

The research design employed in this study is primarily doctrinal legal research, complemented by phenomenological approach through interviews. Doctrinal research is a traditional method of legal research that involves systematic study and analysis of legal texts to identify, interpret, and synthesize legal principles, provisions, concepts, and theories. This approach aims to clarify the functioning of laws and legal institutions, generate new insights and propose potential reforms.<sup>55</sup> Watkins argues that new and complex court decisions must be examined in the context of specific laws and basic legal principles. Through the analysis of legal principles or doctrines, doctrinal research has made great contributions to testing the coherence, consistency and rationality of legal propositions or doctrines, and may further promote the perfection of law.<sup>56</sup>

Phenomenological research, a qualitative method, is used in this study to explore the stakeholders' perceptions and experiences within franchise relationships. This qualitative approach helps understand how stakeholders, particularly franchisees, perceive franchise regulation and their feelings about the current regulatory environment. Maxwell argues that qualitative research enables researchers to understand the physical, social, and cultural contexts underlying participants' perspectives, particularly focusing on the processes that sustain or transform these phenomena and relationships.<sup>57</sup>

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<sup>55</sup> Dawn Watkins, ed., *Research Methods in Law* (Routledge, 2017).

<sup>56</sup> Nuraisyah Chua Abdullah, *Legal Research Methodology* (Thomson Reuters Asia Sdn Bhd, 2018).

<sup>57</sup> Joseph A. Maxwell, *Qualitative Research Design: An Interactive Approach* (Sage Publications, 2012).

Qualitative research allows the researcher to examine laws and regulations from an external viewpoint, while doctrinal research provides an in-depth internal analysis of these legal frameworks.<sup>58</sup> Combining these two methods enhances the rationality and persuasiveness of the study, offering a comprehensive examination of the research subject in both theory and practice.

### **1.6.2 Research Scope**

This study was conducted from January 2023 to July 2024 in China, which has a huge potential consumer market. China has a large base of 1.4 billion people and more than 400 million middle-income groups, which presents opportunities for franchising. The research scope of this study focuses on the regulation of franchising in China, with particular emphasis on the protection of franchisees. Thus, this study analyses the key laws, regulations, and guidelines that govern franchising in China, such as the *CFAR 2007*, *CFIDAM 2012*, *CFRAM 2011*, and the *Civil Code*. In addition, this study interviewed 21 respondents from the cities in the south and north of China. They were selected due to their varied economic profiles and regulatory environments. The respondents consist of five potential franchisees, seven franchisees, three franchisors, one director of the CCFA, three lawyers and two regulators.

It also references key aspects of franchisee protection in the USA, Australia and Malaysia for additional insights. The following legal documents are included in the scope of this study, including, but not limited to, the Federal Trade Commission (hereinafter referred to as "FTC") *Franchise Rule* in the USA, the *Franchise Code of*

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<sup>58</sup> Roger Cotterrell, "The Sociological Concept of Law," *Journal of Law and Society* 10, no. 2 (1983): 242.

*Conduct* in Australia and *the Franchise Act* in Malaysia. There were specific considerations in the selection of these countries for this review. The USA and Australia have well-developed franchising system and sound legal framework for franchising.<sup>59</sup> Malaysia is included in the review as a reference point due to its geographical proximity to China and the fact that both countries are emerging economies experiencing rapid franchise growth.<sup>60</sup>

### 1.6.3 Type of Data

There are two sources of data collection: primary and secondary. Primary data are collected directly from respondents, as well as from laws, regulations, and cases, while secondary data are gathered from published or unpublished materials. In qualitative research, interviews serve as an important method for collecting primary data, whereas in doctrinal research, library data are utilized.<sup>61</sup>

The primary data for this study is derived from laws, regulations, cases, and other documents with legal force, such as *CFAR 2007*, *CFRAM 2011*, *CFIDAM 2012*, *Civil Code* and real franchise agreements.<sup>62</sup> In addition, the researcher conducts interviews, a widely used method in qualitative research, to collect primary data directly from respondents.<sup>63</sup>

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<sup>59</sup> Dada, O., Watson, A., and Kirby, D, "Entrepreneurial Tendencies in Franchising: Evidence from the UK," *Journal of Small Business and Enterprise Development* 22, no. 1 (2015): 82.

<sup>60</sup> Haruna, A. Y., and Mart Handan, G, "Foundational Competencies for Enhancing Work Engagement in SMEs Malaysia," *Journal of Workplace Learning* 29, no. 3 (2017): 165-184.

<sup>61</sup> Joop J. Hox and Hennie R. Boeije, "Data Collection, Primary vs. Secondary," *Encyclopedia of Social Measurement* 1, no. 1 (2005): 593–99.

<sup>62</sup> Amy E. Sloan, *Basic Legal Research: Tools and Strategies* (New York: Wolters Kluwer Law & Business, 2009).

<sup>63</sup> Emmy Holloway and Paul Fallbrook, "Revisiting Qualitative Inquiry: Interviewing in Nursing and Midwifery Research," *NT Research* 6, no. 1 (2001): 540.

Secondary data are collected from various sources, including textbooks, government publications, relevant journal articles, online databases, and the internet. Additional secondary data sources include franchise newspapers, industry reports, public speeches, and franchise company websites. This information helps the researcher gain background knowledge about the interviewees in advance, which supports and strengthens the interview data. Secondary data are used to interpret and supplement the primary data.<sup>64</sup>

#### **1.6.4 Data Collection Method**

Data for this study are collected through two main methods: a library-based approach and interviews. Library data collection involves gathering information from a wide range of sources, including textbooks, journal articles, newspaper articles, government documents, and other scholarly resources available in libraries. Interview data are collected from respondents, providing valuable insights as a primary data source in qualitative research. The interview method is employed as a standard data collection technique, where the researcher asks questions and expects responses from the interviewees. This method is widely used in qualitative research.<sup>65</sup>

This study includes an interview protocol (Appendix A) to standardize the process and ensure reliability. The interview questions (Appendix B) focus on gathering stakeholders' views on franchise regulation and franchisee protection. The interview questions are thoughtfully designed to align closely with the study's research objectives. In addition, semi-structured interviews are employed to encourage

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<sup>64</sup> Anwarul Yaqin, *Legal Research and Writing* (Malayan Law Journal, 2007).

<sup>65</sup> John H. Hitchcock, Bonnie K. Nastasi, and Meredith Summerville, "Single-Case Designs and Qualitative Methods: Applying a Mixed Methods Research Perspective," *Mid-Western Educational Researcher* 23, no. 2 (2010).

respondents to share insights that extend beyond predefined questions.<sup>66</sup> It provides flexibility, allowing participants to introduce additional relevant information that may not be anticipated. Open-ended questions are used to avoid simple "yes" or "no" answers, prompting a more detailed and nuanced range of responses and enhancing the depth and comprehensiveness of the data collected.<sup>67</sup>

This study employs purposive sampling to select respondents, as outlined in Figure 1.3, which illustrates the criteria used for respondent selection.

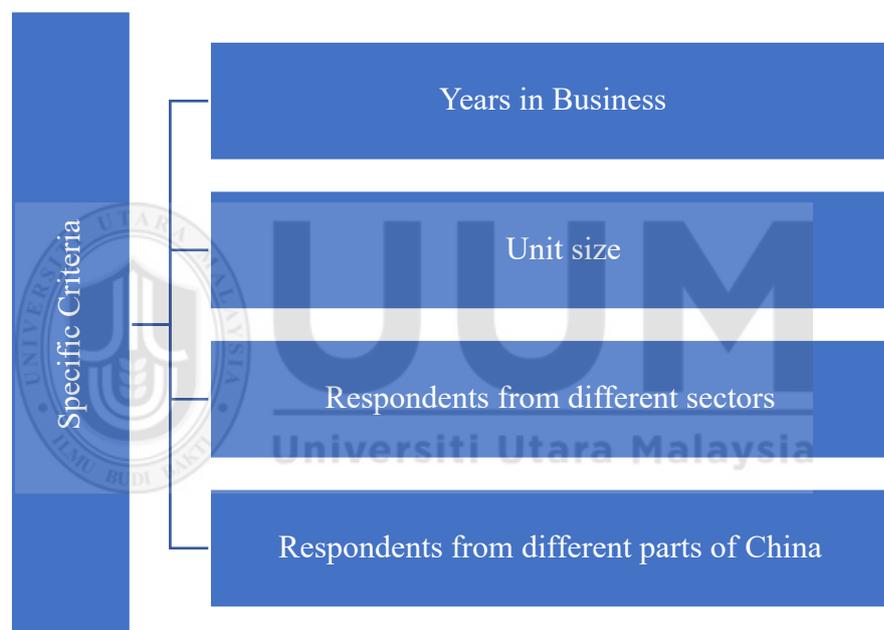


Figure 1.3: Criteria for Respondents Selection

Franchisees and franchisors with more than one year of business experience are selected for their valuable insights. Participants are drawn from both large and smaller franchise networks, ensuring a range of opinions. This study selects franchising sectors

<sup>66</sup> Charles Kakilla, "Strengths and Weaknesses of Semi-Structured Interviews in Qualitative Research: A Critical Essay," *Preprints*, 2021, <https://doi.org/10.20944/preprints202106.0491.v1>.

<sup>67</sup> Alison Doyle, "What Is a Semi-Structured Interview?" *The Balance*, Published on May 24, 2018.

from different parts of China to capture regional differences, as the south has a stronger private economy and market-driven franchising, while the north has more state influence and regulatory oversight. Thirty-three respondents who met the criteria are contacted through the CCFA website, as well as via phone calls and emails.

While efforts were made to interview both franchisors and franchisees from the same brand, three franchisors declined interviews due to concerns about revealing sensitive business information. Considering the long-term relationship, five franchisees were reluctant to participate in the same interview with franchisors. No response from the two MOC officers. Two officers from the local commerce bureau unable to be interviewed due to a heavy workload and scheduling conflicts despite multiple attempts to coordinate.

A total of twenty-one respondents participates in this interview, which is considered to meet reasonable sample size requirements. Green and Thorogood note that "the experience of most qualitative researchers (emphasis added) is that in interview studies little that is 'new' comes out of transcripts after you have interviewed 20 or so people."<sup>68</sup> In this study, a sample size of 21 is sufficient to reach saturation, defined as the point when "no new information or themes are observed in the data," ensuring key insights were captured.<sup>69</sup>

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<sup>68</sup> Mark Mason, "Sample Size and Saturation in PhD Studies Using Qualitative Interviews," *Forum Qualitative Sozialforschung/Forum: Qualitative Social Research* 11, no. 3 (2010).

<sup>69</sup> Greg Guest, Arwen Bunce, and Laura Johnson, "How Many Interviews Are Enough? An Experiment with Data Saturation and Variability," *Field Methods* 18, no. 1 (2006): 59.

Table 1.1  
*Profile of the Respondents*

No	Respondent	Position	Location	Unit Size	Sector	Brand	Years
1	R1	Potential Franchisee	Online	Small	Nil	Nil	Nil
2	R2	Potential Franchisee	Physical at the office	Small	Nil	Nil	Nil
3	R3	Potential Franchisee	Online	Small	Nil	Nil	Nil
4	R4	Potential Franchisee	Physical at the office	Small	Nil	Nil	Nil
5	R5	Potential Franchisee	Physical at the office	Small	Nil	Nil	Nil
6	R6	Franchisee	Physical at the office	Small	Beverage	Brand 1	2 years
7	R7	Franchisee	Physical at the office	Large	Retail	Brand 2	6 years
8	R8	Franchisee	Online	Medium	Hotel	Brand 3	5 years
9	R9	Franchisee	Physical at the office	Small	Retail	Brand 5	2 years
10	R10	Franchisee	Physical at the office	Small	Hotel	Brand 3	2 years
11	R11	Franchisee	Physical at the office	Small	Beverage	Brand 1	3 years
12	R12	Franchisee	Physical at the office	Large	Retail	Brand 2	9 years
13	R13	Franchisor	Physical at the office	Medium	Retail	Brand 4	7 years
14	R14	CCFA (Franchisor)	Online	Large	Hotel	Brand 3	9 years
15	R15	Franchisor	Physical at the office	Medium	Beverage	Brand 1	7 years
16	R16	Franchisor	Physical at the office	Medium	Retail	Brand 5	5 years
17	R17	Lawyer	Physical at the office	Nil	Nil	Nil	Nil
18	R18	Lawyer	Physical at the office	Nil	Nil	Nil	Nil
19	R19	Lawyer	Physical at the office	Nil	Nil	Nil	Nil
20	R20	Regulator	Physical at the office	Nil	Nil	Nil	Nil
21	R21	Regulator	Physical at the office	Nil	Nil	Nil	Nil

**Source:** Researcher

As shown in Table 1.1 above, twenty-one respondents participate in this study, including four franchisors, five potential franchisees, seven franchisees, three lawyers,

and two regulators. For convenience and cost reasons, most respondents in Beijing are interviewed online. The franchisors and franchisees interviewed represent franchise outlets in the beverage, retail, and hotel sectors. Additionally, the selected franchisees and franchisors each have more than one year of business experience. One of the franchisors is a member of the CCFA. Potential franchisees are also included in the interviews, and the researcher interviews lawyers and regulators to gain their perspectives on franchising.

Interviews are conducted between September 2023 and April 2024 using a hybrid format that includes both face-to-face and online sessions. Each interview is limited to 2 hours and begins with a brief introduction to the research. An informed consent form is issued to participants, asking for their permission to conduct the interview. The interviews are conducted in Chinese, with handwritten notes taken for cross-checking purposes. With the consent of the interviewees, the sessions are recorded on mobile phones. The recordings of each interview are transcribed in Chinese and accurately translated into English while strictly adhering to the original Chinese content. To protect privacy, the interviewees are numbered from 1 to 21, and their names are replaced in the transcripts.

### **1.6.5 Data Analysis**

Content analysis is employed to achieve research objective (1) by systematically interpreting and analysing legal documents, policies and industry reports. This process involves analysing China's legal system and the historical development of franchise regulation. This approach identifies key provisions in franchise-related laws and

evaluates their role in franchisee protection, focusing on aspects like information disclosure requirements, registration obligations and contracts.

Thematic analysis is adopted to address research objectives (2) and (4). This method is widely recognized in qualitative research for its ability to identify, analyse and report themes within data sets.<sup>70</sup> The Figure 1.4 below illustrates the process of analysing interview data.

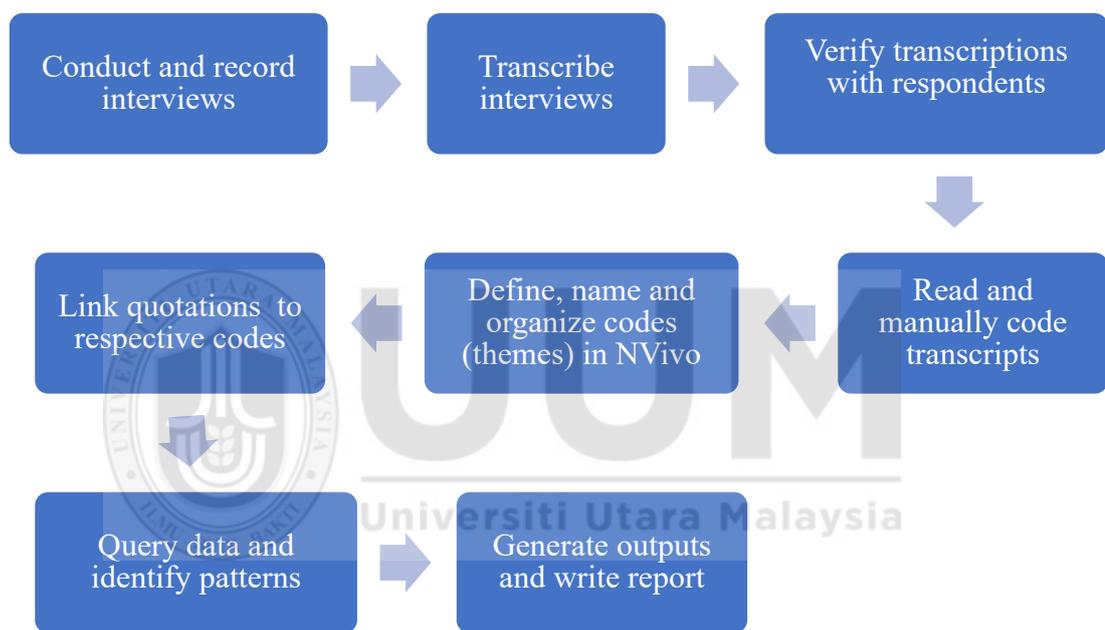


Figure 1.4: Process of Interview Data Analysis

The process involves transcribing interviews into word documents, validating the transcriptions with respondents and manual coding of the transcriptions. Coding is a fundamental step in qualitative data analysis, consisting of open coding (assigning meanings), axial coding (grouping related meanings), and selective coding (labeling themes).<sup>71</sup> In this study, NVivo software is used to define, name, and organize codes

<sup>70</sup> Michelle E. Kiger and Lara Varpio, "Thematic Analysis of Qualitative Data: AMEE Guide No. 131," *Medical Teacher* 42, no. 8 (2020): 846-854, <https://doi.org/10.1080/0142159X.2020.1755030>.

<sup>71</sup> Michael Williams and Tami Moser, "The Art of Coding and Thematic Exploration in Qualitative



Table 1.2  
*Research Questions, Themes and Subthemes*

<b>Research Questions</b>	<b>Themes</b>	<b>Subthemes</b>
How does the current protection protect franchisees in China?	Protection of franchisees	- Disclosure - Registration - Contract
How should China improve its franchising regulation to better protect franchisees?	Recommendations for enhancing franchisee protection	- Clarifying disclosure - Strengthening registration - Enhancing contract fairness

**Source:** Researcher

Based on the identified themes and sub-themes, the researcher critically interprets the significance and implications of the findings concerning franchisee protection in this study. Chapters three and four focus on addressing research question (2) and achieving research objective (2), centered on the first theme: the protection of franchisees. These chapters provide an in-depth analysis of how franchise disclosure, registration, and contracts impact the safeguarding of franchisees. Chapter six addresses research question (4) and achieves the research objective (4), which revolves around the second theme: recommendations for enhancing franchisee protection. This chapter offers targeted suggestions for improving the protection of franchisees in China, with a focus on disclosure, registration, and contractual practices.

To achieve research objective (3), a critical analysis is employed to assess franchisee protection practices in selected jurisdictions. This analysis identifies valuable insights and lessons that can be applied to enhance franchisee protections in China. Additionally, critical analysis contributes to research objective (4) by proposing

recommendations for enhancing franchisee protection in China. By critically examining key provisions such as disclosure, registration, and contract requirements, this approach highlights both strengths and weaknesses in the franchisee protection frameworks.

To ensure the validity and reliability of the research, this study adopts a variety of methods. The validity of the study is achieved by integrating multiple sources, such as legal documents and interview data, and having respondents review transcribed texts. In addition, the researcher uses interview protocols for each interview (see Appendix B) to guide the conduct of the interviews and the wide range of interview questions, keeping the interviews centered around the research topic to ensure reliability.

### **1.7 Limitation of the Study**

The limitations of this research include the difficulty of conducting interviews with a wide range of franchise practitioners across different regions and industries throughout the country. Some data is dispersed among individuals, businesses, and government agencies, making the process of locating, collecting, and compiling information from various sources time-consuming and resource-intensive. This is particularly challenging as most businesses do not make their information publicly available. Moreover, the researcher faced limitations due to the focus on franchisee protection, as not all respondents were willing to fully disclose their experiences, particularly franchisors. Engagement with stakeholders indicated that some participants had limited time to respond to questions, and others were hesitant to share detailed information. It affected the depth of insight into certain aspects of franchise relationships.

In addition, this study focuses on the legal aspects of franchising, while other areas related to franchising can also be explored. The law alone cannot fully address all the challenges faced by franchisees, as franchising is also influenced by economic, cultural, and political factors. Researchers in the fields of politics, sociology, and economics can enhance the depth and persuasiveness of legal analyses by providing insights that consider these broader contexts.

## **1.8 Literature Review**

This section reviews the key aspects of franchising, including operational definitions, franchising laws and regulations, franchise relationships, and international regulatory practices.

### **1.8.1 Operational Definitions**

There are some operational definitions that need to be clarified at the outset, including franchising, franchisors, franchisees, franchising regulation, and franchise information disclosure.

#### **1.8.1.1 Franchising**

Although franchising has experienced more than 100 years of development worldwide, there is not yet a consensus on legislation concept internationally. The meaning of franchising is interpreted differently according to discipline, jurisdiction and the particular application or structure of franchising arrangements in any particular context.<sup>72</sup> The International Franchise Association (hereinafter referred to as "IFA")

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<sup>72</sup> Cristina Ledro, Anna Nosella, and Ilaria Dalla Pozza, "Integration of AI in CRM: Challenges and

defines franchising as a contractual relationship between the franchisor and the franchisee, whereby the franchisor provides know-how and training to ensure the continued profitability of the franchisee, while the franchisee is required to make a substantial investment as capital for the operation.<sup>73</sup> According to the European Franchise Federation, franchising is an ongoing contractual relationship between legally and financially independent subjects (franchisors and individual franchisees) in which the franchisor grants rights and attaches obligations to the franchisee.<sup>74</sup>

In the USA, the definition of franchising varies from state to state. The *Franchise Rule* issued by the FTC defines franchising as a continuing business relationship established by contract and consisting of three elements, namely (1) the sale by the franchisee of goods or services bearing the franchisor's trademarks; (2) significant control or assistance in the franchisee's business; and (3) the payment of franchise fees.<sup>75</sup> Whereas there is no uniformity in state franchise laws in the U.S., most states, such as California and Indiana, consider franchising to be a contractual relationship that encompasses a marketing plan.

In Australia, the *Franchising Code*, which came into effect in 2015, defines franchising as a business model where the franchisor, through a contract, retains control over the business system while granting the franchisee the right to operate the

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Guidelines," *Journal of Open Innovation: Technology, Market, and Complexity* 9, no. 4 (2023): 100151.

<sup>73</sup> Suzana Baresa, Zoran Ivanovic, and Sinisa Bogdan, "Franchise Business as a Generator of Development in Central Europe," *UTMS Journal of Economics* 8, no. 3 (2017): 283.

<sup>74</sup> Odavia Bueno Díaz, *Franchising in European Contract Law: A Comparison Between the Main Obligations of the Contracting Parties in the Principles of European Law on Commercial Agency, Franchise and Distribution Contracts, French and Spanish Law* (Sellier de Gruyter, 2008), <https://doi.org/10.1515/9783866537026>.

<sup>75</sup> Honey V. Gandhi, "Franchising in the United States," *Law & Business Review of the Americas* 20, no. 1 (2014): 4, <https://scholar.smu.edu/lbra/vol20/iss1/2>.

franchise.<sup>76</sup> In Malaysia, the *Franchise Act 1998* considers franchising to be a contract between two or more persons that is agreed upon orally or in writing, expressly or impliedly, and consists of the following elements: (1) the franchisor's granting to the franchisee of the uniform use of trademarks, trade secrets, any confidential information, or intellectual property rights owned by the franchisor or associated with the franchisor; (2) the franchisor's continuing control and (3) the payment of a consideration for the right to franchise.<sup>77</sup>

In China, franchising is defined as a business model in which an enterprise (the franchisor) with registered trademarks, proprietary technology, patents, and other operational resources grants the rights to use these assets to another party (the franchisee) through a contractual agreement. The franchisee operates under a standardized and unified business model prescribed by the franchisor, ensuring consistency across the franchise system.<sup>78</sup>

Through the comparison of the definitions of franchising in the above representative countries or organizations, they have the same characteristics. First, there is a general preference for defining franchising as a relationship of rights and obligations based on a franchise contract. Second, the franchisor has formed a set of business model system with trademark, trade name, proprietary technology, trade secret and other intellectual property resources. Third, the franchise relationship is a continuous relationship, under which the franchisor and the franchisee have a two-way obligation relationship. The

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<sup>76</sup> Elizabeth Crawford Spencer, "An Exploration of the Legal Meaning of Franchising," *Journal of Marketing Channels* 20, no. 1-2 (2013): 28, <https://doi.org/10.1080/1046669X.2013.747858>.

<sup>77</sup> Mohd Amy Azhar Harif, "A New Paradigm of Franchise Definition: Franchising vs. Licensing," accessed September 15, 2023, <https://repo.uum.edu.my/id/eprint/83/1/amyazhar1.pdf>.

<sup>78</sup> *CFAR 2007*, art.3.

franchisee has the obligation to pay the franchise fees and to ensure the quality of products or services. The franchisor has the obligation to provide training, continuous support, and assistance to the franchisee. This study argues that franchising is a relationship of rights and obligations between a franchisor and a franchisee through a contract in which the franchisor grants a franchise and the franchisee pays a consideration.

### 1.8.1.2 Franchisee

A franchisee is a natural person or a business that is granted the right to use the business resources owned by the franchisor. The IFA defines a franchisee as an entity that pays royalties and franchise fees to operate under the franchisor's name and system.<sup>79</sup> The *FTC Franchise Rule* defines a franchisee as an individual who operates a franchised business with substantial control or support from the franchisor and pays royalties.<sup>80</sup> The *Investment Law* defines a franchisee as a person engaged in the business of furnishing, selling, or distributing goods or services under a franchisor's marketing program for which a franchise fee is paid directly or indirectly.<sup>81</sup> The *CFAR 2007* defines a franchisee as a person who is granted the right to use the franchisor's business resources to operate under the unified model and pay the corresponding consideration.<sup>82</sup> For the purposes of this study, a franchisee is a party to a contract who is granted the franchisor's business resources to operate in a uniform manner and pay a franchise fee.

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<sup>79</sup> Radwa Elsaman, "Franchising Law in the United States Between Theory and Practice: Heads Up for Foreign Investors," *Touro Law Review* 31, no. 1 (2024): 24.

<sup>80</sup> Honey V. Gandhi, "Franchising in the United States," *Law & Business Review of the Americas* 20, no. 1 (2014): 4, <https://scholar.smu.edu/lbra/vol20/iss1/2>.

<sup>81</sup> *California Franchise Investment Law*, Section 31005.

<sup>82</sup> *CFAR 2007*, Art. 2.

### 1.8.1.3 Franchisor

Franchisor refers to a natural person or an enterprise that grants its own patents, trademarks, trade names, business models, proprietary technologies, and other business resources to franchisees to operate. The IFA states that the franchisor is the party that grants the trademark, trade name and business system.<sup>83</sup> In Australia, a franchisor is considered to be the party that grants a franchisee the uniform use of its trademarks, advertising or logos under its franchise system or marketing plan.<sup>84</sup> But not any natural person or business could be able to become a franchisor. To prevent the risk of franchising, the government usually restricts the qualifications of the franchisor. Compared with individuals, enterprises have a stronger ability to resist risks because they have business premises and registered capital.<sup>85</sup> In China, *CFAR 2007* requires that the franchisor must be a corporation and have two or more directly operated stores that have been in business for at least one year.<sup>86</sup> In this study, the franchisor is the party to the contract that owns the franchise resources and provides guidance and training to the franchisee.

### 1.8.1.4 Franchising Regulation

Regulation entails the governance and oversight of activities through a structured framework of rules, designed to ensure proper functioning and compliance within a given system.<sup>87</sup> Traditionally, the term encompasses both the regulatory frameworks that oversee business operations and the mechanisms for their enforcement. In the

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<sup>83</sup> Radwa Elsaman, "Franchising Law in the United States Between Theory and Practice: Heads Up for Foreign Investors," *Touro Law Review* 31, no. 1 (2024): 24

<sup>84</sup> *Competition and Consumer (Industry Codes—Franchising) Regulations 2024*. Preliminary, Part 2, Section 6.

<sup>85</sup> Elizabeth Crawford Spencer, "An Exploration of the Legal Meaning of Franchising," *Journal of Marketing Channels* 20, no. 1-2 (2013): 28, <https://doi.org/10.1080/1046669X.2013.747858>.

<sup>86</sup> *CFAR 2007*, Art.7.

<sup>87</sup> Robert Baldwin, Martin Cave, and Martin Lodge, *Understanding Regulation: Theory, Strategy, and Practice* (Oxford University Press, 2011).

context of this study, franchising regulation specifically refers to the comprehensive legal and regulatory structures—including statutes, regulations, judicial precedents, and contractual agreements—that govern the administration and oversight of franchising activities.

The debate over the regulation of the franchise sector in China highlights two contrasting viewpoints: proponents of weak regulation and advocates for strong regulation.<sup>88</sup> Supporters of weak regulation argue that excessive administrative interference can stifle the growth and innovation within the franchise sector. They emphasize the civil rights of individuals and businesses to engage freely in franchise activities without overbearing regulatory constraints.<sup>89</sup> Advocates of this perspective also believe that China can benefit from the advanced management practices and supervisory frameworks established in other countries, suggesting that a thoughtful adaptation of these systems could foster a more flexible and efficient regulatory environment.<sup>90</sup>

On the other hand, opponents of weak regulation advocate for a more stringent approach, citing the unique characteristics and challenges of China's commercial franchise market, which they view as still developing and somewhat immature. They argue that while it may be beneficial to learn from international practices, China's local context should play a crucial role in shaping regulation.<sup>91</sup> This group insists that enacting strong legislation is necessary to ensure the market's healthy development,

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<sup>88</sup> Xiaosong Hu, *Introduction to Franchising* (Beijing: China Renmin University Press, 2011).

<sup>89</sup> Ping Jiang, *Civil Law* (Beijing: China University of Political Science and Law Press, 2007).

<sup>90</sup> Jun Wang and Lin Xie, *Selection of Commercial Franchise Law Cases in the United States* (University of International Business Press, 2007).

<sup>91</sup> Jianwei Li, "Comparative Analysis of Franchise Information Disclosure System," *Guangdong Social Sciences* 9, no. 6 (2011): 216.

protect franchisees, and prevent potential exploitative practices that could arise in a less regulated environment.<sup>92</sup>

In this research, the franchising regulation in China is conceptualized through two models. One is the model of statutory regulation in the field of public law, which can be implemented through specialized franchising legislation or broader contract law frameworks.<sup>93</sup> The other is the model of contractual regulation in the field of private law, where franchisors and franchisees are free to pursue their respective economic interests and assume their own risks through contractual provisions. Contractual regulation provides the most direct and minimum protection for franchisees.<sup>94</sup> However, this research does not prescribe a uniform structure for franchise law. Governments may introduce it through administrative regulations or integrate it into *Civil Code* as a specialized section within contract law that governs franchise agreements.

#### **1.8.1.5 Franchise Information Disclosure**

Generally, disclosure refers to the disclosure of information held by a dominant party to investors on the ground of mandatory legal requirements or contractual agreements, or on a voluntarily basis. Information disclosure enables investors to make investment judgments based on adequate and truthful information.<sup>95</sup> Information disclosure originated from the US securities market, which refers to the behavior of the relevant

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<sup>92</sup> Yi He, *Franchise Legal Issues Research Judicial Practice Intensive Series* (China Founder Society, 2004).

<sup>93</sup> Jiansheng Feng, "The Notoriety of Commercial Franchise Contracts from the Perspective of Civil Code Compilation," *Law and Business Studies* 36, no. 4 (2019): 14.

<sup>94</sup> Elizabeth Crawford Spencer, *The Regulation of Franchising in the New Global Economy* (Edward Elgar Publishing, 2010).

<sup>95</sup> Frank H. Easterbrook and Daniel R. Fischel, "Mandatory Disclosure and the Protection of Investors," *Virginia Law Review* (1984): 669-715.

parties in the securities market to publicly disclose the security-related information to investors and the public in accordance with relevant regulations during a series of processes such as securities issuance, listing, and trading.<sup>96</sup> One of the fundamental trends in franchising legislation across various countries is the adoption of information disclosure systems modeled after those in securities law.<sup>97</sup>

In this study, franchise information disclosure refers to the system that franchisors need to provide legal information to investors or franchisees in a timely, complete, and accurate manner before the signing of the franchise contract and during the performance of the contract. For example, franchisors are required to disclose information about the franchisor and its ownership of operating resources, franchise fees, provision of products and services to franchisees, as well as guidance and supervision, financials, records of violations, and a sample franchise contract.

### **1.8.2 The Laws and Regulations of Franchising in China**

In China, a clear understanding of the laws and regulations governing franchising is essential for both franchisors and franchisees. As a contractual relationship, franchising falls under the *Civil Code*, which governs all civil matters, including franchise contracts. Additionally, a key feature of franchising in China is its strong administrative regulation, such as *CFAR 2007*.<sup>98</sup>

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<sup>96</sup> Zhongjun Zhang, *Legal System of Listed Companies* (Law Press, 2000).

<sup>97</sup> Chaoyang Xiao, *Franchising Law Practice* (Beijing: CITIC Press, 2002).

<sup>98</sup> Fen Zhou and Jiangang Zhang, "Research on Legislative Policy Issues of Franchising: A Case Study of European Union Experience," *Journal of Central University of Finance and Economics* 12 (2015): 32.

### 1.8.2.1 Underlying Laws of General Application

Under the civil contract regulation, there are general law rules that can be interpreted and applied. As in other civil law countries, *Civil Code* sets out general guidelines for all civil relationships, including franchise relationships.<sup>99</sup> The contract law within *Civil Code* governs the formation, validity, performance, and termination of contracts, including franchise agreements. It requires the parties to contracts (including franchise contracts) to abide by the principles of fairness, voluntariness, and good faith. Remedies for breach of contract are provided, including damages and the right to demand performance or termination of the contract.<sup>100</sup>

The *Civil Code* also provides for tort liability provisions that can be applied to franchise relationships where damage is caused by negligence, violation of rights or unfair competition. It provides a legal basis for the franchisee to seek compensation for losses caused by the franchisor's acts or omissions. However, under this regulation model, franchisors abuse their rights by using the principle of freedom of contract and the dominant position, which leads to the failure of contract regulation to play its effective role.<sup>101</sup> In civil law countries, national laws should be interpreted as universal laws that should always be followed.<sup>102</sup>

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<sup>99</sup> Tiantian Zhai and Yen-Chiang Chang, "The Contribution of China's Civil Law to Sustainable Development: Progress and Prospects," *Sustainability* 11, no. 1 (2019): 294.

<sup>100</sup> Anthony T. Kronman, "Contract Law and Distributive Justice," *Yale Law Journal* 89 (1979): 472.

<sup>101</sup> To implement and enforce national laws, the State Council and its departments have the right to make regulations and rules on administrative matters or business areas at all levels of government supervision and management.

<sup>102</sup> Farnsworth, E. Allan, "Duties of Good Faith and Fair Dealing under the UNIDROIT Principles, Relevant International Conventions, and National Laws," *Tulane Journal of International & Comparative Law* 3 (1995): 47.

### 1.8.2.2 Franchise-Specific Regulation

More practical guidance can be found in administrative regulations and local regulations. *CFAR 2007* is widely considered as the most important regulatory legal document regulating franchise management activities in China.<sup>103</sup> It consists of thirty-four articles and is divided into five chapters, namely, General Provisions, Commercial Franchising Activities, Information Disclosure, Legal Liability and By-laws. It provides for a franchisor registration system, a cooling-off period system, information disclosure obligation and enhanced franchisor liability, and these provisions have, to a certain extent, strengthened the legal protection of franchisees.<sup>104</sup> In addition, two measures *CFIDAM 2012* and *CFRAM 2011* supplemented the franchise information disclosure requirements and franchise registration requirements. Both the regulations and measures stipulated that the franchisor who violates the franchise-specific regulations shall bear administrative responsibility, including being ordered to correct the violation and facing fines.<sup>105</sup>

The most notable feature is the information disclosure system aimed at making up for the information asymmetry between franchisors and franchisees. The information disclosure system is an important initiative of *CFAR 2007* in franchising regulation. It imposes disclosure obligations on franchisors to correct the information asymmetry in

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<sup>103</sup> Anne Marie Doherty, Xiaomin Chen, and Nicholas Alexander, "The Franchise Relationship in China: Agency and Institutional Theory Perspectives," *European Journal of Marketing* 48, no. 9/10 (2014): 1664-1689.

<sup>104</sup> The Legal Affairs Office and the Ministry of Commerce, "The Legal Affairs Office and the MOC Answer Questions on the Regulations on Commercial Franchise Management," last modified February 15, 2007, [http://www.gov.cn/zwhd/2007-02/15/content\\_528054.htm](http://www.gov.cn/zwhd/2007-02/15/content_528054.htm). Last accessed January 1, 2023.

<sup>105</sup> Article 28 of the *CFAR 2007* stipulates that where the franchisor violates the provisions of Articles 21 and 23, the competent commercial authority shall order correction and impose a fine of 10,000 to 50,000 yuan; If the circumstances are serious, a fine of 50,000 to 100,000 yuan shall be imposed, and a public announcement shall be made.

franchise relationships. Information disclosure system has become the main mode of franchise legislation in the world. In some countries, such as the USA, franchise law is considered a disclosure law.<sup>106</sup> Franchisees often face challenges due to their weaker position in information acquisition, making it difficult to understand and screen critical information. The information disclosure system aims to stop franchisors from taking advantage of their power to harm franchisees.<sup>107</sup>

*CFAR 2007* places information disclosure as the key to regulate commercial franchising activities, with a special chapter on Information Disclosure, which contains four articles, providing detailed provisions on the time limit, manner, and content of information disclosure. Franchise information disclosure system is a risk prevention mechanism to prevent franchise fraud and protect investors. Most of the national legal systems compel franchisors to fulfill their pre-contract information disclosure obligations. The information disclosure regulatory model is commonly used as a main regulatory tool in many countries, including Australia, the USA, Belgium, Brazil, Canada, France, Italy, Malaysia, Vietnam, Japan, Korea, Sweden and seventeen other countries.<sup>108</sup> It mandates franchisors to provide franchisees with information, enabling them to make informed investment decisions, particularly regarding potential risks.<sup>109</sup>

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<sup>106</sup> Lena Peters, "Franchising: Recent Legislation and the UNIDROIT Model Franchise Disclosure Law," *Business Law International* 5 (2004): 33.

<sup>107</sup> Eric H. Karp and Ari N. Stern, "A Proposal for A Mandatory Summary Franchise Disclosure Document," *Franchise Law Journal* 35, no. 4 (2016): 541.

<sup>108</sup> Elizabeth Crawford Spencer, "Effective Disclosure in the Regulation of Franchising," (paper presented at the 22nd Annual International Society of Franchising Conference, Saint-Malo, Brittany, France, June 2008), [http://epublications.bond.edu.au/law\\_pubs/249](http://epublications.bond.edu.au/law_pubs/249).

<sup>109</sup> UNIDRIOT. *Model Franchise Disclosure Law*. 2002. Accessed July 20, 2023, <https://www.unidroit.org/instruments/franchising/model-law>.

Notably, 90% of franchise disputes globally stem from claims of incorrect or incomplete information disclosure.<sup>110</sup> In judicial practice, even if the people's court recognizes the plight of the franchisee, it is difficult to effectively intervene through the existing franchise regulation, and can only reduce the loss of the franchisee by termination of the contract.<sup>111</sup> In the case of *Youmi Company (Franchisor) v. Sheng (Franchisee)*, Franchisor claimed that the company uses milk sources from New Zealand and Australia to ensure the healthy nutrition of rice yogurt with the best quality lactic acid bacteria. However, the raw material of its yogurt is a solid protein drink produced locally, which is obviously inconsistent with the publicity information. Since raw materials are a key factor in guaranteeing the quality of the yogurt, the Shanghai Court therefore found that the Franchisor constituted a breach of franchise agreement and awarded the termination of the franchise agreement.<sup>112</sup>

As for the violation of information disclosure by the franchisor, it mainly includes inadequate information disclosure and false information disclosure.<sup>113</sup> Inadequate information disclosure happens when the franchisor fails to provide complete information to the franchisee. This means the disclosed information does not meet the required level of comprehensiveness. False information disclosure means that the information disclosed by the franchisor is inconsistent with the reality, which misleads the investment decision of the franchisee.

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<sup>110</sup> Lena Peters, "Franchising: Recent Legislation and the UNIDROIT Model Franchise Disclosure Law," *Business Law International* 5 (2004): 33.

<sup>111</sup> Dan Mou, Li Han, Du Zhihui, Wang Jing, "Trial Practice of Franchise Contract Disputes involving Rapid Brand Expansion." *People's Justice* No. 10, (2022).

<sup>112</sup> Shanghai Intermediate People's Court. Civil Final Judgment No.327, 2022.

<sup>113</sup> David Hirshleifer and Siew Hong Teoh, "Limited Attention, Information Disclosure, and Financial Reporting," *Journal of Accounting and Economics* 36, no. 1-3 (2003): 337-386.

To make matters worse, the franchisor committed fraud. These disputes brought about by the false information disclosure of the franchisor are mainly concentrated in the advertising, such as exaggerating the profit income and fabricating the trademark registration information.<sup>114</sup>

### 1.8.3 Franchise Relationships under the Private Law

Franchising fundamentally represents a contractual relationship governed by private law. In this relationship, both the franchisor and the franchisee are considered equal civil subjects under private law, each with independent liabilities.<sup>115</sup> However, the unique nature of the franchise system often places the franchisee in a subordinate position, making them vulnerable to control and exploitation by the franchisor.<sup>116</sup> At present, the research on franchising has gradually paid attention to the problem of imbalance of franchise relationships and the weak position of franchisees. This imbalance arises from the disparity in economic status and the franchisor's significant control over the contract's terms, which exacerbates the inherent inequality between the two parties.<sup>117</sup> It is necessary to protect the vulnerable franchisees to realize the true fairness of the contract.

Franchise agreements are not explicitly categorized as standard contract types under the *Civil Code*. Therefore, the general principles of contract law govern these agreements, and provisions for specific types of contracts may be applied analogously

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<sup>114</sup> Beijing Haidian District Court, *White Paper on Trial of Franchise Contract Dispute Cases 2013-2019*, (2019).

<sup>115</sup> Jenny Buchan and Gehan Gunasekara, "Administrative Law Parallels with Private Law Concepts: Unconscionable Conduct, Good Faith and Fairness in Franchise Relationships," *Adelaide Law Review* 36, no. 2 (2015): 541-575.

<sup>116</sup> Frank J. Cavico, "The Covenant of Good Faith and Fair Dealing in the Franchise Business Relationship," *Barry Law Review* 6 (2006): 61.

<sup>117</sup> Olufunmilola Lola Dada and Winfred I. Onyas, "Negotiating Agency in Mitigating Franchisee Failure: A Critical Discourse Analysis," *Industrial Marketing Management* 98 (2021): 1-16.

when relevant. Although the *CFAR 2007* includes specific stipulations regarding franchise contract performance, these are fundamentally grounded in the principle that franchisors must operate in good faith and adhere to fair dealing standards in their commercial activities.<sup>118</sup>

In a franchise system, franchisees utilize the franchisor's trademarks, patents, or proprietary technology to operate their businesses. However, in their pursuit of maximizing profits, franchisees may sometimes compromise on the quality of products or services, which can undermine the integrity of the entire franchise system.<sup>119</sup> Consequently, it is essential for franchisors to implement effective supervision and management of franchisee operations. A significant issue arises when franchisors' control over franchisees becomes excessive or unreasonable. For instance, in the food industry, franchisors may require franchisees to purchase products or raw materials exclusively from them at prices that exceed market rates.<sup>120</sup> This form of control can adversely impact the franchisee's profitability and generate friction within the franchise system. Effective oversight must therefore balance maintaining high-quality standards with avoiding unfair or exploitative practices.<sup>121</sup>

In franchising, standard form contracts are commonly used to streamline the process and reduce costs. Franchisors typically prepare these contracts in advance, which helps manage multiple franchisees efficiently. However, because these contracts are created

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<sup>118</sup> Qiang Han, "Responsibility Sharing and Risk Prevention in Franchising," *Law* 6 (2002): 54-58.

<sup>119</sup> Scott Weaven, Lorelle Frazer, and Jeff Giddings, "New Perspectives on the Causes of Franchising Conflict in Australia," *Asia Pacific Journal of Marketing and Logistics* 22, no. 2 (2010): 135-155.

<sup>120</sup> Xueqing Ren, "Analysis on the Basic Legal Issues of Franchising," *Law Forum* 17, no.4 (2002): 56.

<sup>121</sup> Lorelle Frazer, Scott Weaven, and Jeff Giddings, "What Went Wrong? Franchisors and Franchisees Disclose the Causes of Conflict in Franchising," *Qualitative Market Research: An International Journal* 15, no. 1 (2012): 87-101.

by the franchisor and are not usually subject to extensive negotiation, they tend to favor the franchisor's interests. Franchisees often face detailed and onerous obligations, with minimal and vague requirements imposed on the franchisor.<sup>122</sup> This can lead to an imbalance in the contractual relationship, where the franchisee's needs may not be adequately addressed.<sup>123</sup> Moreover, the franchisee needs the franchisor to provide ongoing business guidance, thus forming a dependent relationship on the franchisor. It is the franchisee's dependence on the franchisor that makes the franchisee bear specific obligations to the franchisor.<sup>124</sup> Therefore, the franchisee becomes the weak ones in fact, facing the unequal standard terms, they can only choose to accept or leave.

#### 1.8.4 Overview of Franchise Regulation in Selected Jurisdictions

The importance of legal protection for franchisees has been valued by the legislation of various countries. The legal framework for franchising of the USA is divided into two levels of legal jurisdiction: individual state and federal laws. The FTC develops and reviews the regulations that guide the franchise industry in the federal level, such as disclosure requirements and prohibitions regarding franchising. The *Franchise Rule 1978*, issued by the FTC, was designed to prevent fraud and protect potential franchisees by imposing disclosure obligations on franchisors.<sup>125</sup>

Moreover, the *Relations Act* in individual states sets out the requirements relating to the relationship such as termination, non-renewal, and transfer of a franchise between

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<sup>122</sup> John Stanworth, "The Franchise Relationship: Entrepreneurship or Dependence?" *Journal of Marketing Channels* 4, no. 1-2 (1995): 161-176.

<sup>123</sup> Paul H. Rubin, *The Theory of the Firm and the Structure of the Franchise Contract* (Franchising; Routledge, 2014), 49-59.

<sup>124</sup> Retno Wulandari, "Legal Protection of Franchisee in Franchise Contract which Franchisor Unilaterally Terminates," *NORMA* 18, no. 1 (2021): 1-15.

<sup>125</sup> Federal Trade Commission, *Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures*, 16 C.F.R. Part 436.

a franchisor, a sub-franchisor, and a franchisee.<sup>126</sup> In addition, franchise associations in the USA also play a role, and the IFA outlines a clearly defined code of ethics that governs franchise practices and relationships in the USA.<sup>127</sup>

In Australia, the regulatory environment has been widely supported by participants in the franchising industry, who consider it a successful model for franchise sector regulation.<sup>128</sup> The *Franchising Code of Conduct* 1998 is the general law that governs the franchise industry in Australia. The primary government agency that enforces the franchise regulations is the Australian Competition and Consumer Commission (hereinafter referred to as "ACCC").<sup>129</sup> The *Franchising Code of Conduct*, much like the *FTC Franchise Rule* in the USA, is biased in favor of protecting franchisees by regulating disclosure, franchise agreements, and dispute resolution. It was developed to address the realities of information asymmetry and power asymmetry between franchisors and franchisees, providing for a compulsory information disclosure system, a cooling-off period system and a compulsory mediation system.<sup>130</sup>

Currently, business franchising in emerging markets is growing rapidly. Both Malaysia and China are classified as emerging economies.<sup>131</sup> Malaysia was chosen as one of the best practices to find a legal system that adapts to China's growing franchise

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<sup>126</sup> Megan Woods, Elizabeth A. Houghton, and Michael J. Shadbolt, "Advancing Qualitative Research Using Qualitative Data Analysis Software (QDAS): Reviewing Potential Versus Practice in Published Studies Using ATLAS.ti and NVivo, 1994–2013," *Social Science Computer Review* 34, no. 5 (2016): 597-617.

<sup>127</sup> Gary R. Batenhorst, "Breaking Up is Hard to Do: Challenges and Opportunities in Franchisor Buyback Rights and Obligations," *Franchise Law Journal* 30 (2010): 97-112.

<sup>128</sup> Franchising Policy Council, *Review of the Franchising Code of Conduct* (Canberra: May 2000).

<sup>129</sup> Adams ADEIZA, "Franchising Practices in Selected Markets around the World: A Review," *The Korean Journal of Franchise Management* 10, no. 2 (2019): 7-18.

<sup>130</sup> Gordon Morris Bakken and Brenda Farrington, *The Gendered West: The American West* (Routledge, 2013).

<sup>131</sup> Aliyu Yelwa Haruna and Govindan Marthandan, "Foundational Competencies for Enhancing Work Engagement in SMEs Malaysia," *Journal of Workplace Learning* 29, no. 3 (2017): 165-184.

industry. Malaysia has specially formulated the *Franchise Act* 1998, and has made detailed provisions on franchisors, franchisees, franchise business and other contents.<sup>132</sup> Compared with China, Malaysia's *Franchise Act* 1998 have stricter regulations and higher standards for franchisees and franchisors. It addresses issues such as the definition of franchising, registration of franchises, disclosure of information, termination of agreements, and penalties.

While there are some differences in the practice of business models in these countries, they also have some commonalities. Franchising laws these countries clearly provide for the protection of franchisees' interests such as protecting franchisees from unfair practices, discrimination, information imbalances and power imbalances. The advanced practices of these countries can be used to improve the franchisee protection in China.

In conclusion, previous studies often highlight the information disclosure system and franchise relationships, noting the dominant position of franchisors. The practices of setting pre-contract information disclosure obligations for franchisors is widely adopted in franchising regulation globally.

However, despite the many insights provided by the previous studies, there are still significant research gaps. Previous studies have mainly focused on franchisor perspective, with limited attention to franchisee protection. The research findings in the past focused on the theoretical discussion of franchise legal system, and further empirical work is needed. Moreover, the research on franchise contract has not fully

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<sup>132</sup> Mark Abell, ed., *The Franchise Law Review* (Law Business Research, 2014).

discussed its actual impact on franchisees' rights, leaving a gap in understanding how contractual practices affect franchisee protection. In addition, while international regulatory frameworks provide important references, the application of these findings to improve franchisee protection in specific contexts, such as China, remains inadequate.

Therefore, this study addresses these gaps by evaluating the current legal and regulatory framework of franchising, examining contractual practices, and drawing on international regulatory experiences for China. It integrates empirical data to propose actionable recommendations for better protecting franchisees' interests.

### **1.9 Outline of Chapters**

Chapter one lays a foundation for the whole research. In this regard, the researcher will discuss the introductory content of this doctoral thesis, such as the background of this study, problem statement, research questions, research objectives, research methodology, limitations, literature review, etc.

Chapter two addresses the first research question and fulfills the first research objective by exploring the regulation of franchising in China. It provides an examination of the regulatory framework for franchising in China, detailing its historical development through distinct stages from the pre-1997 era to the current administrative regulations. This chapter analyses the legal system of China, relevant laws of franchising and the unique elements of franchising, distinguishing it from similar business concepts. Furthermore, the regulatory framework in China is outlined, covering essential aspects such as disclosure requirements, franchisor registration, and franchise contracts. This

chapter concludes with a discussion of the theories relevant to franchising, including both economic and legal perspectives.

Chapter three addresses the second research question and achieves the second research objective by conducting a detailed analysis of franchisee protection under the franchising legal and regulatory framework in China. It provides a comprehensive analysis of the franchisee protection in China. It explores the disclosure approach as a critical regulatory tool for protecting franchisees, addressing issues such as the obligations of franchisors, the timing and content of disclosures, and the consequences of non-compliance. Additionally, the chapter introduces the registration approach, clarifying its purpose and compliance requirements. Finally, analyses various franchise agreements and outlines the contractual requirements under the *CFAR 2007* and *Civil Code*. Key legislative documents, including the *CFAR 2007*, the *CFRAM 2011*, the *CFIDAM 2012* and relevant provisions of the *Civil Code*, are critically reviewed to assess their role in safeguarding franchisee rights. Moreover, this chapter incorporates a thematic analysis of interview data to explore stakeholders' perspectives on the current franchising regulation and its role in franchisee protection.

Chapter four addresses the second research question and fulfills the second research objective by examining the current implementation of franchisee protection within the contractual practice. This chapter explores the benefits and risks of franchising for franchisee. The contractual environment is analysed with a focus on critical elements, including obligations, the granting of rights, contract terms, renewal, transfer, termination, and restriction clauses. The dispute resolution mechanism is also analysed, highlighting the advantages of alternative dispute resolution mechanisms compared to

traditional litigation. Additionally, interview data and real contracts are analysed to identify existing problems in protecting franchisees within the contractual practice.

Chapter five addresses the third research question and achieves the third research objective by conducting a critical analysis of franchising regulations in three selected jurisdictions: the USA, Australia and Malaysia. The aim is to identify the international practices that can be referenced to improve franchisee protection in China. The chapter focuses on key regulatory elements, including disclosure requirements, registration processes and contractual practices. By examining how these aspects are handled in these jurisdictions, this chapter highlights effective approaches and regulatory mechanisms that could inform potential reforms in China's franchising regulation.

Chapter six addresses the fourth research question and achieves the fourth research objective by presenting targeted recommendations aimed at improving China's franchising legal and regulatory framework, specifically in the areas of disclosure, registration, and contract governance. These recommendations are designed to enhance the protection of franchisees by clarifying the disclosure requirements, strengthening the registration enforcement and enhancing more equitable contractual terms between franchisors and franchisees. Furthermore, this chapter summarizes the key findings of the entire study and discusses potential areas for further research.

## **CHAPTER TWO**

### **LEGAL AND REGULATORY FRAMEWORK FOR FRANCHISING IN CHINA**

#### **2.1 Introduction**

This chapter aims to provide an examination of the legal and regulatory framework governing franchising in China, addressing the first research question and achieving the first research objective of this study. It begins by exploring the structure of China's legal system, including its state structure, legislative system, and dispute resolution mechanisms. This chapter proceeds to trace the historical development of franchise regulation in China, beginning with the initial recognition of the legitimacy of franchising in 1997 and advancing to the current state of administrative regulation. Next, this chapter introduces the essential elements of the franchise business model within the context of China's legal framework. Key characteristics, classifications, and distinctions from other business models are discussed in detail.

Furthermore, this chapter focuses on China's specific regulation mechanisms for franchising, with particular attention to the provisions set forth in the *CFAR 2007* and the Civil Code. These provisions include mandatory disclosure, franchise registration requirements and regulation of franchise contracts. Finally, this chapter integrates insights from both legal and economic theory, exploring how these theories influence the current regulatory landscape of franchising in China.

## 2.2 The Contemporary Chinese Legal System

### 2.2.1 The State Structure

The structure of the state is a fundamental component of its political and legal system. In modern nations, there are two primary state structures: unitary and federal. A unitary system organizes multiple administrative or autonomous regions under a single sovereign authority, while federalism forms a composite state from multiple political entities, such as states or regions, each retaining certain powers.<sup>133</sup> China, as stipulated in its *Constitution*, is a unitary state. The main characteristic of this structure is the existence of a single constitution and a centralized system of authority.

In modern state systems, power is distributed among the legislative, executive, and judicial branches, each assigned to the respective legislative, executive, and judicial bodies. These three entities operate independently, establishing a system of checks and balances through the separation of powers.<sup>134</sup> Importantly, the system in China establishes an independent power structure among administrative organs, legislative bodies, supervisory organs, judicial authorities, prosecutorial agencies, and military institutions. This arrangement essentially reflects a division of responsibilities under the unified leadership of the Communist Party, rather than a separation of powers.<sup>135</sup> According to the *Constitution*, the central structure includes key institutions as illustrated in Figure 2.1 below.

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<sup>133</sup> Ma Gongcheng, *Constitutional Law* (Beijing: Higher Education Press and People's Press, 2011), 120–122.

<sup>134</sup> Ronald J. Krotoszynski, "The Separation of Legislative and Executive Powers," in *Handbook of Research on Comparative Constitutional Law*, ed. Thomas Ginsburg and Rosalind Dixon (Cheltenham, UK: Edward Elgar Publishing, 2011), 234–253.

<sup>135</sup> Zhipeng, Lu and Guoquan Chen. "The Dual Role of the Contemporary Chinese Government: Administrative Organ or Executive Organ?" *Comparative Economic and Social Systems* 2023, no. 6 (2023): 121-129.

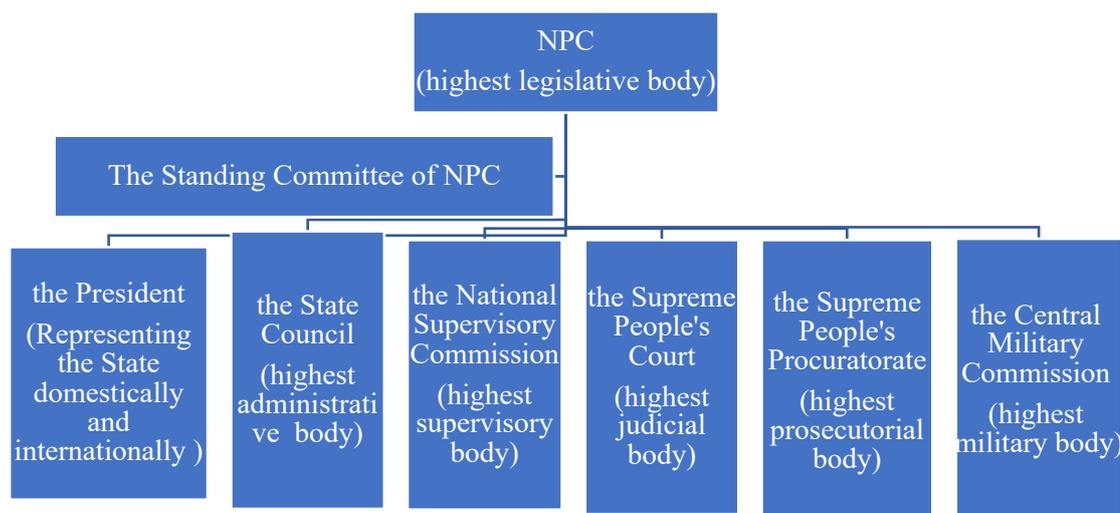


Figure 2.1: The Central State Structure

### 2.2.1.1 NPC

The NPC is China's highest state power organ and its main legislative body.<sup>136</sup> The Standing Committee of the NPC, serves as its permanent institution and exercises certain functions during the recesses of the NPC. In 1954, the First NPC adopted the *Constitution*, formally establishing the Congress system as the nation's core political framework. The *Constitution* establishes that all state power belongs to the people.<sup>137</sup> The NPC holds the highest organ of state power because it exercises state authority on behalf of the sovereign people. This supreme position is ensured through democratic election procedures.<sup>138</sup>

<sup>136</sup> *Constitution*, art.57.

<sup>137</sup> *Constitution*, art.2.

<sup>138</sup> Cai Dingjian, *The System of the National People's Congress of China* (Beijing: Law Press, 2003).

The NPC is formed by representatives elected from local regions. At the provincial and municipal level, representatives are chosen by the People's Congress at the immediately lower level of administration. However, representatives are directly elected in counties and towns.<sup>139</sup> They are elected through legal procedures based on democratic elections by the electorate, forming local and national People's Congresses as the state power organs. These organs are responsible for creating other state institutions and exercising state authority.

### **2.2.1.2 President**

The President, representing the State at both national and international levels, is elected by the NPC. The powers and functions of the President, which are symbolic in representing the country externally, such as promulgating laws, issuing orders, accepting the dispatch of foreign envoys and recalling plenipotentiaries and conferring state medals and honorary titles.<sup>140</sup> A key aspect of the President's authority is that they announce or implement decisions on state affairs made by the NPC, in accordance with the constitutional framework and established procedures.

### **2.2.1.3 State Council**

The State Council, also known as the Central Government, serves as the highest administrative organ of China.<sup>141</sup> China's administrative organs are organized in a hierarchical system comprising five levels: central, provincial, municipal, county, and township. The People's Congress forms the constitutional foundation for government

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<sup>139</sup> *Electoral Law*, art.2.

<sup>140</sup> *Constitution*, art.80.

<sup>141</sup> *Constitution*, art.85.

establishment and legitimacy. The State Council is responsible to the NPC and reports its activities to both the NPC and the Standing Committee.<sup>142</sup>

#### **2.2.1.4 Supreme People's Court and Supreme People's Procuratorate**

The Supreme People's Court is the highest judicial authority in China. It is composed of multiple tiers, including local courts, specialized courts, and the Supreme People's Court. The local courts operate at three primary levels: basic, intermediate, and higher courts.<sup>143</sup> Courts are the adjudicative bodies of the state, tasked with hearing criminal, civil, and administrative cases. Through their judicial activities, they seek to penalize offenders, resolve social conflicts and disputes, and uphold fairness and justice.<sup>144</sup> Besides hearing cases, the Supreme People's Court holds the statutory authority to issue judicial interpretations, propose legislative drafts, and exercise judicial administrative powers.<sup>145</sup> Notably, circuit courts have been established in local areas like Shenzhen and Nanjing. These courts act as permanent judicial bodies dispatched by the Supreme Court to hear major civil, administrative and commercial cases that involve multiple administrative regions.<sup>146</sup>

Meanwhile, the Supreme People's Procuratorate is the highest prosecutorial authority. Procuratorates serve as legal supervisory bodies, primarily responsible for holding individuals criminally accountable, initiating public prosecutions, and conducting legal oversight. People's procuratorates are structured into four tiers: the Supreme

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<sup>142</sup> *State Council Organizational Law*, art.4.

<sup>143</sup> Guangzhong Chen, *Modern Judicial System in China*, 2020 ed. (Beijing: Peking University Press, 2020).

<sup>144</sup> China Courts Network. Accessed March 2, 2023, <https://www.chinacourt.org/index.shtml>.

<sup>145</sup> Fan He, "On the Allocation of Powers Between Higher and Lower Courts: A Perspective on the Functional Positioning of Four-Level Courts," *Application of Law*, no. 8 (2012): 15.

<sup>146</sup> Supreme People's Court, *Provisions on Several Issues Concerning the Hearing of Cases by Circuit Courts*, 2015.

People's Procuratorate, provincial procuratorates, municipal procuratorates, and grassroots procuratorates, operating under a hierarchical leadership relationship. Through their prosecutorial activities, the people's procuratorates promote adherence to the *Constitution* and laws, while actively combating illegal activities and criminal behavior.

### 2.2.2 The Legislative System

In China's current legislative system, the form of legal documents must be in writing. Case law is not allowed in China, and the primary sources of law are written statutes. Judicial interpretations, which provide explanations of the law, are regarded as legal documents used to guide the adjudication of specific cases. Judicial interpretations, while important in the application of laws, do not have the same binding precedent effect as in common law systems. The role of courts in China is to interpret and apply laws within the scope of the law, without creating binding precedents for future cases. This contrasts with common law jurisdictions, where courts are bound by precedent and judicial decisions serve as binding case law. In China, legal judgments do not carry the force of precedent.<sup>147</sup>

However, the introduction of the guiding case system has created a mechanism whereby selected cases, deemed exemplary, provide non-binding but influential legal references for judges.<sup>148</sup> These guiding cases, while not legally compulsory, aid in standardizing judicial interpretation and promoting consistency across the legal system.

Wang Liming explains that,

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<sup>147</sup> Wushu Sung, *From Statutory Law, Case Law to Mixed Law*, Examiner's Journal, July 2017, accessed March 2, 2023, [https://www.spp.gov.cn/llyj/201707/t20170718\\_195918.shtml](https://www.spp.gov.cn/llyj/201707/t20170718_195918.shtml).

<sup>148</sup> Hairong He, *Guiding Cases and the Doctrinal Structure of Chinese Justice*, accessed March 2, 2023, [http://iolaw.cssn.cn/zxzp/202212/t20221208\\_5569626.shtml](http://iolaw.cssn.cn/zxzp/202212/t20221208_5569626.shtml).

Written law often lags the rapid changes in modern society, making guiding cases a vital tool to address the limitations of judicial interpretations and to supplement them. In China, however, guiding cases do not possess the authority of case law and thus can only be used as references rather than as binding precedents.<sup>149</sup>

The NPC is the highest legislative authority in China, vested with the power to enact national laws. The Standing Committee holds the authority to interpret these laws and issue decrees as necessary.<sup>150</sup> The State Council is authorized to promulgate administrative regulations, while its departments are responsible for formulating sector-specific regulations.<sup>151</sup> While the NPC possesses the highest legislative authority and is responsible for enacting the *Constitution*, laws and codes. The State Council is authorized to establish administrative regulations, as long as they do not contradict laws.<sup>152</sup>

The following Table 2.1 highlights significant milestones in the development of China's legislative framework, from its initial concentration of power in the NPC to the gradual decentralization of legislative authority to local governments.

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<sup>149</sup> Wang Liming, "Innovation in the Tradition of Statutory Law: How to See the Case Guidance System," *People's Court News*, February 20, 2012, accessed March 4, 2023, <https://www.chinacourt.org/article/detail/2012/02/id/473206.shtml>.

<sup>150</sup> Dong Jiang, "An Introduction to Chinese Legal Culture," in *Handbook on Legal Cultures: A Selection of the World's Legal Cultures* (Cham: Springer International Publishing, 2023), 197–237.

<sup>151</sup> *Constitution*, art.89.

<sup>152</sup> Chunsheng Zhang, "Innovation in the Legislative System: From One-Level Legislation to Unified Multi-Level Legislation," *Rule of Law Daily*, September 9, 2021.

Table 2.1  
*The Development of China's Legislative System*

Year	Event/Legislative	Significance
1954	Constitution	NPC was established as the sole legislative authority, with the Standing Committee empowered to interpret laws and issue decrees.
1955	2nd Session of the 1st NPC	Standing Committee was authorized to draft specific regulations.
1959	1st Session of the 2nd NPC	Standing Committee was further authorized to amend laws not suited to current needs, continuing the extension of legislative authority.
1979	Local Organization Law	Legislative power was delegated to local congresses and local standing committees.
1982	Constitution	Standing Committee's legislative power was reinforced, and the State Council was empowered to issue administrative regulations.
1986	Amendment to the Local Organization Law	Local legislative powers were extended to municipalities with provincial governments.
2000	Legislative Law	This law formalized China's legislative processes, granting greater legislative power to special economic zones and outlining a structured legislative framework.
2015	Revised Legislative Law	Local legislative powers were expanded from 49 major cities to all cities with districts, clearly defining the scope of local legislative authority.
2018	Constitutional Amendment	The amendment explicitly granted cities with districts legislative authority, formally enshrining local legislative power in the Constitution.

Source: NPC

### 2.2.3 The Dispute Resolution Mechanisms

China's current dispute resolution mechanisms primarily comprise three conventional methods: litigation, arbitration and mediation. Mediation and arbitration serve as the two main forms of Alternative Dispute Resolution (hereinafter referred to as "ADR"). The Chinese government has proposed the concept of a diversified dispute resolution mechanism, emphasizing the following:

...an integrated framework that combines litigation, arbitration, and mediation to effectively address the complex and varied dispute resolution needs of both domestic and international stakeholders.<sup>153</sup>

#### 2.2.3.1 Litigation

Before China's reform and opening in 1978, the development of the country's litigation mechanism was heavily influenced by the Soviet Union and other socialist nations, with mediation emphasized as the primary means of resolving civil disputes.<sup>154</sup> The *Regulations on Mediation in Civil and Criminal Matters in the Shanxi-Gansu-Ningxia Border Region*, effective from 1943, mandated that mediation be applied to all civil disputes and, except for certain major criminal offenses, encouraged mediation in criminal matters as well.<sup>155</sup> This approach aimed to control the scope of litigation by prioritizing mediation. In 1950, the number of civil cases nationwide totaled 659,157, with little growth over the nearly 30 years from 1950 to 1978.<sup>156</sup>

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<sup>153</sup> State Council, *Opinions on Establishing the "Belt and Road" International Commercial Dispute Resolution Mechanism and Institutions*, June 27, 2018, accessed November 8, 2024, [https://www.gov.cn/zhengce/2018-06/27/content\\_5301657.htm](https://www.gov.cn/zhengce/2018-06/27/content_5301657.htm).

<sup>154</sup> Zongzhi Huang, *The Past and Present: An Exploration of Civil Law Practice in China* (Beijing: Law Press, 2009).

<sup>155</sup> Xinghua Guo, "The Transformation of Dispute Resolution Mechanisms in Contemporary China," *Journal of Renmin University of China*, no. 5 (2016).

<sup>156</sup> Zhong Ren, "Reflection and Reconstruction of Civil Litigation Rights in the Context of Chinese-Style Modernization," *China Law*, no. 4 (2024).

However, following the reform and opening, civil cases have increased significantly in parallel with economic growth. Especially since 1999, the central government has promoted litigation as the main mechanism for dispute resolution. The principle of "implementing the rule of law and building a socialist country based on the rule of law" was added to the Constitution in that year. Since then, litigation has been linked closely to both the rule of law and rights awareness. The government has emphasized litigation as the primary and exclusive means for resolving disputes. China's litigation system has thus transitioned from discouraging to encouraging litigation.<sup>157</sup>

Litigation is increasingly seen as the primary way to resolve disputes in China. It highlights problems with a single approach and the monopolization of public power. In 2023, judges nationwide closed an average of 356.51 cases per judge, reflecting a 13.42% increase from previous years.<sup>158</sup> This suggests that, on average, each judge handles approximately one case per day. In regions such as Jiangsu and Chongqing, where the caseload exceeds 500 cases per judge within one year, the judicial burden is even more pronounced. This substantial caseload not only impacts the efficiency of the judiciary but also raises concerns about the timely resolution of disputes and the quality of judicial decisions.

The USA has long employed ADR before litigation, while Australia's *Franchising Code of Conduct* mandates mediation as the first step in resolving franchise

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<sup>157</sup> Xinghua Guo, *A Textbook of Sociology of Law*, 2nd ed. (Beijing: Renmin University of China Press, 2014).

<sup>158</sup> Chinese Government Website, "Work Report of the Supreme People's Court," *Xinhua News*, March 15, 2024, accessed November 8, 2024, [https://www.gov.cn/yaowen/liebiao/202403/content\\_6939583.htm](https://www.gov.cn/yaowen/liebiao/202403/content_6939583.htm).

disputes.<sup>159</sup> Compared to the USA and Australia, which emphasize "mediation before litigation" and prefer arbitration, China can make greater use of these mechanisms to improve dispute resolution.

### 2.2.3.2 Arbitration

Arbitration is a key mechanism in ADR, particularly for international commercial disputes. Arbitration is a dispute resolution process grounded in the principle of party autonomy, which is central to its function.<sup>160</sup> Parties typically include a binding arbitration clause in their contracts, detailing procedural aspects such as the number of arbitrators, location, and rules. It originated with the *Arbitration Act* 1697 in UK and has evolved into a globally recognized dispute resolution system. A major milestone in its development was the *New York Convention* 1958, which facilitates the recognition and enforcement of arbitral awards across 172 member states.<sup>161</sup>

The *Arbitration Law* 1995 has enabled China's transition from administrative arbitration, rooted in the planned economy, to a modern commercial arbitration system based on party autonomy. This shift has established a foundation for aligning China's arbitration practices with global standards. There are 282 arbitration institutions operate in mainland China, staffed by over 80,000 personnel who have collectively

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<sup>159</sup> Alternative Dispute Resolution in Agency Administrative Programs. *Final Report*. December 17, 2021.

<sup>160</sup> Liming Wang, "Several Issues on the Validity of Arbitration Agreements," *Application of Law*, no. 11 (2023).

<sup>161</sup> United Nations Commission on International Trade Law (UNCITRAL), "The Convention on the Recognition and Enforcement of Foreign Arbitral Awards," accessed November 7, 2024, <https://uncitral.un.org/zh/texts/arbitration>.

handled more than 5 million cases. In 2023 alone, arbitration institutions across the country managed 607,000 cases, reflecting a 27.8% increase from the previous year.<sup>162</sup>

However, China's arbitration institutions display uneven standards under the current *Arbitration Law* 1995 framework, with specific provisions in the current framework misaligned with practical arbitration needs and internationally recognized standards.<sup>163</sup>

Enhancing regulatory oversight has become a critical priority in the forthcoming revisions of the *Arbitration Law* 1995 to strengthen both credibility and global competitiveness of China's arbitration framework.

### 2.2.3.3 Mediation

Mediation is another method in dispute resolution system. When delays and high costs in litigation become serious issues, mediation has gained favor from courts, lawyers, and academics due to its convenience and cost-effectiveness. Mediators, who are often experts in a specific field, act as neutral third parties between disputing parties, aiming to facilitate a non-binding settlement. The development of mediation has been further promoted by both private sector initiatives and government support. It includes official mediation by the government and non-official mediation by entities like industry associations, mediators, and lawyers. Common law countries emphasize a market-driven approach, leveraging cost-effectiveness and incentives to encourage non-litigation resolution. In contrast, civil law systems prioritize state promotion and welfare measures, with greater judicial control over mediation.<sup>164</sup>

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<sup>162</sup> Supreme People's Court, *Annual Report on Judicial Review of Commercial Arbitration by the Supreme People's Court (2023)*, China Court Network, September 9, 2024, <https://www.court.gov.cn/zixun/xiangqing/442471.html>.

<sup>163</sup> Xiaofei Mao, "The Revision of the Arbitration Law from the Perspective of Legal Empirical Research: Consensus and Differences," *International Law Studies* 2021, no. 6.

<sup>164</sup> Yu Fan, "The Development and Insights of Diversified Dispute Resolution Mechanisms in the

In practice, Chinese courts often encourage mediation at the case filing stage, where field-specific mediators help reach a settlement, which is then confirmed by a judicial ruling.<sup>165</sup> The Supreme People's Court encourages chambers of commerce, industry associations, and arbitration institutions to establish mediation organizations in areas such as investment, technology transfer, e-commerce, intellectual property, and international trade.<sup>166</sup> Since the reform and opening up, China has promoted alternative dispute resolution, including arbitration and mediation.

However, many disputes, especially civil and commercial ones, are still resolved through litigation. The proportion of alternative dispute resolution remains low, failing to alleviate the court's litigation pressure. Despite the Supreme People's Court's efforts to establish a diversified dispute resolution system, there is still reluctance from parties to use arbitration and mediation.

#### **2.2.4 The Hierarchy of Current Franchising Legislation**

China's franchising regulatory framework is built on a combination of national and local laws that address various aspects of the franchising relationship. In terms of national regulations, the *Civil Code*, enacted by the NPC, provides universal guidance applicable to franchise relationships, offering a general legal framework to govern such commercial agreements. The *Civil Code* serves as the underlying law of general application in China, while *CFAR 2007*, *CFIDAM 2012* and *CFRAM 2011* provide specific regulations for franchising.<sup>167</sup> Under China's central legislative hierarchy,

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Contemporary World," *Chinese Journal of Applied Law*, no. 3 (2017).

<sup>165</sup> Hui Wang and Yunfei Que, "Pre-Mediation of Civil Disputes and Its Implementation Path," *People's Judicature Applied*, no. 31 (2018).

<sup>166</sup> Supreme People's Court, *Opinions on Further Deepening the Reform of the Diversified Dispute Resolution Mechanism by People's Courts*, 2016.

<sup>167</sup> Paul Jones and Erik Wulff, "Franchise Regulation in China: Law, Regulations, and

*CFAR 2007* holds a lower status than the *Civil Code* but ranks higher than *CFIDAM 2012* and *CFRAM 2011*. This positioning requires that *CFAR 2007*, *CFIDAM 2012* and *CFRAM 2011* must be consistent with the *Civil Code*.

The following Figure 2.2 described the hierarchy of these laws and regulations of franchising in the central level.

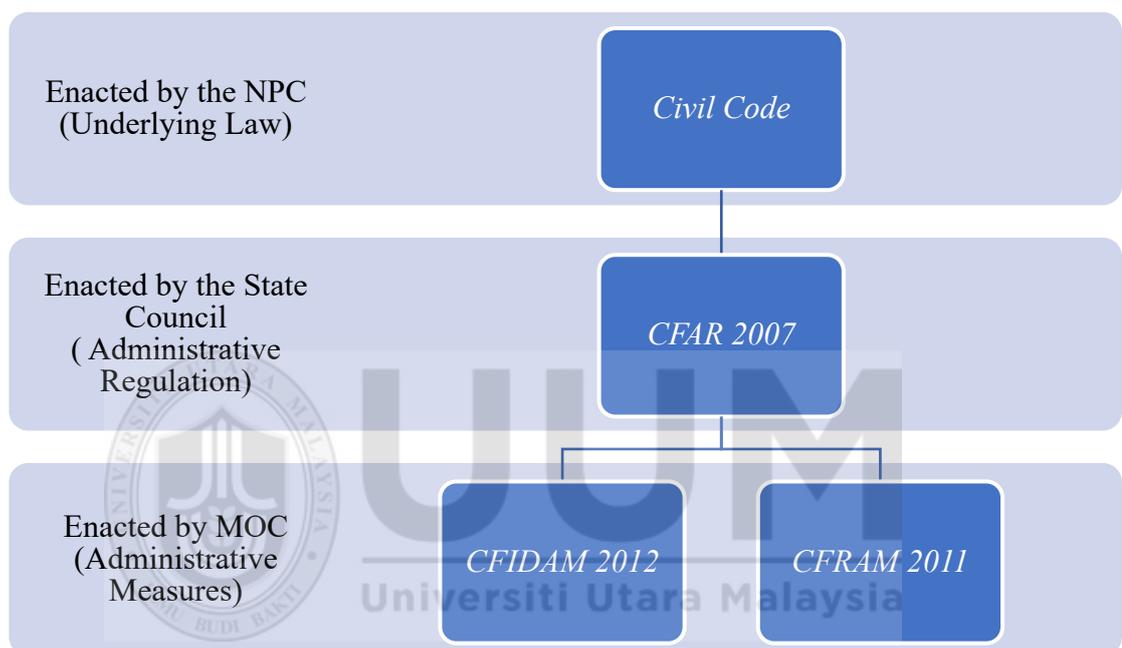


Figure 2.2: The Hierarchy of Franchising Legislation

Beyond national regulations, local governments have instituted region-specific measures to enhance franchising operations according to local economic conditions. For instance, the Beijing Municipal Commission of Commerce introduced the *Measures for the Implementation of Beijing Commercial Franchise Record Management*, which streamlines franchise registration procedures in the capital. Similarly, regions like Guangdong and Shijiazhuang have developed guidelines to

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Guidelines," *Franchise Law Journal* 27 (2007): 57.

strengthen local franchise registration systems and ensure compliance with both national and regional commercial policies. These local regulations are pivotal in managing franchise operations at the regional level, fostering the adaptation of national frameworks to local economic conditions.

It is important to note that local legislation must not contradict national laws. Local regulations are meant to complement the national legal framework by addressing region-specific issues without undermining the uniformity and principles established at the national level. In the case of franchising, local governments may create policies to manage franchise registration, enforcement, and compliance, but these policies must align with the broader guidelines set forth by national laws such as the *CFAR 2007*, *CFIDAM 2012* and *CFRAM 2011*.

### **2.3 Historical Development of Franchise Regulation in China**

The franchise regulation in China plays a pivotal role in shaping and sustaining the franchise sector. The development of franchising regulation in China can be divided into four stages. Initially, during the early beginnings phase (pre-1997), franchising was managed through informal practices. This evolved into the early regulatory initiatives period (1997-2004), where the Chinese government introduced the *CFAM 1997*, marking official recognition and support for franchising as a business model.<sup>168</sup> The initial franchise regulations phase (2004-2007) introduced more formalized guidelines with the *CFAM 2004*, providing comprehensive rules for franchise operations. Finally, in the administrative regulation stage (2007 to present), the State

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<sup>168</sup> Michele Lee, "Franchising in China: Legal Challenges When First Entering the Chinese Market," *American University International Law Review* 19, no. 4 (2003): 962.

Council issued the *CFAR 2007* significantly enhancing franchise regulation and further refining the framework through *CFRAM 2011* and *CFIDAM 2012*. The *CFAM 1997* and *CFAM 2004* have since been repealed or rendered inapplicable. The *CFAR 2007* remains in force and is currently supplemented by two key implementing measures—*CFRAM 2011* and *CFIDAM 2012*.

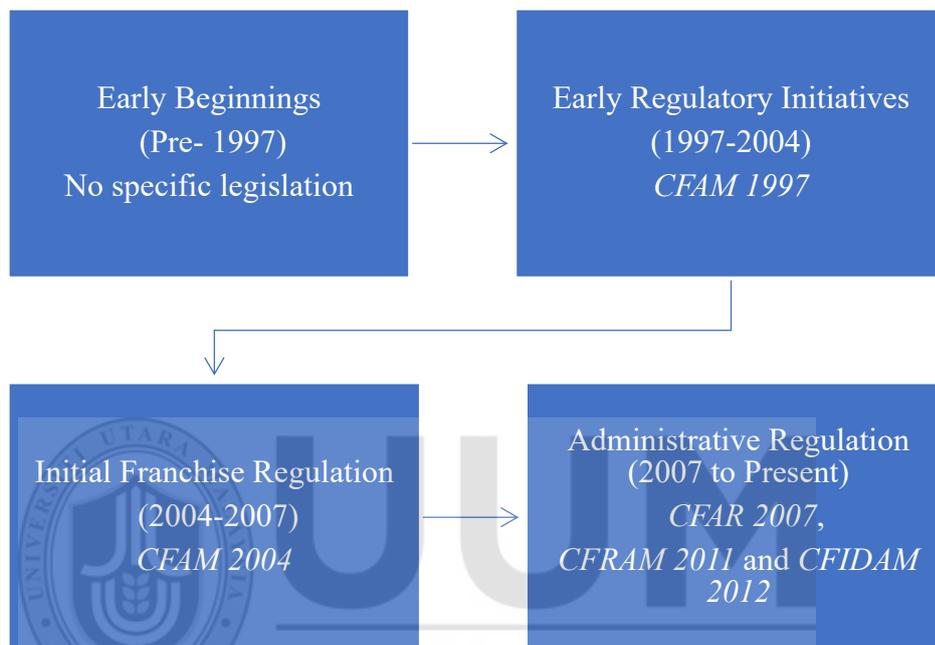


Figure 2.3: Historical Development of Franchising Regulation in China

### 2.3.1 Early Beginnings Stage (Pre-1997)

Franchising originally emerged in the USA in 1863, when the American Seiko Sewing Machine Company pioneered its use to build a successful marketing network. This business model was introduced to China in the 1980s by U.S. fast-food giants like KFC and McDonald's, laying the foundation for its growth in the Chinese market.<sup>169</sup> In 1993, Li Ning became the first domestic brand to adopt the franchise model, further advancing the practice within China. In 1997, the establishment of the CCFA in Beijing marked a significant milestone, signaling the beginning of organized and

<sup>169</sup> David Bell and Mary L. Shelman, "KFC's Radical Approach to China," *Harvard Business Review*, November 2011, <https://hbr.org/2011/11/kfcs-radical-approach-to-china>.

formalized franchise development in China.<sup>170</sup> Before 1997, the management and regulation of franchising in China relied primarily on existing general laws and regulations, lacking a framework specifically tailored to the franchise model.

### **2.3.2 Early Regulatory Initiatives Stages (1997-2004)**

A significant regulatory advancement occurred in March 1997, when the former Ministry of Domestic Trade issued the *Opinions on the Management of Chain Stores*. This document represented the first official recognition of franchising within China's legal framework, providing a clear definition of franchising. It defined franchising, or franchise chains, as agreements in which chain stores enter contracts with a central headquarters to obtain the right to use its trademark, trade name, business technology, and products, with operations centrally managed by the headquarters.

Franchising legislation in China formally commenced on November 14, 1997, with the issuance of the *CFAM 1997*, by the former Ministry of Domestic Trade. It provided a legal definition of franchising, specifying that:

Franchising involves a contractual agreement where the franchisor grants the use of its trademarks (including service marks), trade names, products, patents, know-how, and business models to the franchisee. In return, the franchisee operates under the franchisor's uniform business model, adhering to the contractual provisions and paying the requisite fees to the franchisor.<sup>171</sup>

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<sup>170</sup> The China Chain Store Franchise Association (CCFA), registered in 1997 with the Ministry of Civil Affairs, is the only national industry organization for chain store management, consisting of local and multinational retailers, franchising enterprises, and suppliers, with the aim of protecting members' rights, promoting integrity, and serving as a bridge between members and the government to advance chain management in China.

<sup>171</sup> *CFAM 1997*, art. 4.

The *CFAM 1997*, consisting of 19 articles, was designed to establish a framework for franchising by defining its concept, outlining the qualifications of both parties, and detailing their mutual rights and obligations, as well as basic elements of franchise contracts. It required franchising activities to be registered with the CCFA. At that time, the regulation of domestic franchising has primarily depended on industry self-regulation.<sup>172</sup> During the same period, eight normative documents issued by various State Council departments addressed aspects such as registration, financial management, tax compliance, product varieties, and trademark licensing, aiming to clarify the legitimacy of franchising and guide enterprises in franchise operations.<sup>173</sup> This period represents a crucial phase in China's franchise legislation, marked by a surge in legislative activity.

Despite these efforts, the regulations fell short in detailing how to effectively manage franchise activities, resulting in limited success in preventing franchise fraud and protecting investor interests. These provisions are criticized for their generality and lack of specificity. They do not provide detailed guidance on the precise rights and obligations of franchisors, franchisee protection plans, or the specific content required

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<sup>172</sup> Oake, R. "How Open Is the Door? Franchising in Mainland." 1992. Accessed February 1, 2005. <http://www.oake.com/franchisors.htm>.

<sup>173</sup> Opinions on the Management of Chain Operations. Ministry of Domestic Trade, 1997; Notice on Issues Related to the Management of Chain Registration. State Administration for Industry and Commerce and Ministry of Domestic Trade, 1997; Interim Provisions on Financial Management of Enterprise Chain Operation. Ministry of Finance, 1997; Notice on VAT Payment of Chain Operation Enterprises. Ministry of Finance and State Administration of Taxation, 1997; Notice on the Operation of Franchised Commodities by Chain Stores. State Economic and Trade Commission, Ministry of Domestic Trade, Ministry of Culture, Ministry of Posts and Telecommunications, State Press and Publication Administration, State Administration of Industry and Commerce, and State Tobacco Monopoly Administration, 1997; Measures for the Record of Trademark Licensing Contracts. Trademark Office of the State Administration for Industry and Commerce, 1997; Interim Provisions on the Recognition and Administration of Well-known Trademarks. State Administration for Industry and Commerce, 1996; Pilot Measures for Foreign-Invested Commercial Enterprises. State Economic and Trade Commission and Ministry of Foreign Trade and Economic Cooperation, 1996.

in franchise contracts. Furthermore, there is no clear guidance on contract modifications or terminations, reducing the practical utility of these regulations. In addition, there was significant debate over the disclosure of information, as concerns about revealing trade secrets led to inadequate provisions in this regard.<sup>174</sup>

### **2.3.3 Initial Franchise Regulation Stage (2004-2007)**

On November 10, 2001, China's accession to the WTO mandated updates to its commercial laws, including those affecting franchising. China pledged to remove special restrictions and open its market to foreign businesses by December 2004.<sup>175</sup> To fulfill its commitments to the WTO, the MOC promulgated the *Administrative Measures for Foreign Investment in Commercial Fields* on April 16, 2004. The third article of this measure stipulates the requirements for foreign-invested enterprises engaged in franchising. It indicates that the Chinese government has given recognition to foreign-invested enterprises engaged in franchising in China.

Although foreign capital is allowed to carry out franchising activities in the country, it can only be carried out by setting up foreign-invested enterprises at that time. It is worth noting that both foreign enterprises and foreign-invested enterprises conducting franchise business in China must comply with the Catalogue for the Guidance of Foreign Investment Industries.<sup>176</sup>

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<sup>174</sup> Geping Guo, "Establishment of Standardised Market Rules for the Rapidly Growing Franchise Sector," speech delivered at the CCEA 2004 International Franchising Forum, Shanghai, October 19, 2004.

<sup>175</sup> China's accession to the WTO mandates the enhancement of a uniform, transparent, and non-discriminatory legal system, acceleration of government reforms, increased transparency in policymaking, overhaul of the administrative approval processes, reduction of administrative interventions, and continued market liberalization.

<sup>176</sup> Dongsheng Wang & Wenqing Wang, "The impact of the adjustment of the Catalogue for the Guidance of Foreign Investment Industries on some Foreign Investment projects," *Finance and Accounting: Financial Management Edition 2* (2008): 18-19.

As franchising rapidly expanded, instances of commercial fraud by dishonest operators increased, drawing significant concern from the State Council. Premier Wen Jiabao emphasized the need for corrective measures in the franchising sector. In response, the MOC identified franchise-related fraud as a key focus in 2004 and introduced the *CFAM 2004* on December 31. It marked a substantial revision of the earlier *CFAM 1997*, offering clearer guidelines on franchise contract terms and the consequences of contract termination.<sup>177</sup> Significantly, it drew from the regulatory practices of western developed countries, introducing several innovative features in information disclosure, anti-monopoly guidance, and market access, filing management procedures.

It established a formal information disclosure system, detailing the required content, procedures, and legal liabilities for non-compliance by franchisors. It emphasizes protecting vulnerable franchisees by limiting the negative behaviors of franchisors, like consumer protection laws. Under the *CFAM 2004*, franchisors must provide detailed information of their business, ensuring its accuracy. Violations can lead to fines and compensation for investor losses.<sup>178</sup> This stringent regulatory approach emerged in response to the rapid expansion of franchising at that time, which exposed problems such as failed ventures and franchisors exploiting investors' desire for quick returns with inadequate support.

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<sup>177</sup> Zhiqiong Wang June, Mingxia Zhu, and Andrew Terry, "The Development of Franchising in China," *Journal of Marketing Channels* 15, no. 2-3 (2008): 167-184, <https://doi.org/10.1080/10466690802014021>.

<sup>178</sup> *CFAM 2004*, art. 18.

The MOC's efforts to monitor and regulate franchising aimed to address these issues and promote fairness in franchise relationships, demonstrating the importance of tendentious legislation in correcting imbalances.

Additionally, it embedded the principle of fair competition, prohibiting franchises from creating market monopolies or impeding competitive practices. Franchisors were also restricted from forcing franchisees to accept supply requirements, except for essential commodities necessary to maintain quality standards.<sup>179</sup> This was the first time a balance between standardized production and competitive freedom was proposed. Moreover, it relaxed market access restrictions for foreign-invested enterprises, granting them greater operational freedom in the franchise sector.<sup>180</sup>

Moreover, it mandated that franchisors report all franchise contracts signed in the previous year to both local commercial authorities and those in the franchisee's location. Local authorities were then required to forward these reports to higher-level commerce departments.<sup>181</sup> Following the introduction of these measures, local commercial authorities developed filing management procedures for franchising, making filing management the primary regulatory model for franchising during this period.

Despite these advancements, its legal framework remained limited, with regulatory effectiveness constrained by low-level legislation. While the information disclosure system represented a significant innovation, its broad legal requirements often proved

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<sup>179</sup> *CFAM 2004*, art. 5.

<sup>180</sup> *CFAM 2004*, art. 23.

<sup>181</sup> *CFAM 2004*, art. 29.

challenging to enforce, leading to concerns about its practical implementation and oversight.

#### **2.3.4 Administrative Regulations Stage (2007-Present)**

Although the above documents were issued over time, they remained as departmental regulations under the State Council. It was not until February 6, 2007, that the State Council officially promulgated the *CFAR 2007*, elevating franchising legislation in China to the level of administrative regulations. It is more streamlined and accessible, relaxing previous conditions by allowing both individuals and organizations to participate as franchisees, thus expanding the scope of franchising. Key improvements include Article 12, which enables franchisees to unilaterally terminate their contracts within a specified period, providing crucial protection and flexibility for franchisees.

The regulations also introduce clear legal responsibilities and penalties for non-compliance, reduce the special provisions for foreign-invested enterprises, and mandate that franchisors disclose 12 essential pieces of information to franchisees.<sup>182</sup>

To ensure the effective implementation of the *CFAR 2007*, the MOC introduced the *CFRAM 2011* and *CFIDAM 2012*. These measures enhance the regulations' clarity, practicality, and fairness.

The *CFAR 2007* established comprehensive guidelines for franchise regulation, addressing franchise market access standards, post-registration procedures, information disclosure requirements, and punitive measures. However, it lacks clear definitions for the conditions related to the alteration, transfer, and termination of

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<sup>182</sup> *CFAR 2007*, art. 23.

franchise contracts. Furthermore, *CFAR 2007* disproportionately favors franchisors' rights during both entry into and exit from the franchise system, which could lead to the abuse of franchisor power. As global perspectives on franchising have shifted to a more balanced approach that safeguards both franchisors' and franchisees' rights, it is necessary to strengthen provisions on franchisee protection to reflect this evolution.

As the only national legislation of the franchise information disclosure system, the State Council issued *CFAR 2007* on February 6, 2007, and implemented on May 1, 2007, improving the provisions of the *CFAM 2004* on the information disclosure system. Nowadays, the disclosure requirements for franchising are set out in Chapter 3 of *CFAR 2007*. It involves the time, method, content of disclosure, cooling-off period, and the responsibility for non-compliance of disclosure.

Compared with the *CFAM 2004*, the latest *CFAR 2007* requirements for franchise information disclosure have the following three changes. First, the obligation of franchise information disclosure is a requirement for franchisors who are in a dominant position under the *CFAR 2007*. It limited the subject of the franchise information disclosure obligation to the franchisor and cancelled the franchisee's information disclosure obligation. Second, *CFAR 2007* extended the time requirement for franchisor information disclosure. The time of disclosure was changed from 20 days to 30 days in *CFAR 2007*. Third, the *CFAR 2007*, perfect the basic principles of information disclosure, which added the integrity principle.

## 2.4 Elements of Franchising

This section details the essential elements of franchising. It begins by identifying four primary characteristics of franchising. Subsequently, product and trademark franchising, and business format franchising are discussed. The section concludes by distinguishing franchising from other commercial arrangements, including chain operations, commercial agency, distribution, and intellectual property licensing.

### 2.4.1 The Characteristics of Franchising

In China, according to Article 3 of *CFAR 2007*, franchising is defined with a focus on the use of business resources, particularly those tied to intellectual property rights. Four essential characteristics of franchising can be identified: (1) franchising is a legally binding contractual relationship; (2) it involves the transfer or granting of business-related resources; (3) the franchise follows a standardized and unified business model; and (4) franchise fees.<sup>183</sup>

#### 2.4.1.1 Contractual relationship

Franchise relationship is a kind of civil and commercial legal relationship between equal subjects, more accurately said is a contractual relationship in private law.<sup>184</sup> Franchise contract is the key to the formation and continuation of the franchise relationship. The franchise contract defines the rights and obligations of both parties, with each bearing different risks and legal responsibilities during its execution.<sup>185</sup> The

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<sup>183</sup> The State Council Legislative Affairs Office and the Ministry of Commerce, "Questions and Answers Regarding China's New Franchise Regulation," February 16, 2007, accessed February 9, 2023, [http://www.gov.cn/zwhd/2007-02/15/content\\_528054.htm](http://www.gov.cn/zwhd/2007-02/15/content_528054.htm).

<sup>184</sup> Elizabeth Crawford Spencer, *The Regulation of the Franchise Relationship in Australia: A Contractual Analysis* (PhD diss., Bond University, 2007).

<sup>185</sup> Francine Lafontaine and Roger D. Blair, "The Evolution of Franchising and Franchise Contracts: Evidence from the United States," *Entrepreneurial Business Law Journal* 3 (2008): 381.

franchisor provides business resources to the franchisee, who in turn is obligated to pay the franchisor the agreed consideration. The parties are not in an employment relationship, nor is the relationship between the headquarters and the branch but are two independent civil subjects.<sup>186</sup> Both parties to the franchise contract have equal legal status and there is no subordination.

In addition, the franchise contract is concluded in accordance with the principle of voluntariness and is legally binding on both parties once it enters into force. Under the franchise agreement, the franchisor grants the franchisee the right to use its trademark and other resources, while providing guidance, training, and ongoing support. The franchisee agrees to pay franchise fees, maintain a consistent business model, and uphold confidentiality obligations.<sup>187</sup>

#### **2.4.1.2 Granting of Business Resources**

Franchising starts with the granting of business resources, typically in the form of intangible property rights. In the USA, these rights are often represented by the franchisor's trademarks, service marks, trade names, or other identifiers of the franchisor's brand.<sup>188</sup> In China, business resources include intangible assets like trademarks, logos, patents and management know-how owned by the franchisor within the franchise system.<sup>189</sup> Both the Shanghai High Court and the Beijing High Court emphasized intellectual property attributes in their findings on business resources.

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<sup>186</sup> Paul Steinberg and Gerald Lescatre, "Beguiling Heresy: Regulating the Franchise Relationship," *Dickinson Law Review* 109 (2004): 105, <https://ideas.dickinsonlaw.psu.edu/dlra/vol109/iss1/5>.

<sup>187</sup> Levent Altinay and Maureen Brookes, "Factors Influencing Relationship Development in Franchise Partnerships," *Journal of Services Marketing* 26, no. 4 (2012): 282, <https://doi.org/10.1108/08876041211237578>.

<sup>188</sup> Ilan Alon, "The Use of Franchising by U.S.-Based Retailers," *Journal of Small Business Management* 39, no. 2 (2001): 111-122, <https://doi.org/10.1111/1540-627X.00011>.

<sup>189</sup> *CFAR 2007*, art. 2.

Thus, unlike a buyer-seller relationship, business resources with intellectual property attributes are granted to the franchisee for use as the object of the franchise relationship.

The franchisee utilizes a complete set of business resources owned by the franchisor that can bring competitive advantage. Franchisees obtain these resources by paying consideration, effectively shortening the start-up time in the form of legal "free riding". At the same time, to maintain the business reputation attached to the operating assets, the granting is often accompanied by certain restrictive conditions.

#### **2.4.1.3 Unified Business Model**

Franchising is often accompanied by the rapid replication of unified and standardized business models. Notably, the franchisee uses the franchisor's business resources under a unified business model, as granted by the franchisor. The franchisor exercises continuous control over the franchisees to maintain the unity and standardization of the system. It serves the dual purpose of creating a uniform business model to better sell the product and preventing the franchisee from inappropriately utilizing the franchisor's business resources.<sup>190</sup>

The franchisor's control is reflected in various aspects, for example, unified supply of raw materials, unified management or training, fixed sales areas and sales categories, the development of business plans and advertising, unified store decoration and location, limited product prices.<sup>191</sup> Although the franchising parties are independent

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<sup>190</sup> Emily Decker, Maral Kilejian, and Danell Olson Caron, *Basics Track: What Is a Franchise?* paper presented at the International Franchise Association 44th Annual Legal Symposium, Washington, D.C., 2011, 4.

<sup>191</sup> Peter C. Lagarias and Robert S. Boulter, "Modern Reality of the Controlling Franchisor: The Case for More, Not Less, Franchisee Protections," *Franchise Law Journal* 29 (2009): 139.

entities, there is still a management relationship based on the franchisor's continued control.

Successful franchising in practice often shows strong unity, which is manifested in external and internal form. The external form has strong consistency including the layout of the business site, store decoration, staff clothing, business slogans, advertising and so on. McDonald's, for example, was founded in 1955 and has more than 37,000 restaurants in more than 100 countries and regions. These restaurants maintain a unified operating image in store logo, store layout, employee dress, product variety, product price, product flavor and even business hours. Franchisors and franchisees work to maintain the unity and reputation of the franchise network. Before operations begin, franchisors typically provide comprehensive training and instruct franchisees to follow their guidelines closely.

#### **2.4.1.4 Payment of Franchise Fees**

Franchising is a commercial activity involving payment, with the franchisee typically paying a franchise fee.<sup>192</sup> Franchise fees are divided into one-time initiation fee and long-term maintenance fees. The franchisor's business resources, developed over time with high commercial value, require the franchisee to pay a one-time initiation fee for their use when signing the franchise contract. Payment of the initiation fee is the threshold for the franchisee to enter the franchise system. It has nothing to do with whether it makes a profit or a loss. The franchisee must pay royalties and advertising

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<sup>192</sup> Gillis, William, and Gary J. Castrogiovanni. "The franchising business model: an entrepreneurial growth alternative." *International Entrepreneurship and Management Journal* 8 (2012): 75-98.

fees, typically 5-10% of their turnover, for the franchisor's guidance, training, and unified advertising.<sup>193</sup>

## **2.4.2 Types of Franchising**

Franchising is evolving in various forms while retaining its core features. Two primary types have emerged: product and trademark franchising, and business format franchising, which differs based on the scope of rights granted by the franchisor. Product and trademark franchising primarily involves the licensing of a brand or product line, while business format franchising goes further by providing a complete business model, including operational guidance, marketing strategies, and continuous support. This study primarily focuses on the business format franchising.

### **2.4.2.1 Product and Trademark Franchising**

Product and trademark franchising, the first generation of franchising, involves the franchisor authorizing the franchisee to produce and sell products using the franchisor's trademarks, formulas, and marketing methods within a specified area.<sup>194</sup>

This business model was born in 1982 in Singer Sewing Machine Company. The company grants the right to sell its sewing machines to retailers and provides them with training. The retailer pays a fee to the company for the right to sell the sewing machines.<sup>195</sup>

By the early 1900s, Coca-Cola expanded the scope of granting in franchising from product sales and service to product manufacturing. The Coca-Cola Company grants

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<sup>193</sup> Weihua Li, Yingrui Lu, Jijian Hou, *Introduction to Franchise* (Mechanical Press, 2003).

<sup>194</sup> Steven C. Michael, "Franchising," in *The Elgar Companion to Transaction Cost Economics*, ed. Edward Peter (Edward Elgar Publishing, 2010), 234-250.

<sup>195</sup> Riikka Lavonen, *Franchising as a Potential Growth Strategy for a Small Enterprise* (2010).

the franchisee the blending, bottling, and distribution of the beverage supply chain, while the Coca-Cola Company itself becomes a beverage concentrate manufacturer and brand holder.<sup>196</sup> Today, this model is prevalent in the cosmetics, apparel, beverage, gas station, and auto sales industries.

#### **2.4.2.2 Business Format Franchising**

Business format franchising, the second generation of franchising, involves the franchisor granting not only a trademark and product but also a complete business and management model.<sup>197</sup> The franchisor provides the franchisee with resources such as branding, store design, and sales channels. This ensures consistency in image, philosophy, product quality, and management. The franchisee pays a fee and royalties, following the franchisor's guidance.<sup>198</sup> Business format franchising appeared in the 1950s in the restaurant and hotel industry, in which KFC and McDonald's are typical cases of rapid expansion through this way.<sup>199</sup> Although this model started late, it has developed very rapidly, gradually extending to finance, intermediary, education and training, real estate, and other industries.

#### **2.4.3 Distinguishing Franchising from Similar Concepts**

Franchising has become a popular business model in the world. However, it is often confused with concepts such as chaining, commercial agency, distribution, and

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<sup>196</sup> Tauseef Iqbal Khan and Syed Ali Raza, "Revitalizing the Retail: A Case of the Coca-Cola Company," *Asian Journal of Management Cases* 20, no. 2 (2023): 174-182.

<sup>197</sup> Steven C. Michael, "Franchising," in *The Elgar Companion to Transaction Cost Economics*, ed. Peter G. Klein and James C. Cooper (Edward Elgar Publishing, 2010), 234-250.

<sup>198</sup> Mika Tuunanen and Kimmo Hyrsky, "Entrepreneurial Paradoxes in Business Format Franchising: An Empirical Survey of Finnish Franchisees," *International Small Business Journal* 19, no. 4 (2001): 47-62.

<sup>199</sup> Mika Tuunanen, "Franchising as Entrepreneurial Activity: Finnish SME Policy Perspective," in *Economics and Management of Networks: Franchising, Strategic Alliances, and Cooperatives* (2007): 213-233.

intellectual property licensing. Therefore, this thesis distinguishes franchising from other similar concepts to facilitate a more accurate understanding of franchising.

#### **2.4.3.1 Franchising and Chaining**

Chaining refers to several stores in the form of common purchase or granting franchise to join to achieve standardization and unification of modern business methods and organizational forms.<sup>200</sup> Franchising is a type of chain. In addition, there are direct chain and voluntary chain. All three feature a unified business model, standardized services, and ongoing guidance and assistance. However, franchising is fundamentally different from direct chain and voluntary chain.

Direct chain refers to the business model in which each chain store belongs to the same capital and is directly operated and centrally managed by the headquarters. Direct chain stores have no independent legal subject qualification and are subordinate to the headquarters, which owns the ownership of each chain store. But the two parties of the franchise are independent of each other, and there is no affiliation with the headquarters.<sup>201</sup>

The franchisor and franchisee's relationship are contractual, with defined rights and obligations. Each franchise operates independently in terms of personnel and finance, with no interference from the franchisor. In a direct chain, the headquarters owns the

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<sup>200</sup> Weihua Li, *Franchise* (Beijing: China Development Press, 2009).

<sup>201</sup> Olav Sorenson and Jesper B. Sørensen, "Finding the Right Mix: Franchising, Organizational Learning, and Chain Performance," *Strategic Management Journal* 22, no. 6-7 (2001): 713, <https://doi.org/10.1002/smj.185>.

stores and controls operational decisions. The chain store manager, as an employee of the headquarters, operates under its full direction.<sup>202</sup>

Voluntary chain is a business model initiated by manufacturers or wholesalers, voluntarily joined by various retailers, and operated jointly under the leadership of the headquarters.<sup>203</sup> Voluntary chains have more operational autonomy than franchisees and are more loosely connected to each other. Franchisees are not free to withdraw during the term of the contract, while voluntary chains can freely withdraw from the chain system without bearing the liability for breach of contract. In addition, voluntary chain headquarters are generally non-profit organizations that do not charge or charge a small membership fee. In franchising, franchisees need to pay franchise fees and franchise royalties, etc.

#### **2.4.3.2 Franchising and Commercial Agency**

Franchising and commercial agency are both business models established by contract. Commercial agency is the act of an agent being granted by a principal to carry out commercial activities in a specific geographic area.<sup>204</sup> The designation of territories and the granting of operations are common to franchising and commercial agency. It is precisely because of the similarity between the two business models that many people mistakenly believe that franchising is a special form of commercial agency.

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<sup>202</sup> Matthias Glaser, Michal Jirasek, and Josef Windsperger, "Ownership Structure of Franchise Chains: Trade-off Between Adaptation and Control," *International Journal of the Economics of Business* 27, no. 3 (2020): 357-375.

<sup>203</sup> Ho-Taek Yi, "Antecedents and Consequences of Cooperation in Retail Voluntary Chain," *Journal of Distribution Science* 14, no. 6 (2016): 65-73.

<sup>204</sup> Tiantao Shi, *Commercial Law*, 4th ed. (Beijing: Law Press, 2010).

However, there are significant differences between the two business models. First, the franchisee obtains the franchise for the consideration of paying royalties to the franchisor. In commercial agency, the agent does not pay fees for the agency right, but the principal must compensate the agent for their labor. Second, the franchisee is a commercial entity independent of the franchisor and bears the consequences of its acts on its own. In contrast, the agent is subordinate to the principal and the consequences of the agent's actions are borne by the principal. The franchise contract specifies that the franchisee is not an agent of the franchisor and does not have the authority to act on its behalf. Franchisees are also required to make this distinction known to their customers in a reasonable manner.<sup>205</sup>

#### **2.4.3.3 Franchising and Distribution**

Distribution is a business model where a manufacturer or supplier provides a product to distributors in a specific area for resale.<sup>206</sup> In franchising, franchising and distribution are indeed easily confused when the franchisee acts as the seller of the product.

However, the objects of franchising also include intangible intellectual property rights. The essence of franchising is the granting of a set of franchise resources, while distribution is the buying and selling of goods. The supplier or manufacturer sells the product to a distributor, and the distributor distributes, promotes, and sells it to consumers in a specific geographical area for a profit margin.<sup>207</sup> Each party to a

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<sup>205</sup> UNIDROIT, *Guide to International Master Franchise Arrangements*, 2nd ed. (Rome: UNIDROIT, 2007), 9.

<sup>206</sup> Andrew J. Sherman, *Franchising & Licensing: Two Powerful Ways to Grow Your Business in Any Economy* (New York: AMACOM/American Management Association, 2004).

<sup>207</sup> Michael H. Seid and Dave Thomas, *Franchising for Dummies* (Hoboken, NJ: John Wiley & Sons, 2006).

distribution agreement makes its own decisions regarding pricing, sales, and management.

#### **2.4.3.4 Franchising and Intellectual Property Licensing**

Intellectual property licensing allows use of intellectual property by another person for a certain period and territory, without transferring ownership.<sup>208</sup> In practice, the owner licenses its intellectual property to others through a licensing contract and charges a certain licensing fee, while the licensee uses its intellectual property in an agreed way at the agreed time and place. It is easy to confuse intellectual property licensing with franchising. Intellectual property rights, including trademarks, patents, and logos, are part of the franchise grant. Their use is also limited by geography and time.

While both involve granting intellectual property rights, franchising requires adherence to a standardized business model, unlike intellectual property licensing.<sup>209</sup> The intellectual property licensee enjoys more freedom than the franchisee. Additionally, intellectual property rights are legally defined, while franchise rights arise from negotiations between the franchisor and franchisee.

### **2.5 Franchise-Specific Regulation in China**

China's franchising sector is primarily regulated under the *CFAR 2007*, which was promulgated by the State Council. This regulation forms the legal foundation of franchising in the country, focusing on mandatory disclosure and registration

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<sup>208</sup> Guifang Yang and Keith E. Maskus, "Intellectual Property Rights and Licensing: An Econometric Investigation," *Weltwirtschaftliches Archiv* 137, no. 1 (2001): 58-79.

<sup>209</sup> Lance Eliot Brouthers and Jason Patrick McNicol, "International Franchising and Licensing," in *The Sage Handbook of International Marketing*, ed. Masaaki Kotabe and Kristiaan Helsen (London: Sage Publications, 2009), 183-197.

procedures, as well as outlining the responsibilities and rights within franchise relationships. In addition, to clarify the relevant provisions, two key administrative measures were issued by the MOC, namely *CFIDAM 2012* and *CFRAM 2011*. These measures further refine and supplement the disclosure and registration requirements set out in *CFAR 2007*.

### **2.5.1 Regulation of Information Disclosure**

The information disclosure in franchising has been widely adopted by many jurisdictions, making it the most prevalent method of franchise regulation. One of the most significant issues in franchising is information asymmetry, where one party (typically the franchisor) has more or better information than the other party (the franchisee). This imbalance may result in unfair practices and misguided decisions by franchisees.<sup>210</sup>

Many jurisdictions have implemented legislation to address this issue by mandating pre-contractual disclosure, such as the USA, Australia and Malaysia. The rationale is that disclosure obligations imposed on franchisors ensure that potential franchisees have access to comprehensive and accurate information to make more informed decisions and reduce investment risk.

In China, the disclosure requirements for franchising are set out in Chapter three of *CFAR 2007*. Article 21 of *CFAR 2007* and Article 4 of *CFIDAM 2012* both require the franchisor to provide disclosure documents in written within 30 days before signing

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<sup>210</sup> Quinn, Barry, and Anne Marie Doherty, "Power and Control in International Retail Franchising—Evidence from Theory and Practice," *International Marketing Review* 17, no. 4/5 (2000): 354-372.

the franchise agreement. Article 22 of *CFAR 2007* mandates that franchisors disclose 11 specific items to franchisees, while Article 5 of *CFIDAM 2012* refines these requirements by offering detailed descriptions for each disclosure, enhancing both clarity and practicality. These include the franchisor's basic information and business reputation, legal representative details, the franchisor's ownership of business resources, its ability to provide ongoing services to the franchisee, the management and supervision of franchise operations, the franchise fee and its collection method, the investment budget for franchise outlets, and other essential aspects, totaling 12 key points for comprehensive disclosure.

Article 17 of *CFAR 2007* mandates that franchisors must not deceive or mislead potential franchisees in promotional activities. Specifically, advertisements must not guarantee profits or promise positive earnings from the franchise. This regulation aims to protect franchisees from false or exaggerated claims about potential earnings. Article 23 of *CFAR 2007* set out the criteria for disclosure and provides the franchisee the right to terminate the contract when the franchisor violates the disclosure obligation.

It is stipulated as follows:

The franchisor shall promptly notify the franchisee of any major change in the information provided to the franchisee. Where the franchisor conceals relevant information or provides false information, the franchisee may terminate the franchise contract.<sup>211</sup>

When a franchisee seeks to terminate a franchise contract, they must evaluate whether the franchisor's false or concealed information involves material facts that significantly

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<sup>211</sup> *CFAR 2007*, art. 23.

impact the contract's performance. According to Article 9 of *CFIDAM 2012*, termination is permitted only if the franchisor's concealed information directly affects the execution of the contract, making it impossible to achieve the contract's intended purpose, or if false information is disclosed.

### **2.5.2 Regulation of Franchise Registration**

Registration is another regulatory tool used to the regulation of franchise. Franchise registration refers to the system that franchisors engaged in franchise activities must register with the statutory department and accept its supervision and management.<sup>212</sup>

The establishment of the registration system, on the one hand, helps the government departments to understand the franchise market dynamics in time, and carry out legal intervention on the franchise activities. On the other hand, it helps potential investors to make appropriate decisions. Finally, it is beneficial for the public to supervise the franchising activities.

It should be clarified that franchise registration is mostly an act in which the applicant applies to the registry and obtains approval before the franchise activities are carried out.<sup>213</sup> However, registration in China is not an administrative license for the pre-qualification of the franchise. It is essentially a post-contractual filing and recording procedure. Although the registration system is conducive to examining whether the franchisor has a mature business model, business resources and other conditions, the lack of registration does not affect its franchising business. In China, franchise registration is more accurately described as a franchise filing obligation, which the

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<sup>212</sup> Harahap, Nirwana Dewi, and Zetria Erma, "Franchise Registration in the Perspective of Regulation of the Minister of Trade Number 71 of 2019," *Legal Brief* 11, no. 5 (2022): 3315-3321.

<sup>213</sup> Hurwitz, Ann, "Managing the Proliferation of Global Franchise Regulation," *Franchise Law Journal* 40, no. 1 (2020): 43-68.

franchisor must register the franchise within 15 days of commencing the franchise activity.

Franchisors engaged in franchising activities must meet three essential conditions. First, only registered enterprises can serve as franchisors, ensuring they possess the necessary organizational structure and management capabilities to support franchise operations. Second, the franchisor must have a well-established business model and be capable of providing ongoing business guidance, technical support, and training to franchisees. Finally, franchisors are required to operate at least two directly owned stores with a minimum of one year of successful operation, guaranteeing practical experience and a proven business model that mitigates risks for franchisees.

According to Article 3 of *CFAR 2007*, franchisors must be enterprises that own registered trademarks, corporate logos, patents, proprietary technologies, or other specified business resources. Only enterprises are permitted to act as franchisors, excluding other units or individuals from engaging in franchising activities. According to the MOC, registered trademarks serve as franchise resources in over 90% of franchise arrangements in China. This high percentage reflects the critical role of trademarks in the franchising model, where franchisors grant franchisees the right to use their registered trademarks to operate under a unified business model.

However, *CFAR 2007* does not explicitly differentiate franchising from other similar business models, particularly trademark licensing. This lack of clarity can lead to confusion, as both franchising and trademark licensing involve the granting of rights to use a trademark. The key distinction, as clarified by the Supreme People's Court in

Shenzhen *Eagle Daxin Golf Products Co. Ltd. v. Baikal Tourism Authorized Property Company*, is that franchising requires the franchisee to operate under a unified business model provided by the franchisor, while trademark licensing does not involve such operational control.<sup>214</sup>

Franchisors engaged in franchising activities must possess a mature business model and the ability to provide ongoing business guidance, technical support, and training to franchisees. This maturity is demonstrated through the "two-plus-one requirement," which mandates that the franchisor operates at least two directly owned stores for a period exceeding one year. A directly operated store refers to an establishment owned by the franchisor, whether wholly or through majority ownership. These stores must operate under the same brand and business nature, often in the form of branch companies or subsidiaries. This requirement is a crucial standard for assessing whether the franchisor can offer sustained guidance and a proven business model to franchisees.<sup>215</sup>

Article 8 of the CFAR 2007 stipulates that franchisors engaged in franchise activities within a single province must register with the local provincial department, while those operating across multiple provinces or foreign franchisors must register with the MOC. According to Article 8 of *CFRAM 2011*, franchisors must provide the following for registration:

Basic franchising information, a list of franchisee locations in China,  
the franchisor's marketing plan, business licenses, intellectual

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<sup>214</sup> Beijing Supreme People's Court. Civil Retrial Ruling No. 3368, 2016.

<sup>215</sup> Chien, Shih-Yi. "Franchisor resources, spousal resources, entrepreneurial orientation, and performance in a couple-owned franchise outlet." *Management Decision* 52.5 (2014): 916-933.

property certificates, the initial franchise contract, a sample franchise contract, a table of contents for the operating manual, industry-specific approval documents, and a signed and sealed document by the legal representative.<sup>216</sup>

In addition, Article 19 of the *CFAR 2007* provides for the annual report obligation of the franchisor. The franchisor shall conduct annual report through MOC business system unified platform before March 31 of each year. The contents of the annual report include the contractual information and the business information such as the number of franchise stores, and the revenue data.

### **2.5.3 Regulation of Franchise Contract**

The contractual environment in franchising is predominantly shaped by the legal framework established through franchise agreements, where the franchisor holds a dominant position. Franchise contracts are essential in outlining the terms and conditions of the agreement. These agreements cover various aspects such as obligations and rights, renewal terms, and termination conditions. Contract terms generally represent the interests of all stakeholders and are determined through negotiation. It also creates an inherent power imbalance and information asymmetry, often to the detriment of the franchisee.<sup>217</sup> Protection for franchisees within this environment hinges on both statutory regulation and the express terms of the franchise contract.

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<sup>216</sup> *CFRAM 2011*, art. 8.

<sup>217</sup> Mark Wilson and Greg Shailer, "Information Asymmetry and Dual Distribution in Franchise Networks," *Journal of Business Finance & Accounting* 42, no. 9-10 (2015): 1121-1153.

*CFAR 2007* regulates franchise agreements through four key provisions. First, it mandates that franchise agreements be in written form and include specific essential contents (Article 11). Article 11 lists 11 essential components that must be included in the franchise contract, such as the basic details of both parties, franchise fees, services like business guidance and technical support, quality standards, consumer protection, and provisions for contract transfer or termination. Second, the regulation grants franchisees the right to unilaterally terminate the contract within a specified period after signing (Article 12). Third, it establishes that the franchise period must be no less than three years, unless the franchisee agrees otherwise (Article 13). Finally, *CFAR 2007* prohibits the transfer of the franchise without the franchisor's consent (Article 18).

Thus, the legislation imposes mandatory requirements only for certain key clauses in franchise contracts, leaving the specifics to be negotiated and agreed upon by the parties involved.

In addition to *CFAR 2007*, franchise agreements in China are also governed by the *Civil Code*. China has a legal system where laws and codes form the highest hierarchy of legal norms. Franchising must comply with several legal requirements, starting with the broad principles of the *Civil Code* and then specific provisions related to franchising. The *Civil Code* is the fundamental law governing civil and commercial relations of China and came into force on January 1, 2021. Franchise agreements and activities must comply with the principles and provisions of the *Civil Code*.

Contract rescission is a legal procedure that allows a party to nullify a valid contract due to the absence of genuine intent at the time of formation.<sup>218</sup> Articles 147-151 of the *Civil Code* outline five grounds for contract rescission: material misinterpretation, manifest unfairness, fraud, duress, and exploitation of another's position. There is some debate regarding the validity of franchise contracts when the franchisor fails to meet the disclosure requirement. Regarding issues of the franchisor concealing operational information or providing false information, Article 148 of the *Civil Code* stipulates that legal acts conducted through fraudulent means may be subject to rescission upon request.

Mutual termination occurs when both parties agree to terminate a contract, requiring clear mutual consent as specified in Article 562 of the *Civil Code*. This allows termination if both agree or if agreed-upon conditions are met. Statutory termination, however, permits one party to end the contract if a legal ground arises, with the primary criterion being that the contract's purpose can no longer be fulfilled.<sup>219</sup> According to Article 580 of the *Civil Code*, if the franchisee acknowledges a breach and the contract is terminated, no compensation is provided for operational losses such as rent, equipment, and labor costs. However, if the franchisee claims a fundamental breach

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<sup>218</sup> Liming Wang, Shaokun Fang, and Yi Wang, *Contract Law* (Beijing: China Renmin University Press, 2013).

<sup>219</sup> *Civil Code 2021*, Art. 563, stipulates that a party may terminate a contract under the following circumstances: (1) force majeure prevents the achievement of the contract's purpose; (2) one party clearly expresses or demonstrates an intention not to perform its main obligations before the performance deadline; (3) one party delays performance of its main obligations and, after being urged, still fails to fulfill them within a reasonable time; (4) one party's delay in performance or other breach prevents the realization of the contract's purpose; (5) other conditions specified by law. In contracts for continuous performance, either party may terminate the contract at any time, provided they notify the other party within a reasonable period.

by the franchisor under Article 563 of the *Civil Code*, they may invoke Article 566 of the *Civil Code*<sup>220</sup>, to seek compensation for damages.<sup>221</sup>

## 2.6 Theoretical Framework of Franchisee Protection

This section discusses the basic theories of contract law, such as freedom of contract, fairness and relational contract theory. In addition, information asymmetry theory and principal-agent theory are used to explain franchising and why franchisees should be protected.

### 2.6.1 Freedom of Contract

Freedom of contract is central to contractual regulation, allowing parties to choose and define transaction terms within legal limits. It emphasizes autonomy and equality of civil subjects. Classical contract theory, which asserts "contract is justice," assumes that freedom of contract naturally leads to fairness. This theory relies on the premise of absolute equality and perfect market competition between contract parties.<sup>222</sup> The freedom of contract assumes the parties are in a free and equal position, but when one party has an advantage, unilateral contract terms emerge. In cases of unequal bargaining power, freedom of contract alone cannot ensure a fair balance of interests.<sup>223</sup>

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<sup>220</sup> *Civil Code 2021*, Art. 566, stipulates that after the contract is terminated, if the contract has not been performed, performance shall be terminated; if it has been performed, the parties may request the restoration of the original state or take other remedial measures, depending on the performance and nature of the contract, and have the right to request compensation for damages.

<sup>221</sup> Shiyuan Han, *General Principles of Contract Law* (Beijing: Law Press, 2018).

<sup>222</sup> Irakli Tedoradze, "The Principle of Freedom of Contract, Pre-Contractual Obligations Legal Review English, EU and US Law," *European Scientific Journal, ESJ* 13, no. 4 (2017): 62.

<sup>223</sup> Xingquan Cao, "The Obligation of Voluntary Disclosure of Contracting Information from the Perspective of Separation of Civil and Commercial Affairs," *Henan Social Sciences* 25, no. 6 (2017): 44-52.

Some legal scholars argue that contractual regulation is inadequate for protecting franchisee interests, as franchising typically relies on a standard form contract provided by the franchisor.<sup>224</sup> Driven by profit-seeking, franchisors design standard form clauses to maintain control over the franchisee. Enforcement under the standard form contract may instead amplify the franchisee's losses. In addition, Eisenberg argued that standard clauses were unenforceable because the process of contracting was not based on bargaining.<sup>225</sup> Bargaining power is the ability to obtain as much mutual benefit as possible from any contract.<sup>226</sup> The parties often differ in economic power and trading experience, leading to an imbalance in bargaining power. The bargaining power of the franchisee is weaker than that of the franchisor. Even if the franchisee discovers the existence of unequal terms, it is powerless to change them and may even have to withdraw from the franchise to minimize its losses.

Therefore, the principles of freedom of contract are undermined in cases of standard form contracts and unequal bargaining power. The weak party is easily restricted by the dominant party, resulting in substantive unfairness.

### **2.6.2 Fairness**

According to the principle of fairness, the contract parties should enter into and perform the agreement based on equality and voluntary consent.<sup>227</sup> The content of the contract shall reflect the requirements of the principles of fairness and good faith.

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<sup>224</sup> Tanya Woker, "Franchising—The Need for Legislation: Analyses," *SA Mercantile Law Journal* 17, no. 1 (2005): 49-56.

<sup>225</sup> Lon L. Fuller, Melvin Aron Eisenberg, and Mark P. Gergen, *Basic Contract Law*, 11th ed. (St. Paul, MN: West Academic Publishing, 2023).

<sup>226</sup> John Black, *A Dictionary of Economics* (Oxford: Oxford University Press, 2002).

<sup>227</sup> Article 6 of the Civil Code of the People's Republic of China states that civil subjects engaging in civil activities shall follow the principle of fairness and reasonably determine the rights and obligations of all parties.

Neither party may abuse its economic position to the detriment of the other party.<sup>228</sup>

Professor Liang argues that civil law has shifted from pursuing formal fairness to substantive fairness. He believes modern contract law now focuses on contractual fairness rather than contractual freedom.<sup>229</sup> The theory of fairness emphasizes the balance of interests of both parties. It acknowledges that while contracts are based on mutual consent, the dominant party often holds an advantage over the weaker party.

Therefore, substantial fairness should be incorporated into contract formation to address the limitations of the freedom of contract theory. In situations of inherent inequality, it is necessary to establish a balance between the parties' interests. The theory of fairness emphasizes the protection of the weaker party in the contractual relationship. This study adopts this theoretical framework to support the protection of franchisees, addressing the shortcomings of the freedom of contract theory in contexts where power imbalances exist.

### **2.6.3 Relational Contract Theory**

Classical contract theory conceives contracts as discrete transactions between autonomous parties, grounded in principles of freedom of contract. In the middle and late 20th century, the classical contract theory has been severely challenged. American scholar Gilmore believes that the classical contract theory with the freedom of contract as the core is going to die out in contemporary jurisprudence. Macneil criticized the definition of contract in the U.S. Contract Law Restatement (Second) for failing to capture its true nature. He argued that party consent or agreement is not the sole

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<sup>228</sup> Liming Wang, "Discussion on Some Difficult Problems in the Formulation of Unified Contract Law (Part 1)," *Forum on Political Science and Law* 14, no. 4 (1996): 49-56.

<sup>229</sup> Huixing Liang, "From Modern Civil Law to Modern Civil Law: A Review of Civil Law in the 20th Century," *Chinese and Foreign Law* 2 (1997): 19-30.

element of a contract.<sup>230</sup> The social background or the facts of the transaction should also be considered. Classical contract law assumes that transactions are one-off or discrete, but it's relational. Macneil proposed the relational contract theory, which puts contracts in a social context.<sup>231</sup> Relational contracts are characterized by their incompleteness and long-term nature, as franchisors and franchisees often cannot anticipate all the risks associated with contract performance.<sup>232</sup>

The relational perspective used in this study does not completely reject classical contract theory but develops and expands it to better explain the long-term and complex nature of franchising relationships. Franchise contracts often include open-ended clauses, creating uncertainty about the parties' rights and obligations. To address contractual gaps, franchisors often grant themselves discretionary powers, enabling unilateral changes to the contract. This can lead to increased obligations for franchisees or reduced liabilities for franchisors. Franchisees face a dilemma: accept unfair terms or leave the franchise system. The incomplete nature of such contracts can encourage opportunistic behavior by franchisors, further disadvantaging franchisees.<sup>233</sup>

In addition, the relational contract theory reveals the hidden cost of contracts, especially long-term contracts. The weaker party needs to invest a lot of extra costs to maintain the contractual relationship. These costs, which are not contractual obligations and are not explicitly reflected in the contract text, are known as sunk

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<sup>230</sup> Gillian K. Hadfield, "Problematic Relations: Franchising the Law of Incomplete Contracts," *Stanford Law Review* 42 (1989): 927.

<sup>231</sup> Ian R. Macneil, *The New Social Contract: An Inquiry into Modern Contractual Relations* (New Haven: Yale University Press, 1980).

<sup>232</sup> Alan Schwartz, "Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies," *Journal of Legal Studies* 21 (1992): 271

<sup>233</sup> James V. Jordan and Judith B. Gitterman, "Franchise Agreements: Contracts of Adhesion," *Franchise Law Journal* 16 (1996): 1.

costs.<sup>234</sup> During the performance of the contract, the franchisee relies on the franchisor to provide long-term and continuous guidance and assistance, including guidance on decoration, product supply, and staff training. The franchisee must commit substantial capital to the franchise system, creating sunk cost pressures and continuous risks, particularly for small and medium-sized investors. These sunk costs heighten one party's dependence on the other, with the franchise relationship largely rooted in the franchisee's reliance on the franchisor.<sup>235</sup>

#### **2.6.4 Information Asymmetry Theory**

The theory of information asymmetry, first introduced by Arrow in 1963, is a cornerstone of information economics and broader economic theory.<sup>236</sup> Akerlof expanded the theory by introducing the market for lemons model, highlighting the information imbalance between buyers and sellers. In order to gain more profits, the seller takes advantage of the buyer's inferior information and sells the inferior products to the buyer at the average market price. This has led to the phenomenon of inferior products driving out high-quality products in the market. Akerlof called it adverse selection, and further pointed out that the existence of adverse selection must lead to market inefficiency and even market failure. The theory of information asymmetry provides a new perspective to explain the information disclosure system in the field of franchising.

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<sup>234</sup> Oliver E. Williamson, "Why Law, Economics, and Organization?" *Annual Review of Law and Social Science* 1, no. 1 (2005): 369-396.

<sup>235</sup> Oliver E. Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations," *The Journal of Law and Economics* 22, no. 2 (1979): 233-261.

<sup>236</sup> Gerald Bloom, Hilary Standing, and Robert Lloyd, "Markets, Information Asymmetry and Health Care: Towards New Social Contracts," *Social Science & Medicine* 66, no. 10 (2008): 2076-2087.

Stiglitz applied the theory of information asymmetry to the insurance market and proposed a theoretical model to solve the problem of adverse selection in insurance. His research suggests that governments can intervene in several ways to prevent market failures caused by information asymmetry.<sup>237</sup> For example, governments can set standards and regulations that require companies to provide more information about their products and services. This thesis puts forward that statutory supervision is used to balance the interest relationship of transaction subjects. Professor Zhang Wenxian believes that law is an important means of social control.<sup>238</sup> The law clarifies the distribution of different interests to achieve the coordination and balance of the interest relations between different subjects. According to the view of information economics, law is formed by the compromise and balance of various interests.<sup>239</sup>

### 2.6.5 Principal-agent Theory

Principal-agent theory is developed based on the research of information asymmetry and incentive problems.<sup>240</sup> This theory aims to design an optimal contract that motivates agents despite conflicting interests and asymmetric information. British economist Morris believes that the two sides of the transaction are a principal-agent relationship. The agent refers to the party with the advantage of information in the transaction, while the principal is the party with the disadvantage of information.<sup>241</sup> In a principal-agent relationship, the principal seeks wealth, while the agent seeks

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<sup>237</sup> Joseph Stiglitz and Jungyoll Yun, *Optimality and Equilibrium in a Competitive Insurance Market Under Adverse Selection and Moral Hazard*, no. w19317 (National Bureau of Economic Research, 2013), <https://doi.org/10.3386/w19317>.

<sup>238</sup> Wenxian Zhang, *Jurisprudence*, 5th ed. (Beijing: Law Press, 2018), 54.

<sup>239</sup> Anthony I. Ogus, *Regulation: Legal Form and Economic Theory* (Bloomsbury Publishing, 2004).

<sup>240</sup> Anne Marie Doherty and Barry Quinn, "International Retail Franchising: An Agency Theory Perspective," *International Journal of Retail & Distribution Management* 27, no. 6 (1999): 224-237.

<sup>241</sup> Kathleen M. Eisenhardt, "Agency Theory: An Assessment and Review," *Academy of Management Review* 14, no. 1 (1989): 57-74.

compensation and leisure, creating conflicting interests.<sup>242</sup> The agent may break away from the control of the principal and sacrifice the interests of the principal.

Moreover, due to the difficulty of monitoring, the agent may exploit the information advantage to "free ride," conceal information, or neglect duties, harming the principal's interests.<sup>243</sup> As a result, the principal attempts to design the optimal contract to motivate and supervise the agent in order to avoid the opportunist risk. The principal-agent theory suggests ways to design contracts or mechanisms that minimize costs, reduce the principal-agent problem, and maximize utility.<sup>244</sup> This relationship relies on a contract, where the principal hires the agent to perform services, including delegating decision-making authority.<sup>245</sup>

A franchise relationship is like that between a principal and his "agent". In franchising, the franchisor has the ownership of intangible assets such as trademarks, trade names, logos, trade secrets, technology, and business models. For example, the franchisor owns the trademark as the registrant, while franchisees are granted the right to use it on their products or services.<sup>246</sup> Maintaining uniform standards and high quality in the business process is critical to franchisors because the market value of trademarks is affected by the quality of the franchisee's management. Franchisors typically control the franchisee's business area and ensure adherence to a uniform business model.<sup>247</sup>

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<sup>242</sup> Zohar Goshen and Richard Squire, "Principal Costs: A New Theory for Corporate Law and Governance," *Columbia Law Review* 117 (2017): 767.

<sup>243</sup> Kathleen M. Eisenhardt, "Agency Theory: An Assessment and Review," *Academy of Management Review* 14, no. 1 (1989): 57-74.

<sup>244</sup> James G. Combs, Steven C. Michael, and Gary J. Castrogiovanni, "Franchising: A Review and Avenues to Greater Theoretical Diversity," *Journal of Management* 30, no. 6 (2004): 907-931.

<sup>245</sup> Darren G. Hawkins and Wade Jacoby, "How Agents Matter," in *Delegation and Agency in International Organizations* 1 (2006): 199-228.

<sup>246</sup> Francis J. Duffin and Bryan S. Watson, "Best Practices in Protecting and Enforcing Trademarks, Copyrights, and Other Intellectual Property Rights," *Franchise Law Journal* 28 (2008): 132.

<sup>247</sup> Kenneth H. Wathne and Jan B. Heide, "Opportunism in Interfirm Relationships: Forms, Outcomes,

In short, this study provides a fresh theoretical foundation for understanding and improving the current protection for franchisees. This study highlights the shortcomings of classical contract theory in dealing with the unique characteristics of franchise relationships. Unlike the one-off transactions assumed by classical contract theory, franchise relationships are ongoing and dynamic, often involving changes in the parties' relationship or the broader social environment. By incorporating relational contract theory, this research provides a deeper understanding of how such relationships function over time, emphasizing the importance of fairness as a necessary complement to the traditional focus on contractual freedom. In addition, the study uses information asymmetry theory to explain the critical role of disclosure requirements in franchising. It shows how imbalances in information between franchisors and franchisees can lead to unfair practices. The application of principal-agent theory further examines the conflicts of interest inherent in franchising, offering practical insights into how such conflicts might be managed through effective regulation.

## **2.7 Summary**

This chapter provides a comprehensive analysis of the legal and regulatory framework for franchising in China, addressing key aspects of the contemporary legal system, the historical development of franchising regulation, elements of franchising, current specific regulation of franchising and theories related to franchisee protection.

This chapter begins by examining China's contemporary legal system, focusing on the roles of key institutions such as the NPC, the State Council, and the Supreme People's

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and Solutions," *Journal of Marketing* 64, no. 4 (2000): 36.

Court, and the hierarchical relationship between central and local legislation. It finds that the NPC is the highest legislative body in China, holding the supreme legislative authority. The State Council, as the central government, is tasked with implementing the laws enacted by the NPC and can also enact administrative regulations within its scope of authority. Additionally, the Supreme People's Court plays a critical role in shaping the legal framework by issuing judicial interpretations and guiding cases, which influence judicial practices across the country. This chapter also highlights the hierarchical relationship between central and local regulations, ensuring that local laws do not contradict those established at the national level. Moreover, this study points to the evolving nature of China's dispute resolution system, which incorporates arbitration and mediation as alternative methods alongside traditional litigation, reflecting the China's commitment to a diversified approach in resolving legal disputes.

It also reviews the historical development of franchise regulation in China, which is divided into four distinct phases. It focuses on three landmark legal documents that have shaped the regulatory framework: the *CFAM 1997*, which marked the initial recognition of franchising; the *CFAM 2004*, representing the progression toward formalized regulation; and the *CFAR 2007*, which introduced administrative regulation and established a more comprehensive regulatory system. Despite the progress made since the recognition of franchising in 1997 and the issuance of *CFAR 2007*, this chapter identifies significant gaps, such as the absence of franchise-specific legislation enacted by the NPC and the administrative nature of current regulation.

Moreover, this chapter examines the key elements of franchising under the current franchise legal framework, identifying four fundamental characteristics: a legally

binding contractual relationship, the transfer of business resources, adherence to a standardized business model, and the requirement of a franchise fee. It then explores two primary franchising types: product and trademark franchising, pioneered by the American Singer Sewing Company and recognized as the first generation of franchising, and business model franchising, exemplified by KFC and McDonald's, which involves the comprehensive transfer of franchise resources and represents the second generation. The study also underscores the necessity of clearly distinguishing franchising from other business models, such as chain operations, commercial agency, distribution and intellectual property licensing.

This chapter further delves into the current regulatory approaches, focusing on three key aspects: disclosure, registration and contract regulation. The mandatory disclosure system, as outlined in *CFAR 2007* and *CFIDAM 2012*, provides franchisees with essential information before contract signing, along with a cooling-off period and protections against false disclosures. While the franchise registration system ensures oversight, it does not provide administrative approval, limiting its role in franchise activities. Moreover, while franchise contracts are required to be in writing, the lack of detailed provisions in *CFAR 2007* means these contracts are largely governed by the general contract rules set forth in the *Civil Code*. Finally, this chapter examines key contractual theories, including freedom of contract, fairness and relational contract. It also explores information asymmetry theory and principal-agent theory, providing insights into the challenges within the franchisor-franchisee relationship.

## **CHAPTER THREE**

### **LEGAL REGULATION AND MECHANISM ON FRANCHISEE PROTECTION IN CHINA**

#### **3.1 Introduction**

This chapter aims to achieve the second research objective, which is to analyse the current protection for franchisees in China. This chapter reviews the general provisions of the *Civil Code* and specific franchise regulations, including *CFAR 2007*, *CFRAM 2011* and *CFIDAM 2012*, to assess their role in protecting franchisees. It specifically examines franchisee protection under China's existing legal and regulatory framework, focusing on disclosure system, registration and contract requirements.

This chapter explores the disclosure approach as a critical regulatory tool for protecting franchisees, addressing issues such as the disclosure obligations of franchisors, the timing and content of disclosures, the cooling-off period and the consequences of non-compliance. Additionally, this chapter introduces the registration requirements, clarifying its purpose, process of registration, pre-conditions of registration and compliance requirements. Finally, it analyses various franchise agreements, focusing on specific regulations and general provisions of the *Civil Code* related to good faith, contract validity, civil liability, and remedies.

### **3.2 The Need to Protect Franchisee**

The need to protect franchisees arises from several distinctive features of franchise contracts. Firstly, franchise contracts are often standardized, leaving franchisees with limited bargaining power and room for negotiation. Secondly, franchise contracts are relational in nature, governing a long-term, ongoing partnership rather than a one-time transaction. This extended relationship increases the potential for exploitation and creates a need for safeguards to ensure fair treatment. Thirdly, while franchisees operate individual outlets, they must comply with the franchisor's system to maintain brand consistency, which often limits their autonomy and could lead to unfair practices if not properly regulated. Lastly, the information asymmetry places franchisees at a disadvantage, highlighting the need to protect their interests from exploitation and ensure transparency and fairness in the contractual relationship.

The following section explains why franchisees need protection from four aspects: standard form contracts, relational contracts, the conflict between franchisee autonomy and franchisor control, and information asymmetry.

#### **3.2.1 Standard Form Contract**

Standard form contracts have emerged because of the evolution of labor specialization and the rise of monopolistic entities. It is defined as a clause that the parties have prepared in advance for repeated use and that has not been negotiated with the other

party at the time of contract conclusion.<sup>248</sup> A distinctive feature of franchise contracts is their standardized nature, which is unilaterally established by the franchisor. This standardization significantly impacts the negotiation dynamics within franchise relationships. One of respondent noted that,

*"Franchisors are often unwilling to change contract terms and tend to hold back the official contract until after it's signed, claiming it's to protect their trade secrets. This practice limits the franchisee's chance to negotiate any terms."*<sup>249</sup>

The widespread use of form contracts exacerbates the power imbalance between franchisors and franchisees.<sup>250</sup> Franchisees are typically presented with a "take it or leave it" proposition, without any opportunity for negotiation once the contract is reviewed.<sup>251</sup> As a result, franchisees are compelled to operate strictly within the standardized contract. These contracts are often designed to safeguard the franchisor's interests, with minimal regard for the franchisee's position. Interviews with franchisees reveal that such contracts frequently contain clauses that disproportionately burden the franchisee with obligations and risks. According to the experiences shared by franchisee respondents, the imbalance is further compounded by operational manuals

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<sup>248</sup> *Civil Code*, Art. 496.

<sup>249</sup> R 10 (Franchisee), physical at the office, March 15, 2024.

<sup>250</sup> Alan Felstead, *The Corporate Paradox: Power and Control in the Business Franchise* (Taylor & Francis, 2024).

<sup>251</sup> Frederik Zuiderveen Borgesius, Natali Helberger, and Agustin Reyna, "The Perfect Match? A Closer Look at the Relationship between EU Consumer Law and Data Protection Law," *Common Market Law Review* 54, no. 5 (2017): 1427, <https://doi.org/10.54648/cola2017118>.

that impose additional requirements on franchisees.<sup>252</sup> This results in a contractual framework that predominantly serves the franchisor's interests and may exploit the franchisee's comparatively weaker bargaining position.

### 3.2.2 Relational Contract

The franchise contract is also characterized as a relational contract. Unlike classical contract theory, which focuses on the agreement at the point of formation, relational contract theory emphasizes the dynamic and ongoing nature of contractual relationships.<sup>253</sup> In such contracts, it is impossible for the parties to fully anticipate and allocate all risks at the time of formation, particularly in long-term arrangements like franchise agreements. The rights and obligations of the parties may evolve over time in response to changes in external circumstances, resulting in inherent uncertainty.

Relational contract also highlights the hidden costs associated with long-term contracts. In such agreements, the weaker party often incurs substantial additional costs to sustain the contractual relationship. These costs, not explicitly outlined in the contract, are termed "sunk costs." Unlike one-time contracts, long-term contracts foster a higher degree of trust between the parties.<sup>254</sup> Franchisees, for instance, depend on the franchisor for ongoing support, including guidance on store design, product supply,

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<sup>252</sup> R 10 (Franchisee), physical at the office, March 15, 2024; R 12 (Franchisee), physical at the office, March 9, 2024; R 8 (Franchisee), Online, March 1, 2024.

<sup>253</sup> Nicholas Argyres, Janet Bercovitz, and Giorgio Zancarone, "The Role of Relationship Scope in Sustaining Relational Contracts in Interfirm Networks," *Strategic Management Journal* 41, no. 2 (2020): 222–245.

<sup>254</sup> Shiau-Ling Guo, "When Less May Be More: A Dyadic View of Franchise Contracts," *Long Range Planning* 56, no. 4 (2023): 102343, <https://doi.org/10.1016/j.lrp.2023.102343>.

and staff training. The substantial capital investment required by franchisees creates sunk cost pressures and continuous risks, particularly for small and medium-sized investors. The presence of sunk costs increases the franchisee's dependency on the franchisor, leading to an imbalanced power dynamic within the franchise relationship.

### **3.2.3 The Conflict of Control and Autonomy**

A key feature of franchise agreement is the conflict between the franchisee's ownership of assets and the franchisor's control over operations. The franchisor's ongoing control over the franchisee covers several aspects, including brand usage, business model, product supply, pricing system, marketing strategies and service standards.<sup>255</sup> While such control is necessary to maintain brand consistency, it also limits the franchisee's autonomy. Franchisors often require franchisees to engage in advertising to enhance the brand's visibility, while franchisees may prioritize profit maximization, sometimes at the expense of product or service quality.<sup>256</sup> This decline in quality can harm the franchise system, which is why franchisors enforce quality control measures. As Gillian Hadfield said,

On the one hand, the franchisor has a strong interest in exercising control over the product quality decisions and over the design of the overall system; on the other hand, the franchisee has a strong interest

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<sup>255</sup> Brian Callaci, "Control Without Responsibility: The Legal Creation of Franchising, 1960–1980," *Enterprise & Society* 22, no. 1 (March 2021): 156–182, <https://doi.org/10.1017/eso.2019.58>.

<sup>256</sup> Herman Mark Schwartz, *From Fordism to Franchise* (United Kingdom: Oxford University Press, 2022).

in ensuring that the franchisor's exercise of control is not opportunistic.<sup>257</sup>

As indicated by the experiences shared by franchisors and franchisees during interviews, franchisors often develop highly detailed, unilateral contracts that delineate the obligations of both parties across all stages of the franchise relationship.<sup>258</sup> These contracts are designed to address potential opportunism by specifying pre-contractual, contractual, and post-contractual obligations. Ensuring uniform standards and maintaining high quality in franchise operations is critical for the franchisor, as the value of intangible assets such as trademarks is directly influenced by the franchisee's management practices.

However, it noted that franchisors frequently use their dominant position to exert too much control over franchisees.<sup>259</sup> A common issue is that franchisors often revise the operating manual after the contract is signed, without consulting franchisees, further amplifying the imbalance of power in the relationship. This can lead to unexpected costs or operational changes that impact franchisees, particularly small or financially vulnerable ones. As Gillian Hadfield noted that,

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<sup>257</sup> Gillian K. Hadfield, "Problematic Relations: Franchising the Law of Incomplete Contracts," *Stanford Law Review* 42 (1989): 33, <https://doi.org/10.2307/1228908>.

<sup>258</sup> R 7 (Franchisee), physical at the office, March 30, 2024; R 11 (Franchisee), physical at the office, March 23, 2024.

<sup>259</sup> R 14 (Franchisor), Membership in CCFA, Online, February 16, 2024; R 15 (Franchisor), physical at the office, February 22, 2024; R 11 (Franchisee), physical at the office, March 23, 2024; R 12 (Franchisee), physical at the office, March 9, 2024.

Moreover, the written contract appears to address only one side of the underlying commitment problem in the relationship, specifically the franchisor's problem of quality control. It fails to address the franchisee's problem of controlling franchisor opportunism. Instead, the contract leaves to the franchisor's discretion the exercise of both the powers of quality control and design.<sup>260</sup>

### 3.2.4 Information Asymmetry

In information economics, transaction costs are closely tied to information asymmetry, where one party has access to more or better information than the other.<sup>261</sup> This disparity increases uncertainty and the costs of transactions. In franchise relationships, this phenomenon is particularly evident, as franchisors typically possess detailed knowledge of business operations, while franchisees—especially those with limited business experience—are often at an informational disadvantage.<sup>262</sup> As markets grow more complex and productivity increases, it becomes more difficult for franchisees to acquire complete information. This information gap raises transaction costs as franchisees must invest in gathering and validating necessary details. More critically, it creates a fertile ground for opportunistic behavior. Franchisors, who control essential

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<sup>260</sup> Gillian K. Hadfield, "Problematic Relations: Franchising the Law of Incomplete Contracts," *Stanford Law Review* 42 (1989): 33, <https://doi.org/10.2307/1228908>.

<sup>261</sup> Tom A.E. Aben, Wendy van der Valk, Jens K. Roehrich, and Kostas Selviaridis, "Managing Information Asymmetry in Public–Private Relationships Undergoing a Digital Transformation: The Role of Contractual and Relational Governance," *International Journal of Operations & Production Management* 41, no. 7 (2021): 1145-1191, <https://doi.org/10.1108/IJOPM-09-2020-0675>.

<sup>262</sup> Farhad Sadeh and Manish Kacker, "Quality Signaling through Ex-Ante Voluntary Information Disclosure in Entrepreneurial Networks: Evidence from Franchising," *Small Business Economics* 50 (2018): 729-748.

operational knowledge, may exploit this advantage to impose terms that benefit them at the expense of franchisees, potentially leading to unfair practices or even fraud.<sup>263</sup>

Furthermore, the reliability of such information is not always guaranteed. One of respondent recounted personal experiences where franchisors made exaggerated claims about their franchise systems and provided misleading assurances about potential returns on investment.<sup>264</sup> Because of the information asymmetry, the party with the information advantage does not disclose the information completely and truthfully, and thus engages in the behavior of self-interest at the expense of others.<sup>265</sup>

It has been observed in interviews that some franchisors, utilizing their comprehensive understanding of their products and operations, may engage in the distortion of information to maximize their profitability.<sup>266</sup> They are likely to obscure negative aspects, such as their own operational responsibilities and potential product deficiencies, while overstating positive attributes, including market potential and profitability, to entice prospective franchisees. This selective disclosure undermines transparency and fairness, leading to potential misinformation for franchisees.

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<sup>263</sup> Robert W. Emerson, "Transparency in Franchising," *Columbia Business Law Review* (2021): 172

<sup>264</sup> R 11 (Franchisee), physical at the office, March 23, 2024.

<sup>265</sup> Maureen Brookes, Levent Altinay, and Gurhan Aktas, "Opportunistic Behaviour in Hospitality Franchise Agreements," *International Journal of Hospitality Management* 46 (2015): 120-129.

<sup>266</sup> R 16 (Lawyer), physical at the office, April 5, 2024; R 12 (Franchisee), physical at the office, March 9, 2024; R 20 (Regulator), physical at the office, April 5, 2024.

In summary, the need to protect franchisees stems from the unique and complex nature of franchise contracts, which combine standardization, long-term cooperation, and a delicate balance of control and autonomy. The inherent information asymmetry between the franchisor and franchisee further amplifies the risks for franchisees, making it essential to implement protective measures.

### **3.3 Analysis of the Disclosure Approach**

#### **3.3.1 Disclosure as a Regulatory Tool for Protecting Investors**

The concept of disclosure approach originated in the securities market, where it was developed to ensure transparency and protect investors by requiring comprehensive information about securities to be publicly available.<sup>267</sup> The information disclosure system originated in the early 18th century in the United Kingdom, with the South Sea Bubble of 1720 being a crucial event. The South Sea Company misled investors by exaggerating its prospects, causing a stock price surge and crash that severely affected the economy.

Subsequently, the *Bubble Act* was enacted, prohibiting misleading share issuances and laying the foundation for formal disclosure practices.<sup>268</sup> In 1844, the United Kingdom advanced disclosure requirements with the *Joint Stock Companies Act*, mandating that

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<sup>267</sup> David W. Case, "The Law and Economics of Environmental Information Regulation," *Environmental Law Reporter* 31 (2001): 10774, <https://ssrn.com/abstract=1017639>.

<sup>268</sup> Charles Mackay, *Extraordinary Popular Delusions and the Madness of Crowds* (Harriman House Classics, 2003).

companies report asset usage and undergo audits, thus moving from voluntary to mandatory disclosure.<sup>269</sup>

In the USA, the *Blue-Sky Law* in 1911 marked the start of comprehensive disclosure regulations by requiring public disclosure of key securities information. The 1929 Wall Street crash, compounded by widespread illegal speculation, fraud, and market manipulation, led the U.S. federal government to implement the *Securities Act* in 1933 and the *Securities Exchange Act* in 1934. The *Securities Act* was pivotal, introducing the first comprehensive financial disclosure requirements in the U.S. and setting the standard for formal information disclosure systems globally. Disclosure systems in the securities market address investment protection.

The information disclosure system has become a crucial tool for government oversight of market order and for protecting investor rights. Louis Brandeis's adage—"Sunlight is said to be the best disinfectant; electric light the most efficient policeman"—emphasizes that transparency and disclosure are essential for effective regulation.

### **3.3.2 Disclosure as a Regulatory Tool for Protecting Franchisees**

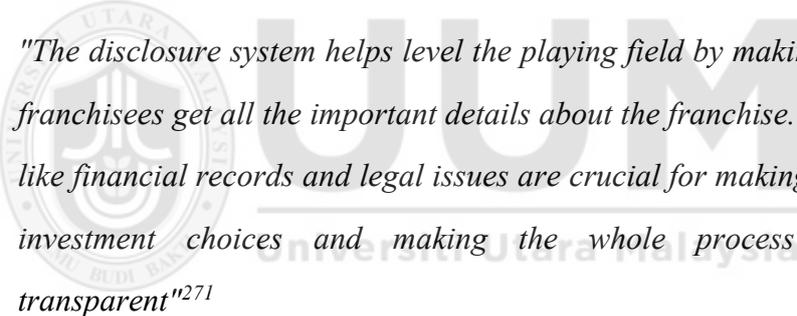
Most franchisors are well-established brands with significant market recognition, placing them in a relatively strong position. Conversely, franchisees, often individual

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<sup>269</sup> Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation* (Aspen Law & Business, 2001).

investors, or small businesses, typically have limited knowledge of the franchising industry and rely heavily on the information and resources provided by the franchisor. This creates an inherent imbalance in the relationship, with franchisees in a weaker position.<sup>270</sup>

Given the shared challenges in investor protection between franchising and securities markets, the lessons learned from securities regulations have informed the implementation of mandatory disclosure requirements in franchising. As Respondent 15 highlighted,



*"The disclosure system helps level the playing field by making sure franchisees get all the important details about the franchise. Things like financial records and legal issues are crucial for making smart investment choices and making the whole process more transparent"*<sup>271</sup>

The *Investment Law* in 1971 was the pioneering legislation in franchising, introducing mandatory disclosure and registration requirements. Its primary goals were to ensure prospective franchisees received crucial information, to prevent fraudulent franchise sales, and to clarify the relationship between franchisors and franchisees.<sup>272</sup> This law set a precedent for franchise regulation by focusing on disclosure and protecting

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<sup>270</sup> Richard C. Hoffman and John F. Preble, "Global Franchising: Current Status and Future Challenges," *Journal of Services Marketing* 18, no. 2 (2004): 101-113.

<sup>271</sup> R 15 (Franchisor), physical at the office, February 22, 2024.

<sup>272</sup> *California Franchise Investment Law*, Section 31001.

investors in the franchise sector. In 2002, the International Institute for the Unification of Private Law introduced the *Model Franchise Disclosure Law*, which emphasizes comprehensive disclosure requirements and permits limited exemptions. This model provides a framework for jurisdictions to develop franchise-specific regulations grounded in effective disclosure practices.<sup>273</sup>

An international survey of disclosure regimes reveals that some jurisdictions, including Belgium, Brazil, France, Japan and Sweden, rely exclusively on an information disclosure system.<sup>274</sup> Franchising information disclosure involves the franchisor providing essential details to the franchisee, which is crucial for the franchisee's investment decision. Before forming a franchise contract, the franchisor must disclose important information, enabling potential franchisees to make informed choices. Respondent 1 agreed that,

*"At the contract conclusion stage, the franchisor's obligation to disclose information allows the potential franchisee to make an informed decision about entering the business, thereby reducing the risk of financial losses due to poor decisions."<sup>275</sup>*

Respondent 3 added,

*"As an investor considering a franchise, I should have the right to fully understand the company's operational qualifications and*

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<sup>273</sup> Lena Peters, "UNIDROIT Prepares a Model Franchise Disclosure Law," *Business Law International* 4 (2000): 279-290.

<sup>274</sup> *Business Franchise Guide* (CCH, 2010).

<sup>275</sup> R 1 (Potential Franchisee), Online, December 11, 2023.

*performance. We need to assess the brand's effectiveness, market share, and other key details to make an informed investment decision."*<sup>276</sup>

These disclosure obligations are intended to protect investors, particularly franchisees, by ensuring they have access to crucial information before committing to an investment.

### **3.3.3 Franchisee Protection through Disclosure**

As franchising expanded in China, fraudulent practices emerged, leading to calls for regulation. The former MOC enacted the *CFAM 1997*, marking its first legislation focused on franchisor disclosure. Although this regulation marked a significant step by introducing disclosure requirements, it was incomplete and lacked specific enforcement mechanisms. Consequently, franchisees continued to face challenges related to inadequate information and protection. On December 31, 2004, MOC enacted the *CFAM 2004*, which replaced the *CFAM 1997*. These regulations require franchisors to provide timely disclosure of information, outlining specific requirements and penalties for non-compliance in Chapter five of the *CFAM 2004*. However, these measures were departmental regulations and lacked robust legal authority.

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<sup>276</sup> R. 3 (Potential Franchisee), Online, December 12, 2023.

It was not until 2007 that the central government enacted the *CFAR 2007*, elevating disclosure requirements to the status of a formal administrative regulation with specific legal provisions. Currently, *CFAR 2007* includes a dedicated Chapter three on information disclosure, underscoring the importance of disclosure as a regulatory tool for franchising. Compared with the *CFAM 2004*, the latest *CFAR 2007* requirements for franchise information disclosure have the following three changes.

First, the obligation of franchise information disclosure is a requirement for franchisors who are in a dominant position under the *CFAR 2007*. It limited the subject of the franchise information disclosure obligation to the franchisor and cancelled the franchisee's information disclosure obligation. Second, *CFAR 2007* extended the time requirement for franchisor information disclosure. The time of disclosure was changed from 20 days to 30 days in *CFAR 2007*. Third, the *CFAR 2007*, perfect the basic principles of information disclosure, which added the integrity principle.

Subsequently, MOC introduced *CFIDAM 2012* to further refine and interpret *CFAR 2007*, enhancing the practical application of franchise disclosure regulations. Compared to *CFAR 2007*, *CFIDAM 2012* introduces several key improvements. It imposes confidentiality obligations on franchisees and simplifies the renewal process by eliminating redundant disclosure requirements. Additionally, *CFIDAM 2012* improves enforcement by allowing franchisees to terminate the contract only if non-

compliance with disclosure obligations prevents achieving the contract's main purpose, thus ensuring contract stability.

### **3.3.3.1 Disclosure by Franchisors**

The primary objective of the disclosure requirements is to address information asymmetry and protect franchisees, who are generally in a weaker position. Compared to *CFAM 2004*, which imposed disclosure obligations on both franchisors and franchisees, *CFAR 2007* and *CFIDAM 2012* represent a legislative shift by focusing disclosure requirements solely on franchisors. Generally, imposing disclosure obligations on franchisees is unnecessary and adds burden, potentially undermining the effectiveness of the disclosure regime. In fact, franchisors can protect their interests through contractual terms, making additional legal intervention possibly redundant and prone to regulatory overreach.

In contemporary franchising practices, the franchise system often involves multiple tiers, including franchisors, sub franchisors, and franchisees, with each layer responsible for various aspects of business operations and development. The introduction of third-party intermediaries, such as regional heads or sub franchisors, complicates the franchise relationship and increases the potential for information asymmetry and collusion. The complexity inherent in hierarchical franchise systems, where regional franchisors act as both franchisees of a master franchisor and

franchisors within their own territories, presents significant regulatory challenges. As Respondent 8 mentioned,

*"... the rules on who needs to disclose information are not clear. They mostly focus on the franchisor, but in practice, some franchisors operate at multiple levels, like regional or master franchisors."<sup>277</sup>*

Therefore, the current regulatory framework needs to improve the clarity of disclosure obligations and responsibilities between master franchisors and regional franchisors to ensure clear legal applicability.

### **3.3.3.2 Timing of Disclosure**

Based on the time when the franchisor and the franchisee sign the franchise contract, the information disclosure of the franchisor includes both pre-contractual disclosure and post-contractual disclosure. As in the USA and Malaysia, most national legislation on the disclosure focuses on the disclosure of pre-contractual information.<sup>278</sup> Article 21 of *CFAR 2007* and Article 4 of *CFIDAM 2012* both stipulate that the franchisor shall disclose the required information within 30 days before the formal signing of the franchise contract. This requirement ensures that franchisees have adequate time to review and understand the franchisor's information, thereby protecting their ability to make good investment choices.

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<sup>277</sup> R 8 (Franchisee), Online, March 1, 2024.

<sup>278</sup> Rakan F. Alrdan, "Pre-Contractual Disclosure as a Cornerstone of the New Saudi Commercial Franchise Legislation," *Beijing Law Review* 12 (2021): 228, <https://doi.org/10.4236/blr.2021.121014>.

However, interviews with potential franchisees revealed that current franchise disclosure regulations are often bypassed when they are required to sign a letter of intent and make a non-refundable deposit before the finalization of the franchise contract.<sup>279</sup> This practice can obscure essential information for franchising, as franchisee may be committed to terms or lose their deposit without sufficient opportunity to review all relevant details. One of the respondents proposed that the Australian franchising legislation, which mandates a 14-day disclosure period before any non-refundable payment or binding agreement, offers valuable lessons.<sup>280</sup> This provision ensures that franchisees receive critical information in a timely manner, thereby reducing the risk of financial loss due to incomplete or delayed disclosures.

### **3.3.3.3 Ongoing Disclosure**

Notably, pre-contract disclosure usually covers only the current state of the franchisor and business, but it quickly becomes outdated as franchisors can change policies or management without notice. This may not fully address future risks or the broader network dynamics, such as financial flows and relationships within the franchise system. Therefore, ongoing disclosure of major changes by the franchisor is essential for safeguarding the interests of franchisees throughout the duration of the business relationship.

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<sup>279</sup> R 3 (Potential Franchisee), Online, December 12, 2023; R 4 (Potential Franchisee), physical at the office, December 22, 2023.

<sup>280</sup> R 16 (Lawyer), physical at the office, April 5, 2024.

Article 23 of the *CFAR 2007* stipulates the franchisor's duty of timely notification to ensure that the franchisee can grasp relevant information in the process of franchising. Due to the continuous characteristics of franchise contracts, the franchisor should timely disclose the relevant information to the franchisee if there is a major change in the subsequent contract performance process.<sup>281</sup> However, neither *CFAR 2007* nor *CFIDAM 2012* define or elaborate on the term "major change." In practice, significant changes are typically understood to encompass any developments that impact the operational aspects of the franchise. Changes in material information such as the franchisor's product offerings and advertising promotions have a direct impact on the franchisee's franchise operations.<sup>282</sup>

In the process of the performance of the franchise contract, the trademark and patent right may not be able to be used by others because of the cancellation, invalidation, or infringement judgment, which will have a substantial impact on the franchise. Therefore, continued disclosure of subsequent information is also critical.

Respondent 8 expressed concern over the lack of timely and comprehensive updates from franchisors regarding changes in franchise system promotion and publicity policies.<sup>283</sup> He emphasized that franchising is a long-term contractual relationship, not just a one-time transaction. However, under *CFAR 2007*, ongoing information

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<sup>281</sup> Robert W. Emerson, "Transparency in Franchising," *Columbia Business Law Review* (2021): 172.

<sup>282</sup> Steven C. Michael, "Do Franchised Chains Advertise Enough?" *Journal of Retailing* 75, no. 4 (1999): 461-478.

<sup>283</sup> R 8 (Franchisee), Online, March 1, 2024.

disclosure is mandated to be "timely," a term that lacks precise definition. Similarly, *CFIDAM 2012* does not offer specific guidelines regarding the timing of subsequent disclosures. This ambiguity poses significant challenges, as timely and detailed disclosure of material changes is essential for franchisees to make informed decisions.

Respondent 12 further pointed out that the absence of a clear disclosure timeframe could allow franchisors to withhold critical information, such as financial losses or market shifts, potentially leading to a misleading impression of the franchise.<sup>284</sup> He expressed concern that franchisors might selectively disclose favorable information while withholding negative details, which could place franchisees at a disadvantage.

#### **3.3.3.4 Form and Deliverer of Disclosure**

Article 21 of *CFAR 2007* mandates that "the franchisor shall provide the franchisee in writing with the information specified in Article 22 of the *CFAR 2007*." However, it lacks specific guidelines for a uniform format or template for disclosure, resulting in potential inconsistencies in the presentation and completeness of the information provided. Franchisees often face difficulties when franchisors intentionally omit information or alter specific disclosures.

Without a consistent disclosure format, it becomes challenging to assess whether the franchisor has adhered to regulatory requirements and provided all necessary

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<sup>284</sup> R 12 (Franchisee), physical at the office, March 9, 2024.

information comprehensively. In addition, it increases the time and resources required for both parties to prepare and review documents. This lack of uniformity can lead to delays and misunderstandings, complicating the evaluation process and ultimately affecting the overall effectiveness of the disclosure system.

Moreover, both Article 21 of *CFAR 2007* and Article 4 of *CFIDAM 2012* mandate that information disclosure must be provided in writing. The requirement for written disclosure helps mitigate the risk of ambiguity, as written records can serve as evidence in legal disputes to verify whether the franchisor has met its disclosure obligations. However, this requirement may not align with contemporary practices in the digital age, where many jurisdictions permit electronic forms of disclosure.

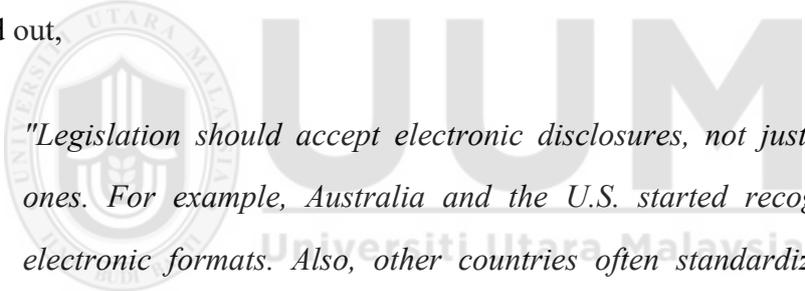
For instance, in the USA, the FTC's regulations permit franchisors to provide documents in both paper and electronic formats, such as fax, email, or CDs.<sup>285</sup> While *CFAR 2007* does not explicitly address electronic delivery, Article 469 of the *Civil Code* supports the use of electronic data messages as valid forms of information disclosure, provided they can be physically represented and accessed. In the case of *Qingdao Sumipin Real Estate Brokerage Co., Ltd. v. Qingdao Haina Maya Trading Co., Ltd.*, the court accepted WeChat records as evidence of information disclosure. The franchisor had used WeChat groups to inform the franchisee about changes in the master franchisor. The court found this method acceptable, noting that the franchisee's

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<sup>285</sup> *Code of Federal Regulations*, title 16 (Commercial Practices), Section 436.2.

participation in these communications implied awareness of the disclosed information.<sup>286</sup>

Adapting to electronic disclosure methods could enhance efficiency and relevance in the current technological landscape.<sup>287</sup> Although the advantages of written form are obvious, compared with the efficient and convenient network transmission, the modern network disclosure form with low cost and high time limit is more conducive to the actual operation of the parties, more in line with the needs of modern society, and can solve the problem of single form of information disclosure. One respondent pointed out,



*"Legislation should accept electronic disclosures, not just paper ones. For example, Australia and the U.S. started recognizing electronic formats. Also, other countries often standardize how disclosures are presented, like with the Model Franchise Disclosure Law. This makes everything more consistent and efficient in franchise dealings."*<sup>288</sup>

### **3.3.3.5 Truthfulness, Accuracy and Completeness of Disclosure**

According to Article 23 of the *CFAR 2007*, information disclosure should meet the specific criteria. An effective information disclosure standard is conducive to

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<sup>286</sup> Shandong Higher People's Court. Civil Final Judgment No.2629, 2020.

<sup>287</sup> Kabir C. Sen, "Franchise Systems in the Information Age: Challenges and Opportunities," in *Networks in International Business*, ed. G. W. Hendrikse, G. Cliquet, I. Hajdini, A. Raha, and J. Windsperger (Cham: Springer, 2023), 123-135, [https://doi.org/10.1007/978-3-031-18134-4\\_7](https://doi.org/10.1007/978-3-031-18134-4_7).

<sup>288</sup> R 15 (Franchisor), physical at the office, February 22, 2024.

providing compliance norms for franchisors.<sup>289</sup> The basic principles of franchise information disclosure system run through the whole information disclosure system, which can make up for the deficiencies of information disclosure legislation to some extent. One respondent observed that frequent disputes over information disclosure arise partly because franchisees often underestimate the risks and the importance of obtaining comprehensive information.<sup>290</sup>

The principle of truthfulness in franchise disclosure mandates that the information must accurately and objectively reflect the current situation. This fundamental requirement ensures that the franchisee receives precise and reliable information, crucial for making informed investment decisions and avoiding potential losses. Furthermore, truthfulness also entails timeliness; information must be up to date to avoid becoming misleading or obsolete. Delays in fulfilling disclosure obligations can compromise the accuracy of the information, thereby impacting the franchisee to make sound judgments.<sup>291</sup>

The principle of accuracy requires that the information disclosed by the franchisor be clearly understood by both parties. Given that franchisors and franchisees often differ in their knowledge, management experience, and understanding of terminology, it is

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<sup>289</sup> Elizabeth Crawford Spencer, "Effective Disclosure in the Regulation of Franchising," paper presented at the 22nd Annual International Society of Franchising Conference, Saint-Malo, Brittany, France, June 2008, [http://epublications.bond.edu.au/law\\_pubs/249](http://epublications.bond.edu.au/law_pubs/249).

<sup>290</sup> R 20 (Regulator), physical at the office, April 5, 2024.

<sup>291</sup> Philip Mark Abell, *The Regulation of Franchising in the European Union* (PhD diss., 2011).

essential that the franchisor uses precise and unambiguous language to avoid misleading interpretations. Accuracy should align with the comprehension capabilities of the average franchisee. Furthermore, the ongoing nature of franchise agreements necessitates that the franchisor continuously updates and maintains the accuracy of the information provided, fulfilling what is known as the update obligation or post-contract disclosure obligation. This ensures that the franchisee receives current and relevant information throughout the franchise relationship.

The completeness principle mandates that franchisors must disclose all relevant information that could impact a franchisee's investment decision. Investment decisions are based on the full scope of information provided by the franchisor<sup>292</sup>. Incomplete disclosure, even if partially accurate, can lead to a misleading overall representation. In the case of *Long Qifang v. Guizhou Giant Biological Technology Co., Ltd.*, the judge emphasized that the regulations on mandatory disclosures are not subject to arbitrary modifications by the parties involved. The judge affirmed that once parties enter into a commercial franchise agreement, they must adhere fully to the mandated disclosure requirements, as outlined in the regulations.<sup>293</sup> Therefore, franchisors are required to present both positive and negative aspects of the franchise opportunity.

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<sup>292</sup> Farhad Sadeh and Manish Kacker, "Quality Signaling through Ex-Ante Voluntary Information Disclosure in Entrepreneurial Networks: Evidence from Franchising," *Small Business Economics* 50 (2018): 729-748.

<sup>293</sup> Gui Yang *Intermediate People's Court*. Civil Final Judgment No.012245, 2020.

However, while completeness is crucial, it does not obligate franchisors to provide exhaustive details on every point but ensures that all material information necessary for making an informed investment decision is included. For franchisees, the complexity of information disclosure can be overwhelming, often leading to difficulty in identifying and understanding critical details. Respondent 12 highlighted a critical issue with the complexity of disclosures, stating,

*"The information from franchisors is often way too technical and complicated, which can make it tough for franchisees who are not business experts to understand the important stuff. If they simplified the language or offered some professional help, it would make a huge difference and help franchisees make better decisions."<sup>294</sup>*

The current system for disclosing information in commercial franchising frequently suffers from excessive complexity and lack of clarity. Franchisees may struggle to identify key information within the extensive and often complex documents provided, potentially missing important details.

### **3.3.3.6 Content of Disclosure**

Article 22 of the *CFAR 2007* outlines eleven specific disclosure requirements for franchisors, while Article 5 of *CFIDAM 2012* refines and expands these requirements,

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<sup>294</sup> R 12 (Franchisee), physical at the office, March 9, 2024.

particularly concerning franchisor's business operations, operating expenses and litigation or arbitration history. As shown in the following Table 3.1:

Table 3.1  
*Contents of Information Disclosure*

<b>Item</b>	<b>Type of Disclosure</b>	<b>Specific Content</b>
1	Franchisors and Franchising Activities	<ul style="list-style-type: none"> <li>- Franchisor's name, contact info, legal representative, general manager, capital, business scope, and details of directly operated stores.</li> <li>- Overview of business franchising activities of franchisors.</li> <li>- Franchisor's record-keeping practices, information on related parties, and any bankruptcy of the franchisor or affiliates in the past 2 years.</li> </ul>
2	Business Resources	<ul style="list-style-type: none"> <li>- Details on trademarks, patents, logos, business models, related parties, authorization terms, and any ongoing litigation or arbitration.</li> </ul>
3	Franchise Expenses	<ul style="list-style-type: none"> <li>- Details on fees, deposit collection and refund conditions, and pre-contract expenses and their refund terms.</li> </ul>
4	Pricing and conditions for products, services, and equipment provided to franchisees.	Whether there are connected transactions, and the necessity and rationality of connected transactions.
5	Ongoing Services	Content of training and technical support, method, and implementation plan.
6	Methods and Contents of Guidance and Supervision	<ul style="list-style-type: none"> <li>- Business guidance, supervision, franchisee obligations, and consumer complaint liability.</li> </ul>

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7	Budget of Investment in Franchise Outlets	- Franchise fee, training fees, real estate and renovation costs, equipment, initial inventory, utilities, license fees, and working capital.
8	Relevant Information about Franchisees in China	- Franchisee count, locations, authorization scope, and exclusive territories.
9	Financial Accounting Report and Audit Report	Capital verification report and audit report issued by certified public accountant within two years.
10	Litigation and Arbitration Related to the Franchise in the Last 5 Years	Fined over 300,000 yuan, investigated for criminal responsibility, and has a record of major legal violations.
11	Text of the Franchise Contract	- Sample franchise contract. - If the franchisee enters any other franchising contract with the franchisor (or its affiliates), a sample of such contract shall also be provided.

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**Sources:** *CFIDAM 2012*

The content clause of information disclosure is crucial in commercial franchising as it provides detailed guidance for both franchisors and franchisees. The franchisor must disclose essential information including: their basic details, business resources, capability to support the franchisee, management and oversight practices, franchise fees and payment methods, financial performance, litigation and arbitration history, investment costs for franchise outlets, and a sample franchise contract. The franchisor's obligation to disclose information helps franchisees by reducing the need for extensive independent research, thus lowering transaction costs.

However, excessive disclosure can increase operational costs for franchisors and hinder franchise expansion. Too much detailed information may impose financial and administrative burdens, negatively affecting franchise growth. One respondent mentioned,

*"If franchisees can check certain records on their own through official channels, the franchisor should not be required to disclose them. Not sharing this info does not mean a failure to meet their disclosure duties. In fact, some of us even think this requirement should be removed, much like the details of trademark registrations, which are already publicly available."<sup>295</sup>*

Franchisees often incur significant costs to obtain essential information from franchisors and face substantial risks if they fail to acquire or properly evaluate this information. It highlighted a significant challenge, noting that gathering information through official websites or background checks is often resource-intensive, demanding substantial time, manpower, and financial investment. If the franchisor deliberately fails to disclose or intentionally conceals information from the franchisee, it is unlikely that the franchisee will be able to obtain complete information, no matter how thorough its prior investigation.

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<sup>295</sup> R 15 (Franchisor), physical at the office, February 22, 2024.

Therefore, it is essential for the franchise information disclosure system to strike a balance between providing sufficient information for informed decision-making and managing the cost of disclosure. Respondent 16 highlighted a critical issue, noting,

*"Right now, franchisors only have to share 11 specific pieces of information. But when you look at places like the USA or Australia, their rules are a lot more detailed. Here, the disclosure can be vague and too broad, which might leave franchisees with gaps in the information they need."*<sup>296</sup>

One respondent mentioned that,

*"Franchisors sometimes set up new companies to hide their bad history and past problems, which can trick franchisees into making poor decisions and losing money. It's crucial to follow the example set by the U.S. and Australia, where laws require franchisors to reveal not just their status but also details about their past, including any lawsuits, bankruptcies, and financial troubles."*<sup>297</sup>

The information regarding the directors and senior managers of a franchisor is crucial for franchisees when making investment decisions and assessing potential risks. The current franchise specific regulations require franchisors to disclose information about the legal representative and general manager. However, in large-scale franchise

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<sup>296</sup> R 16 (Lawyer), physical at the office, April 5, 2024.

<sup>297</sup> R 21 (Regulator), physical at the office, April 7, 2024.

operations, senior executives extend beyond just these roles, and it may not accurately reflect operational realities.

One respondent expressed concern that the requirement to disclose the franchisor's overview was unclear, noting that the term "overview" felt too vague and did not clearly indicate what specific information franchisors are expected to provide.<sup>298</sup> This ambiguity can lead to inconsistent disclosures and may result in franchisees receiving insufficient or incomplete information. He further pointed out that the regulation regarding the investment budget for outlets uses the term "can," which grants franchisors excessive leeway in what they disclose.

Contract terms, such as those related to transfer, renewal, and termination, directly impact the interests of franchisees. However, one of respondent pointed out that franchisors rarely disclose contract information, and the *CFAR 2007* are vague on these matters.<sup>299</sup> The existing specific franchise regulations only mandate the disclosure of sample franchise contracts without requiring the disclosure of specific, detailed information, making it difficult to effectively protect franchisees' rights in practice.

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<sup>298</sup> R 21 (Regulator), physical at the office, April 7, 2024.

<sup>299</sup> R 10 (Franchisee), physical at the office, March 15, 2024.

It is important to force franchisors to share the full terms of their franchise contracts.

Respondent 11 said,

*"Franchisors often try to hide these details from franchisees, so we really need the law to step in and make sure franchisees get all the info they need to protect their interests."<sup>300</sup>*

### **3.3.3.7 Termination for Disclosure Non-Compliance**

Article 23 of the *CFAR 2007* entitles franchisees to terminate the contract if the franchisor fails to provide accurate and complete information or engages in misleading practices. Under Article 9 of the *CFIDAM 2012*, a franchisee is entitled to terminate the contract if disclosure deficiencies substantially impact the execution of the franchise agreement or involve the provision of false information.

The information disclosure system is crucial in franchise litigation. Common issues leading to legal action include the franchisor's failure to disclose trademark information, omission of specific records, and the provision of incomplete or fraudulent information.<sup>301</sup> The respondents stressed that ensuring strict adherence to disclosure obligations is vital for mitigating disputes in the franchising industry.

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<sup>300</sup> R 11 (Franchisee), physical at the office, March 23, 2024.

<sup>301</sup> Shaokun Fang and Peiyang Liu, "Commercial Franchise Contract Validity Defects and Corrective Measures," *Shandong University Journal (Philosophy and Social Science Edition)*, no. 2 (2021): 114.

Respondent 21 emphasized that many disputes arise from franchisors making exaggerated claims or failing to meet revenue promises.<sup>302</sup>

Assessing whether a franchisor has properly met its disclosure obligations is often a complex issue in litigation. Courts evaluate whether undisclosed information relates to crucial business resources, the extent of deviation from actual conditions, and the overall impact on execution of the franchise agreement to determine if there has been a breach of disclosure obligations.<sup>303</sup> Essential business resources often encompass trademarks in relevant classes, such as Class 43 (restaurant services) and Class 35 (advertising and business management).

Courts generally uphold the right to terminate a franchise contract if a franchisor fails to disclose or intentionally misrepresents information about these critical assets. For example, in *Chen Hua v. Guangzhou Meat Lianbang Food Co., Ltd.*, the franchisor, operating a fresh retail chain, disclosed trademarks for core categories like Class 35 but did not disclose trademarks for non-core categories, such as "cereals and vegetables." The court determined that the undisclosed trademarks were not vital to the core business operations, and thus rejected the claim for contract termination.<sup>304</sup>

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<sup>302</sup> R 21 (Regulator), physical at the office, April 7, 2024.

<sup>303</sup> China Chain Franchise Association and Zhonglun Law Firm, *White Paper on Adjudication of Commercial Franchise Contract Disputes in China 2019-2021* (2022).

<sup>304</sup> Guangdong Higher People's Court. Civil Final Judgment No. 5231, 2021.

In practice, franchisees sometimes enter contracts based on misleading information from franchisors, resulting in financial losses. For instance, in *Ye v. Guangxi Catering Management Co., Ltd.*, the court revoked the contract because the franchisor falsely claimed ownership of a registered trademark, which misrepresented its business resources. The court found that these misleading claims were substantial enough to affect the franchisee's decision, warranting contract termination.<sup>305</sup>

However, in cases where misleading information, such as exaggerated promotional claims, does not significantly impact the contract's performance, courts may reject requests for termination. This was illustrated in *Wu Shengzhi v. Shandong Xinming Biotechnology Co., Ltd.*, where, despite the franchisor's inflated product claims, the court determined that the franchisee should have exercised due diligence and thus denied the termination request.<sup>306</sup>

The validity of a franchise contract is determined by compliance with both contractual and regulatory requirements. In most instances, a franchisor's failure to meet information disclosure obligations does not automatically nullify the franchise contract.

As the Shanghai High Court explained,

The legal impact of a franchisor failing to meet disclosure requirements should be evaluated alongside Contract Law. This

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<sup>305</sup> Guangxi Intermediate People's Court. Civil Final Judgment No.756, 2021.

<sup>306</sup> Shandong Higher People's Court. Civil Final Judgment No.2577, 2021.

involves considering how the franchisor's dishonesty or misleading information affects the contract's goals and overall execution.<sup>307</sup>

Due to the private law regulation, franchise contract termination is primarily governed by contract signed by the parties. However, franchise contracts frequently do not clearly specify the franchisee's right to terminate the agreement unilaterally, leading to disputes over the validity of such terminations. Articles 147-152 of the *Civil Code* include grounds such as gross misunderstanding, fraud, coercion, and manifest inequality. The franchise contract disputes caused by franchisor fraud have attracted public attention. Fraud means that the actor deliberately states false facts or conceals the true situation, so that the deceived person falls into the wrong understanding and makes the wrong expression of meaning.<sup>308</sup> This is similar to the false information under *CFAR 2007*.

However, breaches of *CFAR 2007*, though subject to enforcement actions or penalties, do not automatically invalidate the contract. For example, in *Zhao Huijuan v. Hangzhou Heao Enterprise Management Co., Ltd.*, the franchisor failed to disclose the number of franchisees and recent litigation history required by *CFAR 2007*, the court determined that these omissions did not prevent the franchisee from conducting

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<sup>307</sup> Shanghai Municipal High People's Court, *The Answers to Several Issues Concerning the Trial of Franchise Contract Disputes* (2012).

<sup>308</sup> Jiafu Wang, *Chinese Civil Law and Civil Law Creditor's Rights* (Law Press, 2005).

business, as the franchisee had already established and operated franchise stores. Consequently, the court denied the request for contract termination.<sup>309</sup>

### 3.3.3.8 Cooling-off Period

The cooling-off period system originated in the United Kingdom, which is a special right granted by law to consumers in a vulnerable position without responsibility to terminate the contract.<sup>310</sup> The right of retraction in Germany and France or the cooling-off period system in the USA and Australia, in essence, all reflect the legislative purpose of slanting protection for the weak party. The relationship between the parties in a franchise contract is based on equality.

However, it is important to note that there is a wide gap between the franchisor and franchisee in terms of commercial strength and operating experience. The franchisee is in a disadvantageous position in the aspects of information acquisition, risk assessment and negotiating position. Given the weak position of the franchisee in franchising, the *CFAR 2007* provides the franchisee with special protection, specifically the right to unilaterally terminate the contract.<sup>311</sup>

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<sup>309</sup> Zhejiang Higher People's Court. Civil Final Judgment No. 876, 2021.

<sup>310</sup> Jeff Sovern, "Written Notice of Cooling-Off Periods: A Forty-Year Natural Experiment in Illusory Consumer Protection and the Relative Effectiveness of Oral and Written Disclosures," *University of Pittsburgh Law Review* 75 (2013): 333.

<sup>311</sup> Dharu Triasih and Dewi Tuti Muryati, "Legal Protection of the Parties in the Franchise Agreement," paper presented at the 2nd International Conference of Law, Government and Social Justice (ICOLGAS 2020), Atlantis Press, 2020.

In China, Article 12 of the *CFAR 2007* establishes a cooling-off period that permits franchisees to unilaterally terminate the franchise agreement without incurring liability. This provision is a key protective measure designed to address the power imbalance between franchisors and franchisees. It allows franchisees to rescind the contract within a specified timeframe, which is determined by the franchisor and detailed in the franchise agreement. The cooling-off period aims to mitigate the risk of impulsive investment decisions by providing franchisees with a legally sanctioned opportunity to withdraw from the agreement without facing penalties.

It is important to note that the franchisee's right to terminate under the cooling-off period clause is different from the statutory termination of the contract under Article 563 of the *Civil Code*.<sup>312</sup> Even if the franchisor is not at fault, the franchisee may terminate the contract and cease operation without liability.<sup>313</sup> This is a unilateral right of termination, which goes beyond ordinary contractual rights of Article 563 of the *Civil Code*. Therefore, for the sake of transaction security and the stability of the contract, the right of unilateral termination should be exercised within a reasonable period.

Respondent 21 pointed out that the duration of the cooling-off period is not clearly defined in China's franchising regulations, which easily leads to disputes.<sup>314</sup> This

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<sup>312</sup> Shaokun Fang and Peiyong Liu, "Commercial Franchise Contract Validity Defects and Corrective Measures," *Shandong University Journal (Philosophy and Social Science Edition)*, no. 2 (2021): 114.

<sup>313</sup> *CFAR 2007*, art.12.

<sup>314</sup> R. 21 (Regulator), physical at the office, April 7, 2024.

ambiguity results in varying interpretations regarding the length of the cooling-off period, which is generally meant to be agreed upon by the parties involved. He emphasized that franchisors often omit clauses specifying the franchisee's right to unilateral termination in the franchise contract.<sup>315</sup> When such a clause is not included, courts generally apply the principle of fairness, allowing franchisees to exercise their right of unilateral termination within a reasonable period.

For example, in the case of *Li Honglin v. Chongqing Chaotianmeng Catering Management Co., Ltd.*, the court noted that the *CFAR 2007* does not explicitly define the duration for exercising the right to unilateral termination. Instead, the contract should outline this period. In the absence of such stipulations, a reasonable timeframe should be determined based on fairness principles governing civil activities.<sup>316</sup> Consequently, whether a franchisee can unilaterally terminate the contract during the cooling-off period depends on the specifics of contract performance and adherence to fair practice.

Article 18 of the Beijing Guiding Opinions restricts the cooling-off period to instances where the franchisee has not yet used the operating resources.<sup>317</sup> As a result, in many cases, the determination of whether the cooling-off period is still applicable depends

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<sup>315</sup> R 21 (Regulator), physical at the office, April 7, 2024.

<sup>316</sup> Chongqing Intermediate People's Court. Civil Final Judgment No.00051, 2012.

<sup>317</sup> Beijing Municipal High People's Court, *The Guidance Opinions of the Beijing Municipal High People's Court on Several Issues Concerning the Application of Law to the Trial of Commercial Franchise Contract Disputes* (2011).

on whether the franchise resources have been utilized. Once the resources are used, the franchisee generally loses the right to unilaterally terminate the contract.

A significant case demonstrating the application of the cooling-off period is *Fangli v. Beijing Education Technology Co., Ltd.* In this case, the franchisee attempted to terminate the franchise agreement using the cooling-off period provision. However, the court rejected the claim, ruling that the cooling-off period was no longer applicable because the franchisee had already utilized the franchisor's business resources. The court determined that once the franchisee had engaged in substantive performance and benefited from the franchisor's resources, the cooling-off period could not be invoked.<sup>318</sup> This decision highlights that the cooling-off period is meant to allow contract withdrawal only before substantial performance occurs, ensuring fairness and maintaining contractual stability.

In contrast, in the case of *Huang Peiji v. Escape Garden (Guangzhou) Brand Operation Management Co., Ltd.*, the court reached a different conclusion. Despite the franchise contract specifying a cooling-off period of only one day, the franchisee had not utilized the licensed resources after signing the contract. The court upheld the franchisee's right to unilaterally terminate the contract within this cooling-off

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<sup>318</sup> Beijing Intermediate People's Court. Civil Final Judgment No. 562, 2021.

period.<sup>319</sup> This ruling was intended to protect franchisees from potential losses due to premature decisions made at the contract's inception.

In addition, there is ambiguity regarding the appropriate method of communicating contract termination, whether it should be delivered orally, in writing, or through judicial procedures. If the contract does not specify a cooling-off period, it is uncertain whether the franchisor would be liable for contractual negligence. Further questions arise concerning whether franchisees can exercise termination rights prior to the contract taking effect and how to precisely define the "certain period" for a cooling-off phase. This may require judicial consideration of industry standards and transactional fairness.

#### **3.3.3.9 Liability for Noncompliance with Disclosure**

Enforcement of disclosure requirements relies on clear and stringent legal liabilities. Noncompliance may incur both administrative and civil penalties. Administrative penalties under *CFAR 2007* include fines, warnings, and potential suspension of operations. These sanctions are designed to enforce adherence to disclosure norms. Civil liabilities arise from disputes related to franchise contracts and can involve claims for damages, cessation of infringement, contract termination, and restitution of property, as outlined in the *Civil Code*.

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<sup>319</sup> Guangzhou Intermediate People's Court. Civil Final Judgment No.6301, 2021.

The Chapter 4 of the *CFAR 2007* outlines the administrative penalties for failing to meet disclosure requirements, including orders to make corrections, fines and public announcements of the violations. Violations include failing to disclose within the required time, insufficient disclosure, false disclosure and franchise fraud. *CFAR 2007* establish a system for reporting violations, with the MOC and local commerce authorities responsible for penalizing non-compliant conduct. As shown in the following Table 3.2, it summarizes the violations and their corresponding administrative penalties.

Table 3.2  
*The Administrative Liability for Noncompliance with Disclosure*

Item	Noncompliance Performance	Administrative Punishment
1	Not disclosed within 30 days before the execution of the contract (Article 28).	- Order correction. - Be fined between 10,000 yuan and 100,000 yuan.
2	Inadequate disclosure or false disclosure (Article 28).	- Public notice of violations.
3	Failure to inform the purpose and return of the prepaid franchise fee (Article 26).	- Order correction. - Be fined between 10,000 yuan and 50,000 yuan. - Public notice of violations.
4	Deceptive and misleading advertising (Article 27).	- Order correction. - Be fined between 10,000 yuan and 30,000 yuan. - Public notice of violations.
5	Franchise fraud (Article 29).	- Criminal offence

Source: *CFAR 2007*

The regulatory authority is empowered to issue a written order directing the franchisor to rectify or cease illegal operations within a specified period. If the franchisor fails to comply or does not seek rectification within the given timeframe, the authority may impose fines or confiscate illicit earnings. The severity of the fines is proportional to the extent of the violation. While *CFAR 2007* mandates criminal penalties for serious franchise fraud, it lacks a precise definition of what constitutes a "serious" offense. Furthermore, *CFAR 2007* allows for public disclosure of non-compliance to leverage social oversight to compel franchisors to address and correct illegal activities.

Under *CFAR 2007*, failure to adhere to cooling-off period and disclosure requirements can lead to the termination of the franchise contract. Article 12 of *CFAR 2007* grants franchisees the right to terminate the contract within a defined cooling-off period, aimed at preventing impulsive decisions by prospective franchisees. Additionally, Article 23 stipulates that franchisees may terminate the contract if the franchisor conceals or misrepresents information, thereby addressing fraudulent conduct by the franchisor. It is designed to safeguard franchisees from poorly informed decisions and to discourage dishonest practices by franchisors.<sup>320</sup> These provisions are mandated by administrative regulations, ensuring that franchisees can terminate the agreement even if such terms are not explicitly stated in the contract.<sup>321</sup>

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<sup>320</sup> Courtenay Atwell, "Cooling Off Periods in Franchise Contracts: From Consumer Protection Mechanisms to Paternalistic Remedies for Behavioral Biases," *Business and Politics* 17, no. 4 (2015): 697-721.

<sup>321</sup> Tong Yuting, "Legal Issues Related to Commercial Franchise Contracts from the Perspective of

Under the *Civil Code*, a franchisor's failure to comply with disclosure requirements results in civil liability for breach of contract. The available remedies include damages, contract termination, and directives for either continuation or suspension of performance.<sup>322</sup> Generally, legal systems strive to protect the non-breaching party by compensating for losses while maintaining the validity of contract. Remedies such as continued performance directly aim to fulfill the contract's purpose and ensure that the non-breaching party achieves its contractual objectives.<sup>323</sup> Compensation for loss focuses more on filling the damage of the non-breaching party, which is an indirect relief for the purpose of the contract.<sup>324</sup>

Under Article 563 of the *Civil Code*, a party may terminate the contract in specific scenarios:

The purpose of the contract cannot be achieved due to force majeure;  
Before the expiration of the time limit for performance, the other party explicitly states or indicates by its conduct that it will not perform its principal obligation; One party delays performance of its principal obligation and fails to perform within a reasonable time after being urged to do so; One of the parties delays performance of the obligation or commits any other breach of contract, which makes

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Yihetang Dispute," *Dispute Settlement* 10 (2024): 58.

<sup>322</sup> Liming Wang, *Liability for Breach of Contract*, revised ed. (China University of Political Science and Law Press, 2000).

<sup>323</sup> Liming Wang, *Research on Contract Law* (Vol. 2) (China Renmin University Press, 2011).

<sup>324</sup> Chunmei Wang, "Termination of Contract: Functional Analysis of Relief for Breach of Contract," *Law Research* 6 (2018): 80.

it impossible to achieve the purpose of the contract; Other circumstances provided for by law.

Therefore, statutory termination provides a distinctive remedy for breach of contract, addressing situations where continuing performance is unfeasible, and the primary objectives of contract cannot be realized.<sup>325</sup>

### 3.3.4 Stakeholder Perspectives on the Disclosure

The information disclosure system, introduced in *CFAR 2007*, is designed to protect franchisees by addressing the issue of information asymmetry in franchise relationships. The researcher explored the disclosure requirements in legal documents, which stipulate specific regulations regarding the timing, manner and content of information disclosure. Additionally, qualitative interview data was gathered to obtain perspectives from various stakeholders on the effectiveness of these requirements in franchisee protection.

In the interviews, franchisors, who bear the obligation of disclosure, acknowledged that the system does, to some extent, protect franchisees' right to information.<sup>326</sup>

However, the researcher also noted that redundant disclosures increase their workload and make it more difficult for franchisees to identify useful information. Potential

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<sup>325</sup> Mo Zhang, "Breach of Contracts and Remedies," in *Chinese Contract Law: Theory & Practice*, 2nd ed. (Brill Nijhoff, 2019), 345-380.

<sup>326</sup> R 13 (Franchisor), physical at the office, February 22, 2024; R 14 (Franchisor), Membership in CCFR, Online, February 16, 2024; R 15 (Franchisor), physical at the office, February 22, 2024.

franchisees, often new to a particular market and lacking the expertise to fully assess the franchisor's information, generally view the disclosure system as beneficial. However, concerns were raised about the incomplete adherence of franchisors to their disclosure obligations.

Franchisee respondents expressed that, while the legislation mandates disclosure with good intent, significant improvements are needed in its practical implementation.<sup>327</sup>

They noted that the current operation of the disclosure system falls short in adequately protecting franchisee interests. Some provisions are overly broad and unclear, making enforcement difficult. Moreover, franchisees often struggle to understand technical terms and lack access to legal consultation before entering a franchise, reducing the system's practical effectiveness. Regulators and lawyers, as legal professionals, affirmed that the information disclosure system plays a crucial role in protecting franchisees.<sup>328</sup> However, they acknowledged that there is still room for improvement.

Regulators expressed concerns that the lack of specificity in disclosure requirements increases legal uncertainty, emphasizing the need for clearer and more enforceable provisions.<sup>329</sup>

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<sup>327</sup> R 6 (Franchisee), physical at the office, February 21, 2024; R 9 (Franchisee), physical at the office, February 28, 2024; R 10 (Franchisee), physical at the office, March 15, 2024; R 11 (Franchisee), physical at the office, March 23, 2024.

<sup>328</sup> R 17 (Lawyer), physical at the office, April 18, 2024; R 19 (Regulator), physical at the office, April 26, 2024; R 20 (Regulator), physical at the office, April 5, 2024; R 18 (Lawyer), physical at the office, May 15, 2023; R 21 (Regulator), physical at the office, April 7, 2024.

<sup>329</sup> R 19 (Regulator), physical at the office, April 26, 2024; R 20 (Regulator), physical at the office, April 5, 2024

In conclusion, interviews with respondents suggest that the current disclosure system may not fully meet the expectations of stakeholders. It emphasised the need for more detailed and enforceable provisions to enhance the effectiveness of disclosure practices in franchising.

### **3.4 Analysis of the Registration Approach**

The franchise registration system in China, established by *CFAR 2007* and *CFRAM 2011*, mandates franchisors to fulfill registration obligations. *CFRAM 2011* refines the registration framework established by *CFAR 2007*, enhancing the system's clarity.

#### **3.4.1 Clarifying the Nature of Registration**

It should be noted that, registration is not an administrative license for the pre-qualification of the franchise. The franchise registration mechanism in China is essentially a post-contractual filing and recording procedure. In an interview with a MOC representative, it was clarified that *CFAR 2007* establishes a franchisor registration system instead of administrative licensing.

*"Franchising inherently constitutes a contractual relationship, wherein the parties involved exercise their civil rights to engage in such activities. Consequently, it is generally considered inappropriate for government authorities to impose administrative approval or direct control over franchising operations. Instead, the*

*registration requirements emphasize the oversight of business activities..."*<sup>330</sup>

The regulations detail the registration procedures and necessary documents. Once the department receives and verifies the submission, it will record the registration, notify the franchisor, and update the list of registered franchisors on the government website. One of respondents mentioned that registered franchisors are seen as more trustworthy. He explained,

*"When a franchisor is listed in the MOC's franchise management system, it's viewed as more reliable. Registering shows that the government recognizes the franchise and confirms that it meets certain standards. This official stamp of approval can be more reassuring to potential franchisees than just the franchisor's own promotional claims."*<sup>331</sup>

Respondent 14 emphasized the growth potential in Southeast Asia, a region with a population of about 670 million, and further noted that successful expansion requires a thorough understanding of the local franchise registration system.<sup>332</sup> In light of this, Chapter five delves into franchise regulation in Malaysia, one of Southeast Asia's largest franchise markets, focusing on registration.

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<sup>330</sup> The State Council Legislative Affairs Office and the Ministry of Commerce, "Questions and Answers Regarding China's New Franchise Regulation," February 16, 2007, accessed February 9, 2023, [http://www.gov.cn/zwhd/2007-02/15/content\\_528054.htm](http://www.gov.cn/zwhd/2007-02/15/content_528054.htm).[https://www.gov.cn/zwhd/2007-02/15/content\\_528054.htm](https://www.gov.cn/zwhd/2007-02/15/content_528054.htm).

<sup>331</sup> R 10 (Franchisee), physical at the office, March 15, 2024.

<sup>332</sup> R 14 (Franchisor), Membership in CCFA, Online, February 16, 2024.

### 3.4.2 Timing of Registration

Article 8 of *CFAR 2007* and Article 7 of *CFRAM 2011* both require the franchisor to register with the authority within 15 days after signing the franchise contract. The mandate to register within 14 days of signing the franchise contract diverges from the pre-contractual registration requirements observed in many jurisdictions. For instance, in Malaysia and several U.S. states, registration must be completed prior to the finalization of the franchise agreement. The regulation of franchise registration in China is considerably more permissive compared to jurisdictions with pre-contractual registration requirements.

Respondent 19 supports the practice of post-contract registration in China, arguing that,

*"Franchise contracts are based on the principle of freedom of contract, which ensures the protection of agreements voluntarily entered into by both parties. Excessive administrative intervention could slow down the franchise market and hurt entrepreneurial efforts."*<sup>333</sup>

However, the post-contract registration in China has contributed to a low franchise registration rate. Respondent 17 discussed the registration tool, emphasizing that once a franchise is registered, the franchisor is subject to oversight by the MOC.<sup>334</sup> Some enterprises resist this regulatory supervision, viewing it as an unnecessary constraint.

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<sup>333</sup> R 19 (Regulator), physical at the office, April 26, 2024.

<sup>334</sup> R 17 (Lawyer), physical at the office, April 18, 2024.

In fact, the actual number of franchised brands operating in the market is significantly higher than the 9,955 registered with the MOC.<sup>335</sup>

Many franchisors fail to comply with the franchise registration obligation or deliberately avoid registration. One of respondents argued that the enforcement of the franchise registration system is relatively weak, and penalties for non-compliance are not stringent enough to ensure universal adherence.<sup>336</sup> Additionally, some businesses bypass registration by using licensing or partnership agreements instead of formal franchise contracts.

The discrepancy between the number of franchised brands registered with the MOC and those actually operating in the market has raised concerns about franchisee protection. Unregistered franchisors may evade disclosure obligations, increasing risks for franchisees. Fortunately, the MOC has recognized the severity of this issue and initiated a public consultation in 2023 to strengthen and improve the enforcement of franchise registration.

### **3.4.3 Pre-Conditions of Registration**

According to Articles 3 and 7 of *CFAR 2007*, four key requirements must be met for franchise registration:

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<sup>335</sup> Peiyin Liu, *Research on Commercial Franchise Rights* (PhD thesis, Jilin University, 2022).

<sup>336</sup> R 14 (Franchisor), Membership in CCFA, Online, February 16, 2024.

(1) the franchisor must be a legally recognized enterprise, as non-enterprise entities or individuals are ineligible; (2) the franchisor must own or have rights to essential business assets such as registered trademarks, corporate logos, patents, or proprietary technology, or have the authority to grant these rights; (3) the franchisor must have an established business model and be capable of providing ongoing business guidance, technical support, and training to franchisees; and (4) the franchisor must operate at least two directly managed stores, each in operation for a minimum of one year.

#### **3.4.3.1 Requirements for Franchisor Identity**

Article 3(2) of *CFAR 2007* stipulates that only legally recognized enterprises are permitted to act as franchisors, explicitly prohibiting non-enterprise entities from engaging in franchise activities. Regulatory frameworks in China impose specific restrictions on various business activities. For instance, Article 9 of the *Securities Law* forbids the public issuance of securities without lawful registration, while Article 11 of the *Commercial Bank Law* mandates approval from the banking regulatory authority under the State Council for engaging in public deposit collection and other commercial banking activities. These provisions indicate that an administrative license from a government agency is required to engage in securities and banking business.

However, it is crucial to distinguish that franchise registration in China does not function as an administrative license for pre-qualification. Instead, the franchise

registration system operates as a post-contractual filing and recording procedure, aimed at documenting and monitoring franchise agreements rather than pre-qualifying franchisors. In 2010, the Supreme People's Court established that franchise contracts involving entities other than legally recognized enterprises, including individuals, could be deemed invalid.<sup>337</sup> This judicial interpretation has been consistently upheld by local people's courts, which have largely aligned their decisions with the Supreme People's Court's precedent.

For example, in *Ran Longqin v. Wang Jianqin*, the defendant Wang Jianqin, an individual lacking the requisite enterprise status, was found ineligible to engage in franchising activities. The court declared the franchise contract invalid and ordered Wang Jianqin to compensate Ran Longqin for reasonable losses, such as rent and store decoration expenses, and to refund the franchise fee. Similarly, in *Chen v. Peng*, the court invalidated the franchise contract on the grounds that Chen, as an individual, did not possess the necessary qualifications to act as a franchisor.<sup>338</sup>

In the case of *Yang Lirong v. Healthy Floating Drink Bar*, the court determined that Healthy Floating Drink Bar, operated by an individual, lacked the necessary legal qualifications to be a legitimate franchise business entity. As a result, the franchise contract was deemed invalid, and the individual was held liable for compensating the

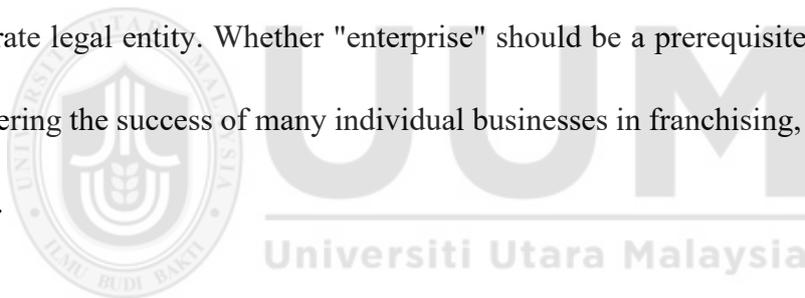
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<sup>337</sup> Supreme People's Court. "Reply on the Validity of Franchise Contracts Entered into by Units and Individuals Other Than Enterprises as Franchisees." No. 19,2010.

<sup>338</sup> Guangzhou Intellectual Property Court. Civil Final Judgment No.571, 2020.

franchisee for incurred losses.<sup>339</sup> This decision affirms that franchise agreements with individuals or non-business entities lacking statutory qualifications are invalid, and the liable party must compensate the franchisee for any resulting losses.

In addition, the term "enterprise" is not clearly defined in the current regulations. Generally, an enterprise is understood to be an organization established in accordance with the law, engaged in business activities, and possessing an independent or relatively independent legal personality.<sup>340</sup> However, individual businesses are not classified as enterprises, as they operate informally or on a small scale without forming a separate legal entity. Whether "enterprise" should be a prerequisite for franchisors, considering the success of many individual businesses in franchising, remains open to debate.



Respondent 14's opinion suggests a need to re-evaluate whether the enterprise requirement sufficiently addresses the complexities of modern franchising practices, noting that,

*"Individual business have some advantages, like simpler procedures, lower costs, and better tax benefits. Because of this, many successful franchisors stay as individual entrepreneurs, and it does not really stop them from running their franchises. But not meeting the*

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<sup>339</sup> Beijing Supreme People's Court. Civil Final Judgment No.1532, 2017.

<sup>340</sup> Judith Freedman, "Limited Liability: Large Company Theory and Small Firms," *The Modern Law Review* 63, no. 3 (2000): 317-354.

*qualifications as a business entity can still lead to the franchise contract being invalid.*"<sup>341</sup>

### **3.4.3.2 Requirements for Business Resources**

Business resources is an important condition to determine the franchisor's qualification. According to Article 3(1) of the *CFAR 2007*, business resources include registered trademarks, corporate logos, patents and proprietary technologies. The Beijing High People's Court Guidelines also include well-known unregistered trademarks, trade secrets, and distinctive business images as business resources.<sup>342</sup> Essentially, these resources represent various forms of intellectual property that contribute to a competitive advantage.

According to the statistics of Commercial Franchise Information Management System, 9,499 enterprises hold registered trademarks, while fewer possess corporate logos, patented know-how, or other franchising assets. This suggests that registered trademarks are currently the primary franchise resource.

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<sup>341</sup> R 14 (Franchisor), Membership in CCFA, Online, February 16, 2024.

<sup>342</sup> Beijing High People's Court. "Guiding Opinions on Several Legal Issues in the Trial of Commercial Franchise Contract Disputes." No. 49,2011.

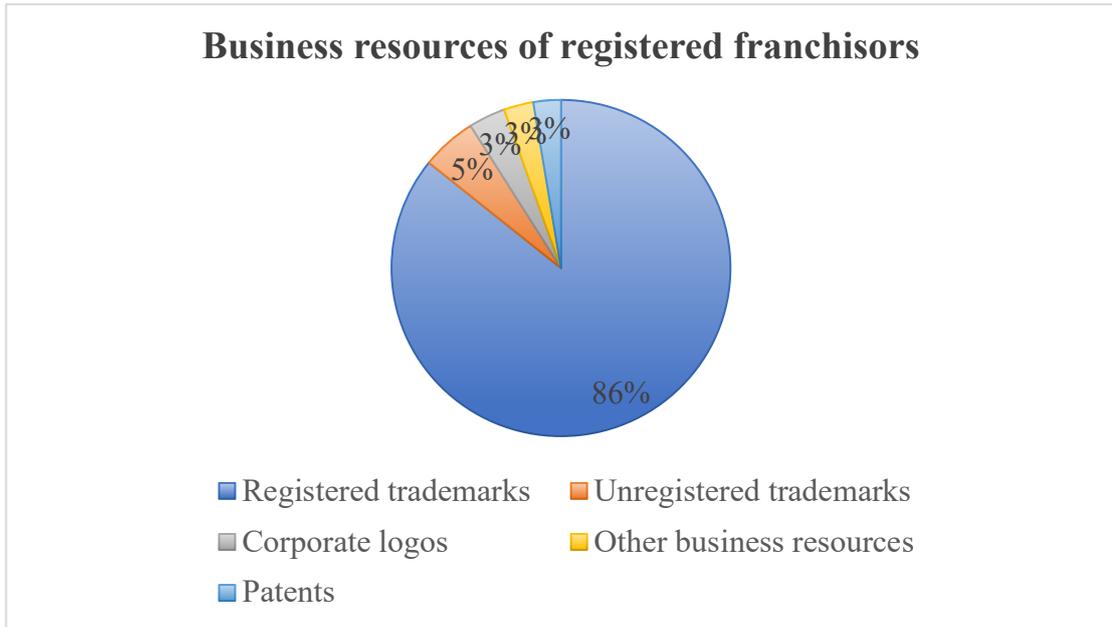


Figure 3.1: Statistics on Business Resources of Registered Franchisors (MOC)

A trademark is an identity card for goods or services, which is used to distinguish the origin of different goods or services.<sup>343</sup> The brand and goodwill of franchise are generally established and spread in consumption through trademark symbols. The respondents indicated that the motivations for franchising was the opportunity to benefit from the franchisor's established trademark recognition, which they believed would enhance their profitability.<sup>344</sup>

*CFAR 2007* designates registered trademarks as a primary business resource for franchising. Courts have reinforced this by ruling that ownership of a registered trademark is essential for a franchisor. For instance, in the case of *Ye Mou v. Guangxi*

<sup>343</sup> Mark P. McKenna, "Trademark Use and the Problem of Source," *University of Illinois Law Review* (2009): 773.

<sup>344</sup> R 10 (Franchisee), physical at the office, March 15, 2024; R 12 (Franchisee), physical at the office, March 9, 2024.

*L Catering Management Co., Ltd.*, the court determined that the essence of franchising involves the granting of registered trademarks. The franchisor claimed ownership of the "Toast G" trademark in the franchise contract, despite not having registered it at the time of signing. The court ruled that this misrepresentation violated *CFAR 2007*, rendering the franchise contract invalid.<sup>345</sup>

However, there is ongoing debate about the transferability and use of unregistered trademarks. While it is established that well-known unregistered trademarks can be transferred through licensing agreements, the legal status of unregistered trademarks remains unclear. This lack of clarity can lead to issues with ownership, potential conflicts, and limitations on rights and territorial use. For example, in *Chen Mou v. Guangzhou D Enterprise Management Co., Ltd.*, the court determined that D Company had been authorized the use of the trademark "X Ming" only for certain products and failed to disclose this limitation to Chen Mou. As a result, Chen Mou was unable to use the trademark as intended, leading the court to conclude that the contract's objectives could not be achieved and thus, Chen Mou was entitled to terminate the contract under Article 23 of *CFAR 2007*.<sup>346</sup>

It is important to acknowledge that both registered trademarks and patents have specified protection periods. According to Articles 39 and 40 of the *Trademark Law*,

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<sup>345</sup> Baise Intermediate People's Court. Civil Final Judgment No.756, 2021.

<sup>346</sup> Guangzhou Intellectual Property Court. Civil Final Judgment No.5231, 2020.

a registered trademark is valid for ten years and requires renewal to maintain its validity; failure to renew results in cancellation. If a franchise contract extends beyond the trademark's validity period, it may lead to legal and operational challenges due to the potential loss of trademark rights. In contrast, patent rights cannot be renewed once expired. Once patents enter the public domain, they become freely accessible, which can pose risks for franchisees, as they may face increased competition and loss of exclusivity when the patent's protection period expires.<sup>347</sup>

A trade secret consists of confidential technical and business information that is not publicly known and provides economic advantages to its holder.<sup>348</sup> This can involve technical details, business models, processes, product formulas, management techniques, customer lists and strategic plans. In franchising, the franchisor provides these trade secrets to the franchisee, who must use and protect them. Due to the large number of franchisees, safeguarding trade secrets is more challenging compared to other business models.<sup>349</sup> Article 18 of *CFAR 2007* requires franchisees to keep the franchisor's trade secrets confidential and prohibits their disclosure or misuse. Franchise contracts also typically include confidentiality and non-competition clauses to enhance these protections.

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<sup>347</sup> Patent Law of the People's Republic of China, Amended Edition 2020.

<sup>348</sup> Anti-Unfair Competition Law of the People's Republic of China, Amended Edition 2019.

<sup>349</sup> VanderBroek, Mark S., and Christian B. Turner. "Protecting and Enforcing Franchise Trade Secrets." *Franchise LJ* 25 (2005): 191.

### 3.4.3.3 Requirements for Business Model

Article 7 of the *CFAR 2007* specifies essential criteria for franchisors. Paragraph 1 requires that a franchisor must have a well-developed business model and demonstrate the capability to provide continuous business guidance, technical support, and training to franchisees. Paragraph 2 sets a quantitative benchmark, stipulating that a franchisor must operate at least two directly operated stores for a minimum duration of one year (two-plus-one requirement).

The two-plus-one requirement was initially established in Article 7 of *CFAM 2004*, which specifies that a franchisor must maintain at least two directly operated stores within China, or stores managed by its subsidiaries or holding companies, with each store having been in operation for no less than one year. It aims to verify the maturity of the franchisor's business model through practical operational experience. Franchisee respondents highlighted that selecting a franchisor with a proven business model significantly mitigates investment risks and enhances the potential for achieving business profits.<sup>350</sup>

Conversely, franchisor respondents noted that while the requirement of operating at least two directly operated stores for one year helps in identifying franchisors with genuine experience and capabilities, it also presents challenges to franchising.<sup>351</sup>

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<sup>350</sup> R 9 (Franchisee), physical at the office, February 28, 2024; R 11 (Franchisee), physical at the office, March 23, 2024.

<sup>351</sup> R 13 (Franchisor), physical at the office, February 22, 2024; R 14 (Franchisor), Membership in CCFA, Online, February 16, 2024.

Respondent 14, a franchisor and member of the CCFA, observed that the requirement for a franchisor to operate at least two directly operated stores for over one year helps to ensure that only well-established businesses can enter the franchise market. However, he also pointed out that this requirement might be overly restrictive, particularly in a market with many small business franchises, potentially limiting opportunities for newcomers.<sup>352</sup>

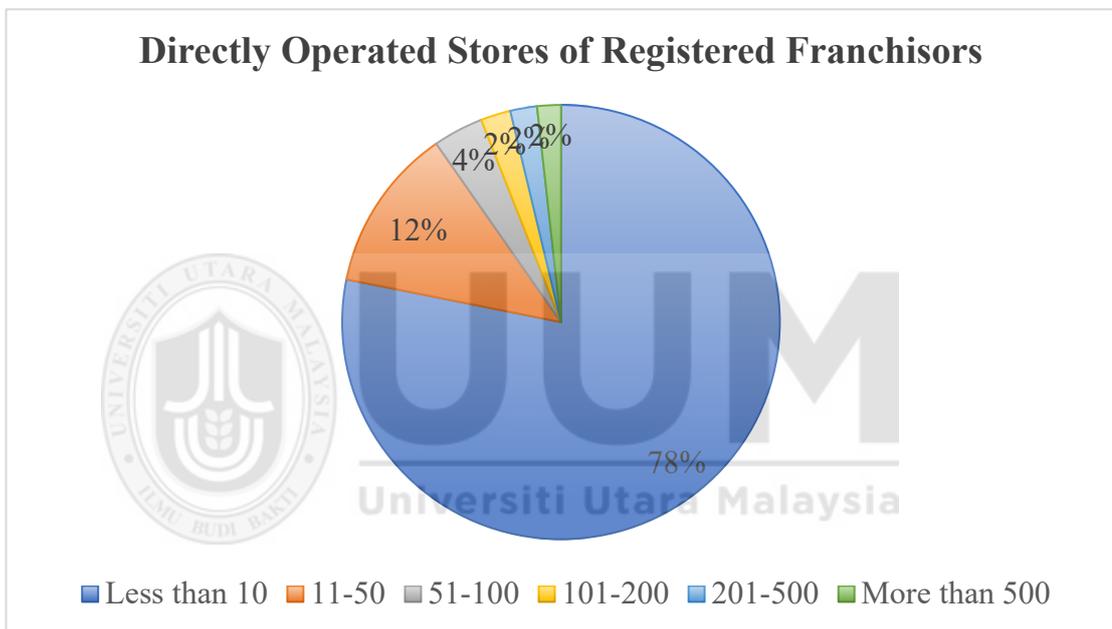


Figure 3.2: Statistics on the Number of Directly Operated Stores of Registered Franchisors (MOC)

The Supreme People's Court has clarified that the two-plus-one requirement functions as an administrative guideline and does not impact the legal validity of a franchise contract under private law.<sup>353</sup> In the case of *Yang Yongmei v. Xinyue International Company*, the court determined that the two-plus-one requirement is a regulatory

<sup>352</sup> R 14 (Franchisor), Membership in CCFA, Online, February 16, 2024.

<sup>353</sup> Supreme People's Court. "Reply on the Validity of Franchise Contracts for Franchisors Without at Least Two Directly Operated Stores for Over One Year." No. 18, 2010.

measure imposed by administrative authorities to oversee the franchising industry. Consequently, a violation of this requirement results in an administrative penalty under Article 24 of *CFAR 2007*, rather than rendering the franchise contract invalid.<sup>354</sup>

#### **3.4.4 Process of Registration**

The registration process for franchisors involves a series of steps designed to ensure compliance and accuracy. Respondent 13 points out that although franchisors are required to complete registration within 15 days of signing the contract, many find the process cumbersome.<sup>355</sup> For instance, in Guangdong, it typically takes between 90 and 120 working days from document preparation to final registration. The cumbersome and lengthy registration procedures discourage franchisors from investing time and effort in the registration process, leading them to opt for direct franchising instead.

For enterprises registered at the national or international level, these documents must be submitted to the MOC. Conversely, for enterprises registered at the provincial level, registration must be completed with the respective provincial commerce authorities. According to Article 8 of *CFAR 2007*, the franchisor must prepare and submit the required registration documents. The required documentation for franchise registration includes:

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<sup>354</sup> Beijing Intellectual Property Court. Civil Final Judgment No.1017, 2022.

<sup>355</sup> R 13 (Franchisor), physical at the office, February 22, 2024.

A copy of the business license or enterprise registration certificate;  
A sample franchise agreement; The franchise operations manual; A  
market plan; A written commitment and relevant supporting  
documents confirming compliance with Article 7 of CFAR 2007;  
Other documents or materials specified by the MOC. Additionally,  
if the franchised products or services require legal approval for  
operation, the franchisor must also submit the relevant approval  
documents.<sup>356</sup>

The registration process for franchisors involves several steps: initially, the franchisor submits paper documents, including business licenses, franchise agreements, and operational manuals, to the relevant registration department. After this, the franchisor must log into the MOC platform to complete the formal registration.<sup>357</sup> The registration department reviews the submission and, if verified, issues a registration number. The franchisor then re-accesses the platform to upload the approved information. Finally, the registration department performs a last review, and upon confirmation of accuracy, the registration is officially published.

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<sup>356</sup> *CFAR 2007*, art.17.

<sup>357</sup> <http://www.mofcom.gov.cn/fzlm/swbywxtypta/index.html>.

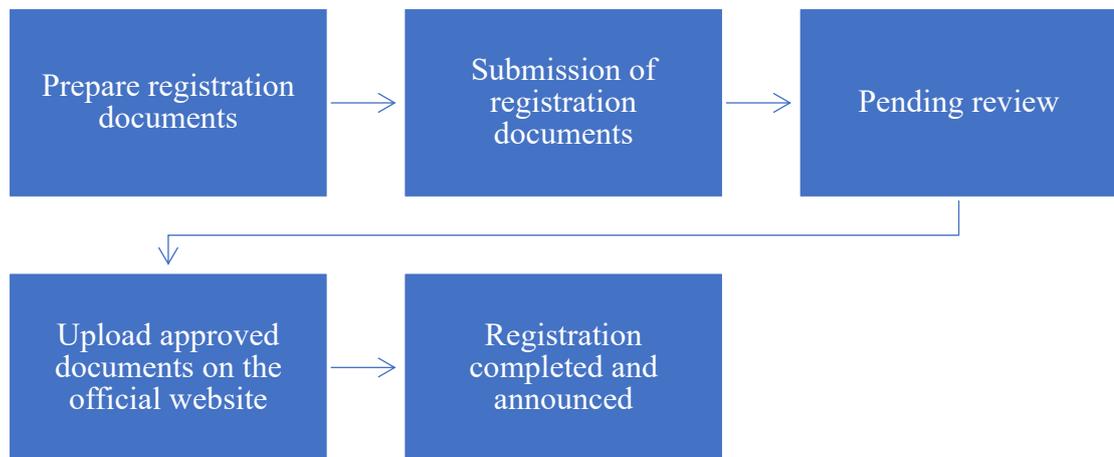


Figure 3.3: Process of Franchise Registration

Article 8 of the *CFAR 2007* establishes a registration requirement as part of administrative management, designed to regulate franchise operations without impacting the substantive validity of franchise contracts. This was affirmed in the case of *Zhong Shirong v. Chongqing Fuxuan Technology Co., Ltd.*, where the Chongqing Higher People's Court clarified that the registration requirement is an administrative obligation rather than a factor affecting the validity of contract under civil law.<sup>358</sup> Failure to comply with registration does not invalidate the franchise agreement but may lead to administrative penalties. Consequently, the enforceability of the franchise contract remains unaffected despite non-compliance with registration requirements.

<sup>358</sup> Chongqing First Intermediate People's Court. First Instance Civil Judgement No. 00273, 2013.

It is evident that franchise registration constitutes a legal obligation for franchisors. One respondent mentioned that the franchise registration system helps franchisees access important information about the franchisor, and franchisees are more likely to invest in those with registered franchisors.<sup>359</sup> However, franchise registration primarily serves as an administrative management tool rather than a protective measure for franchisees. Allowing franchisors to start operations before completing the registration process can let unqualified entities engage in fraud. Respondent 6 highlighted that the existing franchise registration system does not protect franchisees enough, making it less effective in regulating franchisor qualifications and leading to frequent disputes.<sup>360</sup>

#### **3.4.5 Liability for Noncompliance with Registration**

The *CFAR 2007* stipulate in Articles 24 and 25 the administrative liability that the franchisor must assume for noncompliance with registration. The main legal consequences of administrative punishment are three: order to stop or correct the non-compliant behavior, be fined, and be announced. The authority shall issue a written order to rectify or cease illegal operations within a specified timeframe. Only when the wrongdoer refuses to comply or fails to apply for rectification within the given timeframe can their illicit earnings be confiscated, or fines imposed.

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<sup>359</sup> R 4 (Potential Franchisee), physical at the office, December 22, 2023.

<sup>360</sup> R 6 (Franchisee), physical at the office, February 21, 2024.

The administrative penalties under the *CFAR 2007* imposed on the franchisor for non-compliance with the registration are showed in the Table 3.3 below:

Table 3.3

*The Administrative Liability for Noncompliance with Registration*

<b>Item</b>	<b>Noncompliance Performance</b>	<b>Administrative Punishment</b>
1	Units and individuals other than the enterprise as franchisors (Article 24).	<ul style="list-style-type: none"> <li>- Order to stop the illegal operation.</li> <li>- Confiscation of illegal gains.</li> <li>- Be fined between 100,000 yuan and 500,000 yuan.</li> </ul>
2	The franchisor does not meet the two-plus-one requirement (Article 24).	<ul style="list-style-type: none"> <li>- Order correction.</li> <li>- Confiscation of illegal gains.</li> <li>- Be fined between 100,000 yuan and 500,000 yuan.</li> <li>- Public notice of violations.</li> </ul>
3	Not registered within 15 days after execution of the contract (Article 25).	<ul style="list-style-type: none"> <li>- Mandatory registration.</li> <li>- Be fined between 10,000 yuan and 100,000 yuan.</li> <li>- Public notice of violations.</li> </ul>

**Source:** *CFAR 2007*

The most severe penalties apply in two cases: first, when the franchising entity lacks the required qualifications, and second, when it fails to operate two stores for at least one year. If the franchisor commits either of these two violations, its illegal income is confiscated, a fine of 100,000 to 500,000 yuan is imposed, and the violation is publicly announced. Furthermore, if the documents and materials submitted by the franchisor for registration are incomplete and cannot be filed on time, they must be supplemented

within seven days. Failure to do so may result in an order to register within a set period and a fine of 10,000 to 50,000 yuan.

#### **3.4.6 Stakeholder Perspectives on the Registration**

The *CFAR 2007* establishes a franchise registration system, requiring franchisors to register with the MOC or the local provincial Department of Commerce. This study examines its legal requirements, including its nature, timing, prerequisites, process and administrative liability for non-compliance. Furthermore, the researcher sought stakeholder perspectives on the franchise registration system in China to better understand its practical challenges and the effectiveness of its implementation. Interview data show that while respondents acknowledge its role in providing franchisees with useful information, they also point out the issue of weak enforcement in franchise registration.

The current post-contract registration requirement reflects a balanced approach by the Chinese government towards franchising regulation, favoring regulatory moderation over excessive administrative intervention. While franchisors who fail to comply may face administrative penalties, franchise registration is distinct from administrative approval, and courts generally do not invalidate contracts solely due to non-registration. The lack of strict regulation in the registration process has led to widespread non-compliance with registration requirements, increasing pre-contractual risks for franchisees. In conclusion, the current registration requirements offer limited

protection for franchisees, and the issue of weak enforcement needs to be addressed urgently.

### **3.5 Analysis of the Contractual Mechanism**

The franchise relationship is structured by a franchise agreement, a legal document that outlines the rights and obligations of both the franchisor and the franchisee. Through the franchise agreement, the franchisor grants the franchisee access to the franchisor's resources, including trademarks, business systems and operational protocols, while also collecting franchise fees. The franchise contract serves as the principal regulatory mechanism, directly binding both parties in the franchising relationship. As Hadfield notes,

There is no comprehensive or uniform system of regulation. Either because current regulation is piecemeal or, more fundamentally, because franchise relationships are too complex to reduce to precise statutory term, the heart of franchising's legal structure is still contract.<sup>361</sup>

Moreover, the franchisee agrees to follow the franchisor's business model and offer the same products or services. The franchisor, in turn, is contractually bound to provide ongoing support and guidance to help the franchisee comply and succeed in operations. Compensation for these resources and support is structured through a franchise fee, covering the costs of accessing the franchise's intellectual and operational assets. In

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<sup>361</sup> Gillian K. Hadfield, "Problematic Relations: Franchising the Law of Incomplete Contracts," *Stanford Law Review* 42 (1989): 7, <https://doi.org/10.2307/1228908>.

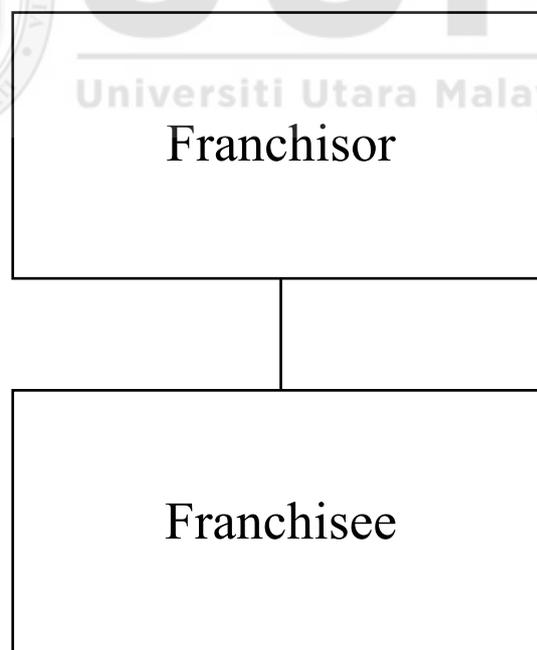
this study, the terms "franchise contract" and "franchise agreement" are used interchangeably, referring to the written agreement between the franchisor and franchisee.

### 3.5.1 The Models of Franchise Agreement

#### 3.5.1.1 Individual Franchise Agreement

An individual franchise agreement, also known as a first-tier franchise agreement. Franchisor and franchisee agree in the franchise agreement to sell single franchise in a specific location.<sup>362</sup> As shown in Table 3.4 below:

Table 3.4  
*Individual Franchise Agreement*



**Source:** (Barringer, et al. 2010, 516)

<sup>362</sup> Bruce R. Barringer, *Four Ways to Start Your Own Business* (Pearson Education, 2010).

It is important to note that under this type of franchise agreement, the franchisee can no longer license an individual franchise to the next tier. KFC, Quanjude Roast Duck and McDonald's all use this type of franchise agreement. The advantage of a single franchise agreement is that the franchisee has the exclusive right to open a single store. In addition, the operation is relatively simple and easy to manage. An individual franchise agreement is the basis of the entire franchise system. No matter what type the franchise agreement is, it is ultimately developed based on an individual franchise agreement.<sup>363</sup>

### **3.5.1.2 Area Development Franchise Agreement**

In an area development franchise agreement, the franchisor grants the franchisee the right to open and operate a specific number of franchise stores in a specific territory.<sup>364</sup> The franchisor signs a development contract with the development agent, giving the development agent the right to develop in the agreed area and time. When the requirements and conditions are reached, the franchisor and the developer sign separate franchise contracts for each outlet.<sup>365</sup> As shown in Table 3.5 below:

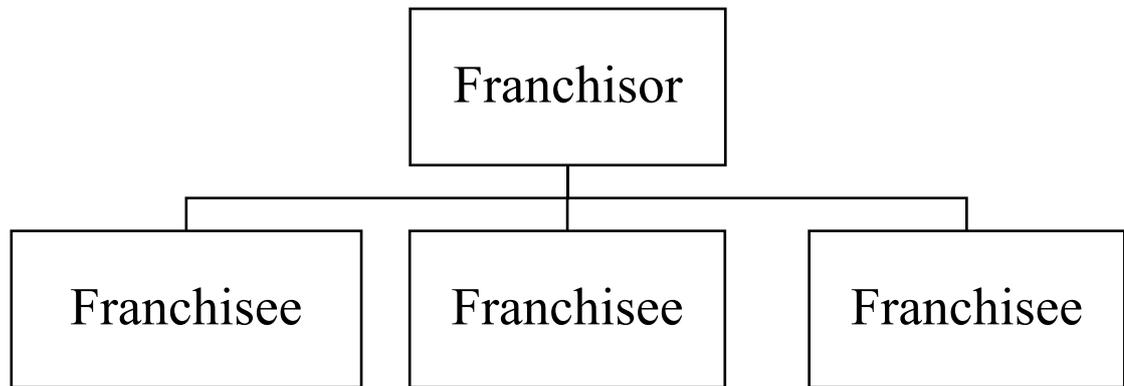
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<sup>363</sup> Kevin B. Murphy, *The Franchise Investor's Handbook: A Complete Guide to All Aspects of Buying, Selling, or Investing in a Franchise* (Atlantic Publishing Company, 2006).

<sup>364</sup> Bruce R. Barringer, *Four Ways to Start Your Own Business* (Pearson Education, 2010).

<sup>365</sup> Vinay K. Garg, Abdul A. Rasheed, and Richard L. Priem, "Explaining Franchisors' Choices of Organization Forms within Franchise Systems," *Strategic Organization* 3, no. 2 (2005): 185.

Table 3.5  
*Area Franchise Agreement*



**Source:** (Barringer, et al. 2010, 516)

Subway is an example of a franchise system with many franchisees spread across a large geographic area, though it does not follow the traditional area development model. Instead, Subway uses a regional development approach, where the franchisor appoints a franchisee in each region as a development agent. The development agent manages all the franchisees within their region, while Subway headquarters oversees only the agent.<sup>366</sup> It helps to realize economies of scale as quickly as possible.

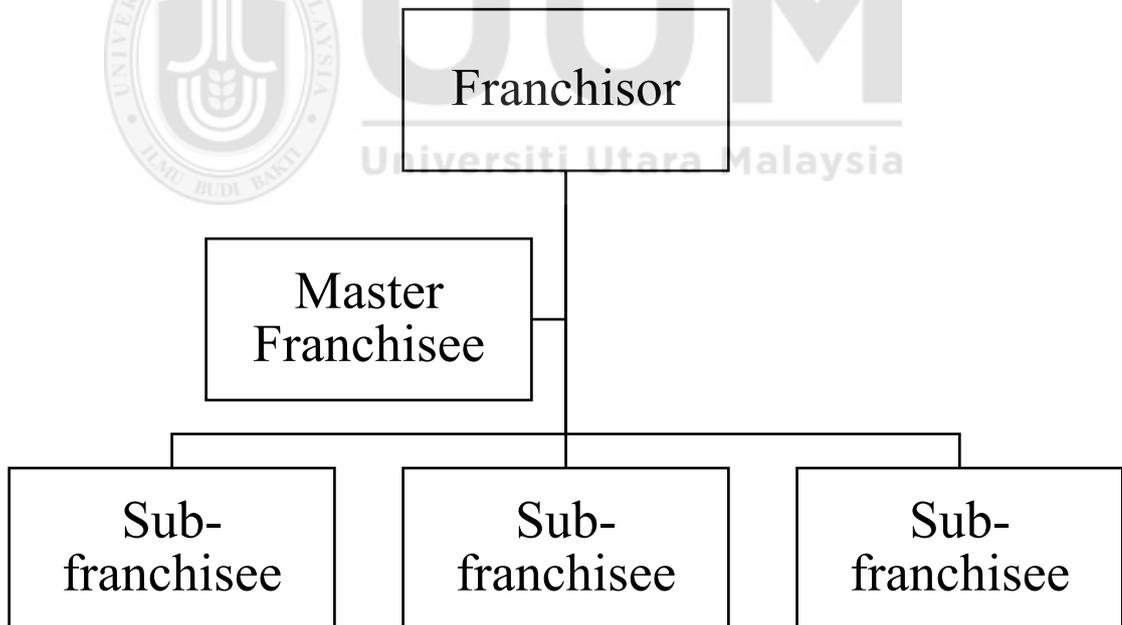
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<sup>366</sup> Rozenn Perrigot, Guy Basset, and Gérard Cliquet, "Multi-Channel Communication: The Case of Subway Attracting New Franchisees in France," *International Journal of Retail & Distribution Management* 39, no. 6 (2011): 434.

### 3.5.1.3 Master Franchise Agreement

In a master franchise agreement, the franchisor grants an exclusive franchise in a specific area to the master franchisee. In addition to investing in the specific area, the master franchisee also re-grant it to the sub-franchisees to operate.<sup>367</sup> It involves the franchisor, the master franchisee, and the sub-franchisee. In the master franchise model, there are two franchise contract relationships: one between the franchisor and the master franchisee, and another between the master franchisee and the sub-franchisee.<sup>368</sup> As shown in Table 3.6 below:

Table 3.6  
*Master Franchise Agreement*



**Source:** (Barringer, et al. 2010, 516)

<sup>367</sup> Barringer, Bruce R. *Four Ways to Start Your Own Business*. Pearson Education, 2010

<sup>368</sup> Manitoba Law Reform Commission. Consultation paper on franchise legislation. *Asper Review* Vol. VIII. 2008, 189.

However, franchisors and sub-franchisees generally do not have a direct relationship. In international franchising, such as 7-Eleven, it is the most common practice for the master franchise to expand overseas. A master franchisee conducts business as a franchisor in a particular territory, usually a country. International franchising needs to overcome cultural and legal differences in different countries. It is more convenient and economical for the franchisor to grant franchise recourse to master franchisee. On the one hand, it is quick to expand the market with the resources and strength of the master franchisee. On the other hand, it is flexible and easy to adapt to the local market.<sup>369</sup>

### **3.5.2 Franchisee Protection through the Contract**

The MOC stressed that it is crucial to balance administrative intervention with the protection of contractual freedom under private law. Although supervision and regulation are necessary to ensure compliance and fairness within franchising, such oversight should not compromise the autonomy of the contracting parties. Therefore, the contract mechanism ensures that administrative authority does not interfere too much with private legal relationships. The main laws governing franchise relationships currently are the *CFAR 2007* and the *Civil Code*. The following provides a detailed introduction to these relevant provisions.

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<sup>369</sup> Olegario Llamazares. What Is a Master Franchise Agreement? Global Negotiator Business Publications 16 October 2014, 1.

### 3.5.2.1 Franchise Contract under the *CFAR 2007*

The Article 11 of *CFAR 2007* stipulates that franchise contracts must be in written form and cover several key elements:

basic information about both parties, the scope and duration of the franchise, franchise fee types and payment methods, specifics of services provided (such as guidance and training), product or service quality standards, advertising and promotional requirements, consumer rights protection and compensation responsibilities, terms for modifying or terminating the contract, liability for breaches, dispute resolution methods, and any other mutually agreed terms.<sup>370</sup>

However, the regulations lack specific guidelines regarding the content of franchise contract, creating ambiguity in practical application. There is little to no opportunity for franchisees to negotiate specific terms during the contract formation process. One respondent stated that the terms of the franchise contract are predetermined by the franchisor, leaving franchisees with no choice but to passively accept them if they wish to join the franchise system.<sup>371</sup> Therefore, it is necessary for legislation to set requirements for key contract terms to prevent franchisors from using standard clauses to evade their responsibilities while ignoring the key rights of franchisees.

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<sup>370</sup> *CFAR 2007*, art.11.

<sup>371</sup> R 11 (Franchisee), physical at the office, March 23, 2024.

Table 3.7 below summarizes the legal requirements for franchise contracts under the *CFAR 2007*.

Table 3.7  
*Contractual Protection for Franchisees under the CFAR 2007*

<b>Common Contract Terms</b>	<b>Clauses Regulated by <i>CFAR 2007</i></b>
Franchisor's Obligations	Article 14: Provide the operation manual and ongoing business support, technical assistance, and training as agreed; Article 11
Franchisee's Obligations	Article 18(2): Franchisees cannot share or allow the use of the franchisor's business secrets; Article 11
Fees/Payments	Article 16: Fees paid before the contract must include details on purpose, conditions, and refund methods; Article 11
Franchisor Advertising and Marketing	Article 17: Advertising and marketing expense disclosures must be accurate and not guarantee income; Article 11
Grant	Article 3: Grants of registered trademarks, enterprise logos, patents, proprietary technology, and other business resources.
Term (Duration)	Article 13: The term must be at least three years, unless shortened by consent or renewal; Article 11
Right of Renewal	Article 11
Transfer	Article 18(1): Franchisees cannot transfer their rights without franchisor approval; Article 11
Termination	Article 12: Cooling-off; Article 11
Restraint of Trade	Article 15: Franchise products or services must meet legal, regulatory, and state standards.
Dispute Resolution	Article 11

*CFAR 2007* specifies several mandatory clauses for franchise contracts. For instance, Article 12 mandates that the franchise contract must include the franchisee's right to unilaterally terminate the contract, commonly referred to as the "cooling-off period" in China's franchising sector. However, the regulation lacks clarity regarding the duration of this period and the penalties for breaching it. One respondent said that in practice, cooling-off periods vary widely—some agreements set a few days, others a few months, or do not include a cooling-off clause at all.<sup>372</sup> This creates challenges for judicial decisions, as courts must consider both whether the cooling-off period is reasonable and the need to respect the contract.

Article 14 of *CFAR 2007* requires franchisors to provide franchisees with a franchise operations manual, which serves as a key resource for ensuring consistency and quality in franchise operations. However, the regulation does not specify the content of the manual, leaving it to be mutually agreed upon by the franchisor and franchisee. Other clauses remain overly broad, and the government has not issued any additional documents to provide further clarification.

### **3.5.2.2 Franchise Contract under the *Civil Code***

In addition to *CFAR 2007*, franchise agreements in China are also governed by the *Civil Code*. The MOC stressed that franchising, as a contractual act, falls under the

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<sup>372</sup> R 21 (Regulator), physical at the office, April 7, 2024.

domain of contract law and relevant civil regulations.<sup>373</sup> The principle of good faith, outlined in Article 7 of the *Civil Code*, holds the highest authority in private law and is often referred to as the "imperial clause" within civil law.<sup>374</sup> This principle mandates that parties engage in civil activities with honesty, fairness and integrity. It serves as a foundational standard for regulating behavior in legal relationships, ensuring that parties fulfill their obligations responsibly and do not abuse their rights or evade their duties.

In franchise contracts, where franchisors typically hold a dominant position, the principle serves as a safeguard against unfair terms, particularly in standard form agreements. Professor Liang observed that,

The principle of good faith now applies not only to the formation, execution, and interpretation of contracts but also to how rights are exercised, and obligations are fulfilled. It has evolved from from being an optional guideline that supports the parties' intentions to a mandatory legal standard, which cannot be excluded by agreement and is applied directly by courts, even without being invoked by the parties.<sup>375</sup>

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<sup>373</sup> The State Council Legislative Affairs Office and the Ministry of Commerce, "Questions and Answers Regarding China's New Franchise Regulation," February 16, 2007, accessed February 9, 2023, [http://www.gov.cn/zwhd/2007-02/15/content\\_528054.htm](http://www.gov.cn/zwhd/2007-02/15/content_528054.htm).

<sup>374</sup> Zejian Wang, *General Principles of Civil Law (Updated Edition)* (Beijing: China University of Political Science and Law Press, 2001).

<sup>375</sup> Huixing Liang, *Civil Law Interpretation* (Beijing: China University of Political Science and Law Press, 1995).

Unlike the common law system, where implied terms are not strictly ordered, Chinese law prioritizes legal provisions over interpretative principles.<sup>376</sup> As a result, the principle of good faith is used to ensure fairness when the law does not fully cover the situation. In practice, the principle of good faith is seldom used and is typically applied only when no legal norms exist or when enforcing them would result in clear unfairness. As a result, its corrective role is limited, mainly activated in extreme cases to address excessive rigidity in contracts.

The *Civil Code* addresses contract validity in Article 153, which stipulates that any civil legal act that violates a mandatory provision of law or administrative regulation is considered invalid. In practice, the impact of mandatory provisions and administrative regulatory provisions on contract validity differs. Mandatory provisions on validity render a contract invalid if violated, while regulatory provisions control conduct. Breaching regulatory provisions may result in penalties but does not automatically invalidate the contract.

The Supreme People's Court has clarified that the "two-plus-one requirement" is a regulatory provision, meaning non-compliance does not automatically invalidate the franchise contract.<sup>377</sup> This distinction shows that only breaches of provisions affecting

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<sup>376</sup> Eric W. Orts, "The Rule of Law in China," *Vanderbilt Journal of Transnational Law* 34 (2001): 43.

<sup>377</sup> Beijing Supreme People's Court, Civil Third Trial No.18, 2020.

legal efficacy result in contract invalidity, while others may allow the contract to remain enforceable.

There shall be legal or agreed reasons for termination of the contract under the background of China's civil law. Article 562 of the *Civil Code* states that parties can agree on specific conditions for contract termination, allowing one party to end the contract when those conditions are met. Article 563 of the *Civil Code* states that a contract may be terminated only if the breach is so severe that it prevents the contract's purpose from being fulfilled.

A franchisee cannot easily terminate the franchise contract solely due to defective information disclosure. According to the Shanghai High Court,

Whether a franchisee can terminate the contract due to the franchisor's breach of the information disclosure obligation should be assessed in light of the legislative intent of contract termination, as outlined in Article 94 of the *Contract Law* (now replaced by Article 563 of the *Civil Code*). Factors such as the extent to which the franchisor's withholding or misrepresentation of information affects contract performance and whether the contract's purpose can still be fulfilled should be comprehensively considered.<sup>378</sup>

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<sup>378</sup> Shanghai Municipal Higher People's Court, *The Answers to Several Issues Concerning the Trial of Franchise Contract Disputes* (2012).

### 3.5.3 Civil Law Remedies

Providing civil remedies for contract breaches is essential to safeguarding the rights of both parties. These remedies allow the injured party to seek compensation or other legal solutions, promoting fairness and helping to address power imbalances. However, current franchise regulations in China primarily focus on administrative penalties, such as fines, without specific provisions for civil remedies in cases of non-compliance.

For instance, Article 19 of the *CFAR 2004* held franchisors liable for financial losses caused by insufficient or false information disclosure. However, this provision was removed in the updated *CFAR 2007*, leaving franchisees without a direct means to claim compensation under the regulations. As a result, franchisees seeking damages for breaches related to information disclosure or other contract violations may need to rely on the broader provisions of *Civil Code*, which could limit the direct legal protection available in franchising contexts.

The essence of liability for breach of contract, as a form of property liability, is not to punish the breaching party but to compensate the non-breaching party for the losses they have suffered.<sup>379</sup> Civil remedies for contractual breaches in franchising include compulsory performance and damages. Compulsory performance requires the breaching party to fulfill their obligations, while damages provide compensation for any financial losses resulting from the breach.

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<sup>379</sup> Pengsheng Sui, *Essentials of Contract Law* (Beijing: China Renmin University Press, 2015).

### 3.5.3.1 Compulsory Performance

Compulsory performance, also known as continuation of performance, is a remedy for breach of contract that allows one party to demand the other party continue fulfilling their contractual obligations. Article 179(1) of *Civil Code* recognizes it as a form of civil liability. Article 577 of *Civil Code* further specifies that if a party fails to perform or performs improperly, they are liable for continuation of performance, taking remedial actions or compensating for damages. This provision continues the principle set out in Article 107 of the previous *Contract Law*, which also identified continuation of performance as a remedy for contract breaches.

In a franchise contract, the franchisor may seek to cancel the agreement if the franchisee fails to meet performance standards. However, franchisees often make significant initial investments that cannot be quickly recovered. If any breach allowed the franchisor to terminate the contract, the franchisee would face serious financial losses. Courts generally only support termination when the breach severely affects the contract's performance.

In *Anhui Investment Management Co., Ltd. v. Beijing Investment Holding Group Co., Ltd.*, the court ruled that contract termination is only justified if changes in circumstances make continuing the contract unnecessary or impossible. In this case, although the franchisee had breached the contract, the breach was not severe enough

to warrant termination. Given the franchisee's substantial investment and the long-term nature of the contract, the court found that ending the agreement would be unfair. As a result, the court ordered the contract to continue.<sup>380</sup>

### 3.5.3.2 Damages

Damages represent the financial liability of a party to compensate the other party for losses incurred due to a failure to fulfill contractual obligations or performance that deviates from the agreed terms.<sup>381</sup> The conditions for claiming damages in the event of a breach of contract are as following,

When a party fails to meet its contractual obligations or performs them inconsistently with the agreement, leading to losses for the other party, the resulting damages must correspond to the actual losses incurred. This includes both direct financial losses and any anticipated benefits that would have been realized had the contract been properly executed.<sup>382</sup>

Therefore, damages for breach of contract encompass both actual loss and loss of expectation.

Actual loss refers to the reduction of existing assets and the expenditure of incurred costs. In the context of a franchise contract, if the franchisor breaches the agreement,

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<sup>380</sup> Beijing Dongcheng District People's Court. First Instance Civil Judgement No.15123, 2014.

<sup>381</sup> Shixiong Zeng, *Principles of Damages Law* (Beijing: China University of Political Science and Law Press, October 2001), 15.

<sup>382</sup> *Civil Code*, Art. 584.

the franchisee's actual losses may primarily include rental expenses and payments for goods. In the case of *Gan v. Hangzhou Clothing Company*, the franchisor's failure to deliver design drawings as stipulated in the agreement was deemed a breach of contract. As a result, the franchisee was entitled to claim compensation for actual damages, including 19,500 yuan for vacant rental costs.<sup>383</sup>

Expectation refers to the potential property gains that can be realized through the proper execution of a contract, typically involving profits or other economic benefits anticipated by the parties. In practice, if a franchisee breaks the contract by buying goods outside the approved franchise, the court may order liquidated damages to cover the franchisor's lost profits. For example, in one case, the court made the franchisee pay 30,000 yuan as liquidated damages to compensate for the franchisor's expected profit loss due to the breach.<sup>384</sup>

It is important to note that franchise contracts often have liquidated damages clauses, where both parties agree on a specific amount to be paid if there is a breach. When a breach happens, courts usually support claims for liquidated damages because they are the agreed solution to compensate the injured party.

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<sup>383</sup> Hangzhou Yuhang District People's Court. First Instance Civil Judgement No.700, 2015.

<sup>384</sup> Shanghai Pudong New District People's Court, First Instance Civil Judgement, No. 554, 2013.

### 3.6 Summary

This chapter systematically examines three key aspects for franchisee protection within the franchise legal and regulatory framework: disclosure, registration and contract. The chapter first analyses the necessity of providing franchisees with protection, highlighting the four inherent characteristics of franchise relationships: standardized format contracts, relational contracts, the conflict between autonomy and control, and the existence of information asymmetry. These characteristics create an imbalance of power between franchisors and franchisees, making legal protection essential for franchisees.

Following this, this chapter examines the first approach of franchisee protection: disclosure. It explores how the mandatory disclosure system helps address the information asymmetry between franchisors and franchisees. Articles 21, 22 and 23 of the *CFAR 2007* establish comprehensive requirements for franchisor disclosure to franchisees, detailing the timing, format, standards, and content of information to be provided. Article 12 of *CFAR 2007* additionally provides franchisees with a legal right to terminate the franchise agreement during a designated cooling-off period. Complementary to these provisions, the *CFIDAM 2012*, issued by the MOC, further strengthen and refine the disclosure requirements. Moreover, Articles 26 through 29 of *CFAR 2007* outline administrative penalties for failure to comply with disclosure requirements, while the *Civil Code* offers civil remedies, including compensation for damages and injunctions, for breaches of contract or infringements.

Although the disclosure system has played a significant role in protecting franchisees, the study found that there is still considerable room for improvement in the current system. One key issue is that the franchise information disclosure system in China is still not specific enough in relation to the actual business practices that take place. The subject of disclosure is limited to the franchisor and does not differentiate between the main franchisor and sub-franchisors. Some disclosure requirements and the provisions surrounding cooling-off periods remain unclear, creating ambiguity in practice. The absence of a uniform disclosure format and the prohibition of electronic disclosure further hinder the effectiveness of the current disclosure system. The accuracy, timeliness, authenticity and completeness of the information provided by the franchisor cannot be guaranteed. Moreover, in judicial practice, the franchisee generally cannot claim the rights of termination on the basis that the franchisor has not fully performed such pre-contractual obligations.

In addition, this chapter examines the registration requirements for franchisee protection. Franchise registration requirements are governed by the *CFAR 2007* and further refined through the *CFRAM 2011*. The *CFRAM 2011* enhances the registration framework established in *CFAR 2007*, detailing provisions related to registration timelines, competent authorities, required documentation, annual reporting obligations, access criteria for franchisors and associated liabilities. Although post-contract registration minimizes transaction costs, it simultaneously creates opportunities for

non-compliant enterprises to exploit franchisee rights. This study critically analyses the qualification requirements for franchisors, highlighting potential risks for small and medium-sized enterprises or self-employed individuals who may pursue rapid financial gains without sufficient due diligence. The registration requirement is not enforced prior to entry but rather as a post-entry penalty, making its role in controlling franchise entry virtually negligible.

Finally, this chapter examines the contractual requirements for franchisee protection. The *CFAR 2007* imposes limited provisions on franchise contracts, primarily setting broad requirements that allow significant autonomy for franchise entities, thereby upholding the principle of freedom of contract. Fundamentally, the franchise relationship is a contractual one, governed by the general provisions of the *Civil Code*, including the principle of good faith, rules on contract validity, civil liability and remedies. However, the inherent characteristics of franchise contracts place franchisees in a weaker position. The current contractual legal framework provides limited guidance on franchise contract, raising concerns about its ability to address the imbalance in the franchise relationship or provide adequate protections for franchisees. The following Chapter 4 will delve deeper into the practical implementation of contractual mechanisms and their role in franchisee protection.

## **CHAPTER FOUR**

### **THE CURRENT PRACTICE OF FRANCHISEE PROTECTION IN CONTRACTUAL MECHANISMS**

#### **4.1 Introduction**

This chapter fulfills the second research objective by examining the current practice of franchisee protection within the contractual mechanisms in China. To ensure both legal and practical dimensions are adequately covered, the second research objective is discussed across two chapters: Chapter 3 examines the broader regulatory framework, while Chapter 4 focuses on the actual contractual practices. This separation allows for a clearer thematic and analytical distinction between the institutional and contractual levels of franchisee protection.

The analysis begins with a discussion of the benefits and risks of franchising for franchisees. Building on this foundation, this chapter critically analyses the current contractual practice in China's franchise sector, highlighting significant gaps in the franchising regulation. The first critical issue is the practical identification of franchise contracts. Despite a clear legal definition of franchising, many franchisors deliberately label their agreements under different contract types to bypass franchise regulations and avoid legal scrutiny.

This chapter further explores the difficulties franchisees face when it comes to the granting of franchise rights, particularly in relation to intellectual property rights and territorial encroachments by franchisors. In addition, it discusses the contractual practices related to the renewal, transfer and termination of franchise agreements, which often limit franchisees' ability to make independent business decisions.

The discussion also highlights the complex competition issues in franchising, focusing on restrictions imposed by franchisors on franchisees. Finally, this chapter evaluates the dispute resolution mechanisms currently implemented in franchise agreements, concluding that ADR methods such as mediation and arbitration offer substantial advantages over traditional litigation. ADR mechanisms not only save costs and time but also allow for the preservation of franchise relationships, fostering a collaborative resolution rather than the termination of contracts.

#### **4.2 Benefits of Franchising for Franchisees**

Franchising presents significant advantages for franchisees, particularly those with limited experience and financial resources. It provides access to a rapidly expanding business network, enhancing market competitiveness, and operational efficiency through standardized processes. Additionally, franchisees benefit from comprehensive training, ongoing support from the franchisor, and reduced operational costs, leveraging the franchisor's established systems and economies of scale. This model facilitates the realization of entrepreneurial aspirations, making franchising an appealing business opportunity for individuals seeking to enter the market with a

proven framework while also offering scalability and potential for international expansion.

#### **4.2.1 Established Brand and Business Model**

Franchising offers franchisees a streamlined path to business ownership by allowing them to leverage an established brand and a proven business model. By joining a franchise, franchisees gain access to a reputable brand and established operational framework, reducing the risks of starting a new business.<sup>385</sup> In the highly competitive market, it's increasingly difficult for entrepreneurs to break into specific sectors. Research from the U.S. Department of Commerce highlights this challenge, revealing that around 80% of new businesses fail within three years. In comparison, franchise stores experience a much lower failure rate, with less than 2% closing within the same period.<sup>386</sup> This difference indicated the lower risk that franchising offers to those looking to start their own business.

For many new entrepreneurs, limited resources and lack of experience are major barriers. With franchising, franchisees gain access to a business model that's already proven to succeed. As one respondent mentioned,

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<sup>385</sup> Farok J. Contractor, Vikas Kumar, and Sumit K. Kundu, "Nature of the Relationship Between International Expansion and Performance: The Case of Emerging Market Firms," *Journal of World Business* 42, no. 4 (2007): 401-417.

<sup>386</sup> Weihua Li, *Franchising* (Beijing: China Development Press, 2009).

*"I did not have a lot of business experience, but the brand's reputation and the structured setup gave me a much stronger start than I would've had on my own."<sup>387</sup>*

Franchisees aim to use the franchisor's intellectual property and established business model to lower risks and gain economic benefits more quickly. The franchisor's established business system, reputation and market-tested practices allow franchisees to bypass many of the common pitfalls of starting from scratch.

With the franchisor's brand recognition and business model, franchisees can enjoy a competitive edge in the market from the outset. The unified franchise system provides franchisees with an efficient and effective management structure. The standardized operating procedures and management practices set by the franchisor enable franchisees to benefit from a well-tested framework, which promotes operational consistency and efficiency across locations.

Franchisees also receive thorough training and ongoing support, which simplifies the startup process and reduces the challenges of managing a new business. By focusing on day-to-day operations under the franchisor's guidance, franchisees can achieve greater efficiency and profitability, making the franchise model particularly appealing for those new to entrepreneurship.

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<sup>387</sup> R 8 (Franchisee), Online, March 1, 2024.

#### 4.2.2 Training and Support

Franchising provides franchisees with critical training and support from the franchisor, which is essential for ensuring a smooth and successful business operation. Once they join a franchise network, franchisees receive comprehensive initial training and ongoing technical assistance, which enables them to operate their stores effectively even without prior industry knowledge or management experience.

The franchisor imparts valuable expertise and business practices, allowing franchisees to leverage tried-and-tested management strategies. This structured training process is especially valuable for those new to the industry, as it enables them to adopt established practices rather than experimenting with unproven methods. One franchisee respondent said,

*"I did not have any experience in this industry when I started. But from day one, the training covered everything—running the store, handling customers, all of it. That really gave me the confidence I needed to run my place smoothly."<sup>388</sup>*

Ongoing support from the franchisor is another benefit. The franchisor's ongoing support encompasses various aspects, including site selection, store setup, management training, and crisis response, all of which serve as strong pillars for franchisees' business success. The franchisor's ongoing support ensures franchisees have access to expert guidance throughout their business journey, allowing them to

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<sup>388</sup> R 12 (Franchisee), physical at the office, March 9, 2024.

focus on daily operations while benefitting from the franchisor's experience and insights. Respondent 11 noted,

*"They kept us updated with tips on running the business and advice on handling market changes, which really helped us make better decisions. Having their support during tough times made it easier to get through challenges and keep our service quality steady, even when things got rough."*<sup>389</sup>

### 4.2.3 Cost Efficiency

Franchising offers franchisees a low-cost entry and growth model by removing the financial burden of brand development from scratch.<sup>390</sup> Joining an established franchise allows franchisees to leverage the franchisor's brand equity, which reduces startup risks and costs. Franchisees benefit from the economies of scale as they gain access to equipment and raw materials often at discounted rates through the franchisor's network. This arrangement not only lowers operational costs but also ensures consistent quality in products and services, which enhances customer satisfaction across the franchise system. Franchisees benefit from the franchisor's established supply chains, helping them reduce costs and maintain product quality. One of the respondents highlighted,

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<sup>389</sup> R 11 (Franchisee), physical at the office, March 23, 2024.

<sup>390</sup> Maureen Brookes and Levent Altinay, "Franchise Partner Selection: Perspectives of Franchisors and Franchisees," *Journal of Services Marketing* 25, no. 5 (2011): 336-346.

*"Having access to the franchisor's global suppliers allowed us to cut sourcing costs and deliver consistent quality, which would have been challenging as an independent startup."<sup>391</sup>*

Additionally, the franchising model minimizes ongoing expenses through shared resources and centralized advertising efforts. As part of a unified brand, franchisees can rely on nationwide marketing campaigns orchestrated by the franchisor, reducing or even eliminating their individual advertising expenses.<sup>392</sup> The franchisor's established business network provides critical market insights and demand forecasting, allowing franchisees to adjust their sales strategies efficiently to avoid wasted resources and optimize profits. Lastly, as franchise systems grow, franchisors often negotiate discounts and concessions from suppliers, further reducing costs for franchisees and reinforcing the financial appeal of the franchise model.

#### **4.2.4 Broader Market Opportunities**

Franchising offers franchisees a practical pathway to enter and succeed in international markets by drawing on the franchisor's established brand reputation and resources. This approach helps franchisees tap into new markets with less risk and more confidence. For example, one franchisee of a popular restaurant chain shared in an interview,

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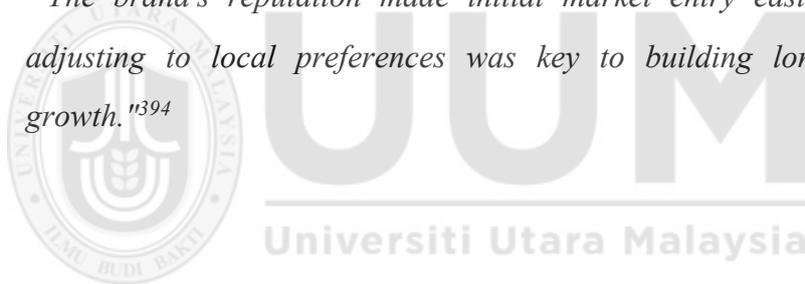
<sup>391</sup> R 10 (Franchisee), physical at the office, March 15, 2023.

<sup>392</sup> Patrick J. Kaufmann and Francine Lafontaine, "Costs of Control: The Source of Economic Rents for McDonald's Franchisees," *The Journal of Law and Economics* 37, no. 2 (1994): 417-453.

*"...joining a globally recognized brand allowed us to bypass the long process of building customer trust from scratch. Instead, we could focus on adapting our offerings to local preferences, which quickly attracted loyal customers."<sup>393</sup>*

By combining the benefits of brand recognition, local adaptation, and cost efficiencies, franchising helps franchisees navigate the complexities of international expansion. This model enables them to effectively respond to diverse consumer needs across regions, making franchising an attractive option for those seeking global growth. Another respondent, who successfully expanded into Southeast Asia, noted,

*"The brand's reputation made initial market entry easier, but adjusting to local preferences was key to building long-term growth."<sup>394</sup>*



Finally, franchising provides franchisees with opportunities to enter international markets.<sup>395</sup> By leveraging the established reputation and resources, franchisees can access new markets with reduced risk. The franchising model allows them to utilize local knowledge and resources to navigate cultural and regional market differences, enabling more effective distribution of goods and services. As the global market becomes more accessible, franchisees are well-positioned to take advantage of expanding international business opportunities.

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<sup>393</sup> R 10 (Franchisee), physical at the office, March 15, 2023.

<sup>394</sup> R 11 (Franchisee), physical at the office, March 23, 2024.

<sup>395</sup> Rajneesh Narula and John H. Dunning, "Industrial Development, Globalization and Multinational Enterprises: New Realities for Developing Countries," *Oxford Development Studies* 28, no. 2 (2000): 141-167.

### **4.3 Risks of Franchising for Franchisees**

Franchise relationships often encounter agency problems, where conflicting interests between the parties can hinder their respective goals. Before the franchise relationship begins, franchisors may misrepresent their resources, support, or brand profitability, leaving franchisees with an incomplete or overly optimistic view of the business. Once the relationship is underway, franchisees may also face challenges in holding the franchisor accountable to performance commitments, increasing the risk of moral hazard. According to agency theory, these risks in franchising largely arise from information asymmetry and moral hazard, which tend to place franchisees in a vulnerable position due to their limited ability to verify the franchisor's claims or enforce standards effectively.<sup>396</sup>

#### **4.3.1 Conflicts of Interest**

The inherent conflict of interest between franchisors and franchisees drives non-compliance in franchise practices. Diverging interests, compounded by information asymmetry and power imbalances, result in inevitable tensions. Addressing these conflicts is a critical aspect of franchise regulation and essential for safeguarding franchisee rights. Bound by franchise agreements, both franchisors and franchisees seek to maximize their respective profits. Franchisees aim to minimize entrepreneurial risks and costs by leveraging the franchisor's established business model, while striving for maximum returns.

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<sup>396</sup> Philip Mark Abell, *The Regulation of Franchising in the European Union* (PhD diss., 2011).

Franchisors, on the other hand, focus on market expansion with minimal investment. This dynamic creates a cooperative yet competitive relationship. Franchisors focus on long-term system growth and brand reputation, while franchisees often prioritize short-term profits, sometimes undermining brand value. This contrast in objectives is a key source of conflict in franchise relationships.

#### **4.3.2 Limitations Imposed by Standardized Contracts**

In the franchise sector, franchisors hold a dominant position in negotiations, allowing them to impose standardized franchise agreements.<sup>397</sup> These standardized contracts are pre-drafted by franchisors for repeated use, eliminating the need for individual negotiations with franchisees during the contract formation process. While such agreements help franchisors reduce costs and improve efficiency, they significantly restrict franchisees' contractual freedom.

For franchisors, standardized franchise agreements reduce operational costs and facilitate the rapid expansion of franchise businesses. By using contracts with identical content and format for different franchisees, franchisors can avoid the complexity of negotiating individual agreements, saving time and reducing negotiation expenses.<sup>398</sup>

Standardized contracts enable franchisors to grant franchise rights on a large scale,

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<sup>397</sup> Felstead, Alan. *The Corporate Paradox: Power and Control in the Business Franchise*. New York: Taylor & Francis, 2024.

<sup>398</sup> William E. Gillis, James G. Combs, and Xiaoli Yin, "Franchise Management Capabilities and Franchisor Performance under Alternative Franchise Ownership Strategies," *Journal of Business Venturing* 35, no. 1 (2020): 105899, <https://doi.org/10.1016/j.jbusvent.2018.09.004>.

supporting the swift growth of their franchise networks. Such contracts also help streamline the franchisor's management, reducing costs and improving overall system efficiency.

From the perspective of franchisees, standardized franchise agreements pose significant challenges to the principles of contractual freedom and fairness.<sup>399</sup> Contractual freedom, a core tenet of civil law, encompasses the freedom to enter into agreements, choose transaction counterparts, and determine the content and form of contracts. However, the widespread use of standardized franchise agreements in practice undermines these principles. These agreements often disregard the unique needs of franchisees, eliminating any opportunity for negotiation and failing to reflect the franchisees' genuine intentions. The rigidity of such contracts clashes with the individual requirements of franchisees, making it difficult for them to express their true preferences and concerns.

Although franchisors and franchisees are formally independent contracting parties, the actual relationship is characterized by a power imbalance. Franchisors, with their superior economic strength and control over scarce commercial resources, dominate the contractual dynamic, leaving franchisees in a weaker position.<sup>400</sup> This imbalance allows franchisors to set unfair terms, leaving franchisees with little choice but to

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<sup>399</sup> Andrew Elmore, "Regulating Mobility Limitations in the Franchise Relationship as Dependency in the Joint Employment Doctrine," *UC Davis Law Review* 55 (2021): 1227.

<sup>400</sup> Joseph M. Matthes, Amit Saini, and Vivek K. Dubey, "Performance Implications of Marketing Agreement, Cooperation, and Control in Franchising," *Journal of Marketing Theory and Practice* 29, no. 3 (2021): 387–408, <https://doi.org/10.1080/10696679.2020.1864216>.

accept unfavorable conditions to join the franchise. The gap in financial power, information access and control over intellectual property deepens the inequality and increases conflicts between franchisors and franchisees. Ultimately, it harms the fairness and autonomy of franchise relationships.

### 4.3.3 Inaccessibility of Information for Franchisees

There exists a clear information asymmetry in franchise relationship. The franchisor typically holds specialized knowledge and expertise in the field of franchising, while most franchisees lack substantial business experience.<sup>401</sup> Although some franchisees may have extensive business backgrounds, many choose the franchising model specifically because they lack the relevant skills and seek the structured support of an established system. The information asymmetry in franchising makes franchisees easily misled by the franchisor's exaggerated promotions and aggressive marketing, often resulting in significant investment risks. One respondent pointed out,

*"Information asymmetry really puts franchisees at a disadvantage because they often do not have access to crucial details about the franchisor's background, financial liabilities, or how they run their operations. A lot of franchisees end up signing agreements without fully understanding the risks, which can lead to problems down the line."<sup>402</sup>*

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<sup>401</sup> Rajiv P. Dant and Nada I. Nasr, "Control Techniques and Upward Flow of Information in Franchising in Distant Markets: Conceptualization and Preliminary Evidence," *Journal of Business Venturing* 13, no. 1 (1998): 3-28, [https://doi.org/10.1016/S0883-9026\(97\)00040-2](https://doi.org/10.1016/S0883-9026(97)00040-2).

<sup>402</sup> R 16 (Lawyer), physical at the office, April 5, 2024.

Although franchisees can require franchisors to disclose statutory information in writing under Article 22 of CFAR 2007, they also have a duty to conduct due diligence as independent business entities. In franchise relationships, business resources with intellectual property attributes are central elements, and franchisors hold a considerable informational advantage. These business resources are intangible assets, and their valuation and market characteristics are complex, requiring specialized expertise. Franchisees, often lacking such expertise, face difficulties in assessing or obtaining sufficient information independently.<sup>403</sup>

In China, the franchising market, particularly in emerging sectors, lacks well-developed transaction rules, industry management and self-regulatory mechanisms, which further limits franchisees' access to external information. The diversity within franchise systems, resulting from variations in business resources across industries and brands, prevents the establishment of standardized rules, increasing the difficulty for franchisees in obtaining accurate and comprehensive information. Given the diversity in the financial capacity, operational expertise and risk preferences among potential franchisees, their demands are more varied compared to the standardized nature of franchising systems. This creates an environment where information asymmetry prevents franchisees from accessing the essential business information they need.

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<sup>403</sup> Scott Weaven et al., "Surviving an Economic Downturn: Dynamic Capabilities of SMEs," *Journal of Business Research* 128 (2021): 109-123, <https://doi.org/10.1016/j.jbusres.2021.02.009>.

#### 4.3.4 Unreliability of Information for Franchisees

The problem becomes worse when franchisors hide or mislead franchisees, increasing their risks. Even if franchisees carefully research beforehand, they may still struggle to get a full understanding of the business if key information is withheld or concealed.<sup>404</sup> Due to information asymmetry, the informed party withholds full and truthful disclosure, engaging in self-interested behavior at others' expense, known as opportunism.<sup>405</sup> As a result, franchisors may leverage their information advantage to gain extra profits, making the franchise deal unfair and encouraging dishonest behavior.<sup>406</sup> This can push franchisors to use unethical tactics like false advertising or deception to increase profits. Some low-quality franchisors may hide negative details or exaggerate the benefits of their franchise to attract franchisees.<sup>407</sup>

One respondent remarked,

*"Some franchisors purposely exaggerate or twist product information in their promotions. They make the franchise look more profitable or lower risk than it actually is, so franchisees end up with high expectations that do not match reality. It's only after joining that many realize the challenges are much greater than they were led to believe."<sup>408</sup>*

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<sup>404</sup> Farhad Sadeh and Manish Kacker, "Quality Signaling through Ex-Ante Voluntary Information Disclosure in Entrepreneurial Networks: Evidence from Franchising," *Small Business Economics* 50 (2018): 729–748, <https://doi.org/10.1007/s11187-017-9892-4>.

<sup>405</sup> Maureen Brookes, Levent Altinay, and Gurhan Aktas, "Opportunistic Behavior in Hospitality Franchise Agreements," *International Journal of Hospitality Management* 46 (2015): 120-129.

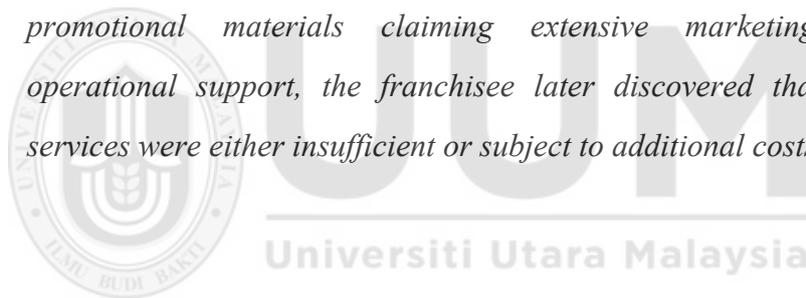
<sup>406</sup> Robert W. Emerson, "Transparency in Franchising," *Columbia Business Law Review* (2021): 172.

<sup>407</sup> Olivier Cochet and Thomas Ehrmann, "Preliminary Evidence on the Appointment of Institutional Solutions to Franchisor Moral Hazard—the Case of Franchisee Councils," *Managerial and Decision Economics* 28, no. 1 (2007): 41-55, <https://doi.org/10.1002/mde.1312>.

<sup>408</sup> R 21 (Regulator), physical at the office, April 7, 2024.

Franchisees also face moral hazard from franchisors. For example, the franchisor often forces the franchisee to purchase specified materials at a much higher price than the market price on the grounds of maintaining uniformity in the quality.<sup>409</sup> In addition, The franchisor focuses on a one-time transaction and neglects to provide ongoing support or fails to meet the contractual service standards. One respondent stated,

*"I am aware of a franchisee who was not provided with complete information regarding the franchisor's support system, which resulted in significant difficulties in meeting operational standards due to inadequate training and guidance. Despite the franchisor's promotional materials claiming extensive marketing and operational support, the franchisee later discovered that such services were either insufficient or subject to additional costs."<sup>410</sup>*



As franchise operations unfold, franchisees become increasingly reliant on the information controlled by franchisors, further exacerbating the imbalance of power.<sup>411</sup> It is an undeniable fact that franchisees often lack the ability to distinguish between reliable and unreliable information, which can lead to a "bad money drives out good" effect in the franchise market.<sup>412</sup> Since franchisees cannot verify the information, they may unknowingly partner with franchisors who provide poor resources or make false

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<sup>409</sup> Grace, Debra, and Scott Weaven. "An Empirical Analysis of Franchisee Value-in-use, Investment Risk and Relational Satisfaction." *Journal of Retailing* 87, no. 3 (2011): 366-380.

<sup>410</sup> R (16), Lawyer, physical interview, April 5, 2024.

<sup>411</sup> Rozenn Perrigot, Begona López-Fernández, and Guy Basset, "Conflict-performance Assumption or Performance-conflict Assumption: Insights from Franchising," *Journal of Retailing and Consumer Services* 55 (2020): 102081, <https://doi.org/10.1016/j.jretconser.2020.102081>.

<sup>412</sup> Steve Tarr, *Market Failure: The Odd Economics of Free News*, June 24, 2022, SSRN, <http://dx.doi.org/10.2139/ssrn.4227214>.

claims. Over time, this discourages reputable franchisors from entering the market while allowing dishonest ones to thrive, harming fair competition and damaging the franchising industry.

#### **4.4 Identification of Franchise Contracts**

Franchise contracts, which often encompass trademarks, patents and licenses, are frequently mistaken for other contractual forms, such as sales contracts, agency agreements and intellectual property licenses. This confusion makes it harder to determine the true nature of a franchise contract, which is essential for clarifying the legal rights and obligations of both parties. Although franchising has a legal definition, different terms like chain operation agreements, brand franchise contracts and special distribution agreements are commonly used in practice. Many franchisors intentionally use different contract names to avoid registration and regulatory oversight under the *CFAR 2007*.

In court, franchisors often argue that the contract is not a franchise agreement to avoid certain regulations. However, courts prioritize the actual rights and obligations of the parties over the contract's title. This approach ensures that franchise agreements are properly recognized, enforcing regulations and protecting franchisees' rights. Franchising involves the authorization of intellectual property rights such as trademarks and proprietary technology, which is the essential characteristic distinguishing franchise contracts from sales contracts, agency contracts and other

types of agreements. The following Table 4.1 illustrates the differences between identifying the nature of franchise contracts and other similar contracts.

Table 4.1  
*Identification of Franchise Contracts*

Type of Contract	Interpretation	Comments
Sales Contract	<ul style="list-style-type: none"> <li>- To earn the difference in the price of goods or to provide services for profit is regarded as a sale contract.</li> <li>- A sale contract has no obvious restrictions on the sale object, area, and price.</li> <li>- A sale contract is a transaction that transfers the ownership of goods from the seller to the buyer.</li> </ul>	<ul style="list-style-type: none"> <li>- A franchise contract obtains franchise fees by licensing.</li> <li>- Franchise contracts unify prices and territories</li> <li>- A franchise contract is a licensing relationship</li> </ul>
Agency Contract	<ul style="list-style-type: none"> <li>- An agency contract entrusts a specific product to another party for sale, and the subject matter of the contract is usually a tangible asset.</li> <li>- Agency contracts benefit from agency commissions and spreads</li> </ul>	<ul style="list-style-type: none"> <li>- The subject matter of a franchise contract is a business resource, usually an intangible asset.</li> <li>- Franchise contracts benefit from franchise fees.</li> </ul>
Intellectual Property License Contract	<ul style="list-style-type: none"> <li>- Both enterprises and individuals under intellectual property licensing contracts are qualified as licensors</li> <li>- There is no mandatory requirement of contract duration and uniform mode in intellectual property licensing contracts.</li> </ul>	<ul style="list-style-type: none"> <li>- A natural person cannot as franchisor.</li> <li>- The term of franchise contract has a minimum of not less than 3 years.</li> <li>- Both parties to the franchise agreement must follow a certain business mode.</li> </ul>

**Source:** Wolters Kluwer

In deciding whether a contract is a franchise contract, the court usually examines if the contract's content matches the basic features of a franchise. The nature of the franchise contract should be determined by what the two parties agree to in the contract, not by

the name it is given. The Beijing court further explained that franchise generally has three basic characteristics: business resources, unified business models and franchise fees.<sup>413</sup>

First, business resources are a collection of intangible assets owned by franchisors. According to Article 2 of the Beijing Guiding Opinions, business resources should form a certain competitive advantage in the market, such as brand names, trade secrets, the business image with a unique style, and pre-used and influential unregistered trademarks. Similarly, the Shanghai Guiding Opinions adds pre-used and influential unregistered trademarks, trade secrets, trade names and other business resources with intellectual property attributes.<sup>414</sup>

In judicial practice, if the contract and the actual cooperation between the parties do not involve the licensed use of business resources, it cannot be identified as a franchise contract. The case of *Central District Yitong Business Department v. Weishi Beverage Co., Ltd.* illustrated that franchise contracts must have business resources. The court held that the contract involved did not contain any agreement on the licensed use of business resources, nor did it involve the management and support relationship between the franchisor and the franchisee. Therefore, the contract involved does not

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<sup>413</sup> Beijing Municipal High People's Court, *The Guidance Opinions of the Beijing Municipal High People's Court on Several Issues Concerning the Application of Law to the Trial of Commercial Franchise Contract Disputes* (2011).

<sup>414</sup> Shanghai Municipal High People's Court, *The Answers to Several Issues Concerning the Trial of Franchise Contract Disputes* (2012).

belong to the franchise contract. From the content of the contract and the actual cooperation of both parties, the contract involved should be a sales contract.<sup>415</sup>

Second, the concept of a unified business model is fundamental in franchising, where the franchisor implements a standardized management and operational framework across all franchisees. This uniformity ensures consistency in various key aspects, including store image, product and service quality, customer targeting, site selection, organizational structure and operational processes. Each franchisee is expected to adhere to these standards to maintain brand integrity. Courts usually focus on two main factors to determine if a franchise relationship exists:

Whether the franchisee's store design and layout follow the franchisor's standard model; Whether the franchisor provides important support services like supervision, operational guidance, technical support and business training to help the franchisee comply with the unified business model.<sup>416</sup>

In the case *Wu Bin v. Beijing Elegant Style Environmental Protection Technology Co., Ltd.*, the court ruled that the contract between the two parties did not meet the criteria of a franchise agreement. Wu Bin was unable to provide evidence demonstrating that his store's design and decoration followed the franchisor's prescribed model. Additionally, the contract lacked provisions for critical franchise-related services, such

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<sup>415</sup> Yunnan Higher People's Court. Civil Final Judgment No.735, 2016.

<sup>416</sup> Xiao Lin, *Franchising Business Legal Solutions: A Guide to the Application of the Commercial Franchise Management Regulations* (Beijing: Law Press, 2007).

as supervision and training, which are necessary to meet the legal definition of a franchise agreement.<sup>417</sup>

Third, the franchise fee is the amount the franchisee pays to the franchisor in exchange for the right to use the franchisor's business model and resources. This makes franchise agreements different from other types of contracts. Unlike exclusive agency contracts, where the agent earns commissions, or product distribution contracts, where dealers mostly pay for the products themselves, the franchisee's payment is specifically for access to the franchisor's trademarks, systems and support. In court reviews, judges examine different fees to see if they are payments for the franchisor's business resources. If these fees are directly connected to using the franchisor's business model, they are considered franchise fees.

In the case of *Zhu Lumi v. Kunshao Food Store*, the court assessed the nature of the agreement between the parties and concluded it constituted a franchise contract. Despite the absence of the term "franchise" in the contract's title, the court identified key features indicative of a franchise relationship. The defendant, acting as the franchisor, authorized the plaintiff, the franchisee, to use the "Luomao" trademark and operate in accordance with the franchisor's established business model, including product lines, business style and operational systems. The franchisee also paid a franchise fee for the "Luomao" project.<sup>418</sup> The court's decision highlighted that the key

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<sup>417</sup> Jiangxi Higher People's Court. Civil Final Judgment No.21, 2012.

<sup>418</sup> Zhejiang Higher People's Court. Civil Final Judgement No.6807, 2019.

features of the agreement matched those of a franchise contract, emphasizing the importance of focusing on the actual nature of the relationship rather than just the contract's name.

In court rulings on franchise contracts, the main factor in determining its nature is the actual content of the contract. For instance, the Fengtai District Court in Beijing has identified several types of agreements—such as trademark and copyright license agreements, coaching service contracts, marketing service management agreements and material distribution agreements—as unified franchise contracts. The court's reasoning includes several key factors: (1) these contracts work together to carry out the franchise project, (2) when considered as a whole, they include all the essential parts of a franchise contract, and (3) the actual performance of the contracts and the intentions of the parties show the characteristics of a franchise relationship.<sup>419</sup>

#### **4.5 Performance of Obligations in Franchise Agreements**

The key to a franchise contract is the rights and obligations of both parties. According to private law, contractual rights and obligations are mostly created through the agreement made between the parties involved.<sup>420</sup> However, in practice, sometimes the parties leave out important obligations needed to achieve the contract's purpose. Or one party may use their dominant position to avoid fulfilling their obligations, preventing the contract from being successfully carried out by either or both parties.<sup>421</sup>

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<sup>419</sup> Beijing Fengtai District Court. 0106 Civil First Instance Judgment No. 19958,2017.

<sup>420</sup> Ergysa Ikononi, "Franchise Contract and Good Faith," *Mediterranean Journal of Social Sciences* 5, no. 22 (2014): 313-319.

<sup>421</sup> Hanoch Dagan, "The Limited Autonomy of Private Law," *The American Journal of Comparative*

Therefore, the law steps in to limit the freedom of the parties in a contract and sets minimum obligations that must be fulfilled.<sup>422</sup> These legal obligations are also part of the contract, and the parties cannot remove them through mutual agreement.

The rights of a franchisee can differ depending on the terms of the franchise contract. However, regardless of what the parties agree upon, there are certain essential elements that must be included in a valid franchise contract.<sup>423</sup> It is important to note that the rights and obligations of both parties to the franchise relationship are interconnected. The protection of the franchisee's interests largely depends on whether the franchisor fulfills its obligations. To avoid repetition, the following discussion mainly focus on the fundamental contractual duties of both franchisors and franchisees.

#### **4.5.1 The Obligations of the Franchisor**

##### **4.5.1.1 Obligation to Provide Assistance**

Article 14 of *CFAR 2007* requires franchisors to offer ongoing support to franchisees. This includes providing a franchise operation manual, business guidance, technical assistance, training and other agreed services. Respondent 14 stated,

*"Our training programs for franchisees generally include essential topics like business models, product knowledge, marketing strategies, operations, human resources and legal compliance. We also offer pre-opening training for staff and provide ongoing support*

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*Law* 56, no. 3 (2008): 809-834.

<sup>422</sup> Liming Wang, *Contract Law Research* (Vol. I) (China Renmin University Press, September 2015).

<sup>423</sup> Alin Speriusi-Vlad and Claudia Rosu, "Franchise Agreement: Obligations of the Parties," *Romanian Journal of Intellectual Property Law* (2016): 106.

*for store location, design, marketing planning and daily operations.*"<sup>424</sup>

Franchisees benefit greatly from a clear understanding of the support provided by franchisors. Research shows that franchisees are more confident in their decision to invest when they are well-informed about the support mechanisms available from the franchisor.<sup>425</sup> While the regulation mandates the provision of support, it does not specify the exact content or delivery methods, leaving these details to be determined in the franchise contract. In practice, franchisors often fail to provide clear terms regarding quality standards, inspection schedules, and procedures for returns or exchanges in their contracts.

Respondents have pointed out that while franchisors initially provide trademark licenses and other resources, they often fall short in maintaining ongoing support and services. This includes areas like technological assistance, business model guidance and supply chain resources.<sup>426</sup> This lack of ongoing support leaves franchisees feeling unsupported and isolated after committing to the franchise. They stated that franchise contracts should specify product quality standards, brand names, supply discounts, quantities, supply cycles, payment methods and sales rebates. One of respondents find

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<sup>424</sup> R 14 (Franchisor), Membership in CCFA, Online, February 16, 2024.

<sup>425</sup> Marie Doherty, Anne, Xiaomin Chen, and Nicholas Alexander, "The Franchise Relationship in China: Agency and Institutional Theory Perspectives," *European Journal of Marketing* 48, no. 9/10 (2014): 1664-1689.

<sup>426</sup> R 12 (Franchisee), physical at the office, March 23, 2024; R 7 (Franchisee), physical at the office, March 30, 2024.

that after signing the contract, the quality of goods or services was inferior to what had been promised during the pre-contract phase.<sup>427</sup>

Another significant problem in franchising is that some franchisors fail to provide essential business manuals and necessary training. This lack of support harms franchisees' operations and breaches the franchisor's contractual obligations. In the case of *Wutong Media Co., Ltd. v. Maya Housing Agency Co., Ltd.*, the court concluded that although the franchisee had fulfilled its payment obligations, the franchisor failed to provide key support, including the operational manual, business training and management guidance. This lack of essential follow-up services prevented the franchisee from utilizing the established business resources to engage in franchising activities effectively. Consequently, the court held the franchisor liable for breach of contract, emphasizing the legal obligation to provide continuous support under the franchise agreement.<sup>428</sup>

#### **4.5.1.2 Obligation to Disclosure**

Article 23 of the *CFAR 2007* requires franchisors to provide franchisees with truthful, accurate and complete information, allowing franchisees to evaluate the risks of franchising. Legislation across various jurisdictions commonly includes provisions to enforce franchisors' obligations to disclose information, aiming to balance the franchise relationship and mitigate potential misconduct. Respondent 13 emphasized

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<sup>427</sup> R 12 (Franchisee), physical at the office, March 23, 2024.

<sup>428</sup> Baoji Intermediate People's Court. Civil Final Judgment No.140, 2016.

the legal obligation of franchisors to comply with regulatory disclosure requirements, noting,

*"Information disclosure is a mandatory obligation. Even if the franchisor and franchisee do not agree on disclosure in the franchise contract, the franchisor cannot escape mandatory disclosure requirements from the regulatory authorities. Otherwise, he must accept an administrative fine or a claim lawsuit from the franchisee."*<sup>429</sup>

He added that,

*"Adherence to mandatory disclosure obligations is essential for transparency. However, ensuring the protection of the franchisor's confidential business information remains a significant challenge within this framework."*<sup>430</sup>

To protect the franchisor's trade secrets, some important information that could affect decision-making in franchise agreements is not required to be disclosed by law. Instead, this sensitive information is usually shared through separate disclosure methods before the contract is finalized. A respondent from the CCFA mentioned that sharing business plans or trade secrets could harm the franchisor's operations. However, he also acknowledged that withholding such information could negatively impact the legitimate rights of franchisees. Therefore, it is crucial to create a confidentiality clause

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<sup>429</sup> R 13 (Franchisor), physical at the office, February 12, 2024.

<sup>430</sup> R 13 (Franchisor), physical at the office, February 12, 2024.

that properly protects both the franchisor's sensitive information and the franchisee's rights.<sup>431</sup>

Following the execution of the franchise contract, franchisors are obligated to promptly communicate any significant changes to relevant franchise resources. Respondents noted that during the contract period, they were required to provide regular reports, including sales performance and customer feedback.<sup>432</sup> While the franchisor controls the franchise relationship, franchisees only have the right to use the intellectual property without being able to modify or improve it. However, the franchisor can update operational technology based on the information provided by franchisees. Respondents expressed a desire for more updated information from the franchisor to help improve the franchise's overall performance.<sup>433</sup> Since a franchisor's competitive advantage often relies on its established reputation, it is essential to promptly inform franchisees of significant operational changes to maintain the franchise relationship.

#### **4.5.2 The Obligations of the Franchisee**

In contrast to the franchisors, franchisees often face detailed and demanding obligations. These include the payment of fees, adherence to supervision, and maintenance of trade secrets.

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<sup>431</sup> R 14 (Franchisor), Membership in CCFA, Online, February 16, 2024.

<sup>432</sup> R 12 (Franchisee), physical at the office, March 23, 2024; R 11 (Franchisee), physical at the office, March 23, 2024; R 7 (Franchisee), physical at the office, March 30, 2024.

<sup>433</sup> R 12 (Franchisee), physical at the office, March 23, 2024; R 11 (Franchisee), physical at the office, March 23, 2024; R 7 (Franchisee), physical at the office, March 30, 2024.

#### 4.5.2.1 Obligation to Pay Franchise Fee

The franchise fee is a vital component of the franchise model, facilitating access to the franchisor's proprietary resources while supporting the franchisor's brand development and revenue generation. Typically, the fee is paid upfront by the franchisee upon the execution of the franchise agreement, compensating the franchisor for access to its intellectual property, trademarks and operational systems.

However, there are several shortcomings. First, the contract does not break down the different parts of the franchise fee, like setup costs, royalties, advertising fees, security deposits and training fees. This can create confusion about financial responsibilities and make it harder to recover fees if the contract ends. Additionally, the lack of clear rules about payment schedules, refund conditions, and how to return fees increases the risk of financial disputes between the franchisor and franchisee.

The advertising and promotion terms in franchise contract often state that the franchisor is responsible for promoting the franchise system's brands, trademarks and products through various advertising activities, while the franchisee is obligated to pay the advertising fee.<sup>434</sup> However, important details about the use and management of advertising funds are missing. While advertising fees are meant to support promotions across the franchise system, there is no requirement to create a separate advertising

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<sup>434</sup> Shanghai Administration for Industry and Commerce. *Shanghai Commercial Franchise Contract Model Text* (2013 Edition).

fund or to keep track of these fees separately. The contract also usually does not state that the franchisor must notify the franchisee about how the advertising money is being spent or allow the franchisee to audit the fund. These gaps could lead to a lack of transparency and potential disagreements about how the advertising money is used.

#### **4.5.2.2 Obligation to Maintain Uniformity**

A key feature of franchising is the use of a standardized business model. Franchisees must follow the franchisor's rules to maintain a consistent look and quality across all locations. As part of this, franchisors have the right to supervise and control the franchisee's operations. This often includes using specific supply sources, sticking to pricing policies and undergoing regular checks. For less experienced franchisees, this level of supervision helps them adjust quickly to the proven business model, allowing them to benefit from a system that has already been successful.

However, this control can sometimes go too far, negatively impacting the franchisee's interests. A common concern arises when franchisors require franchisees to purchase goods or raw materials exclusively from specified suppliers. While this practice is intended to ensure product quality and consistency, it often results in franchisees paying higher prices compared to similar products available on the open market, thereby affecting their profitability.<sup>435</sup> Thus, while franchisor's oversight is necessary to maintain brand consistency, it is critical that the supervision is both reasonable and

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<sup>435</sup> Thomas Mellewigt, Thomas Ehrmann, and Carolin Decker, "How Does the Franchisor's Choice of Different Control Mechanisms Affect Franchisees' and Employee-Managers' Satisfaction?" *Journal of Retailing* 87, no. 3 (2011): 320-331.

proportionate. Excessive or overly intrusive control can disrupt the franchisee's normal business operations and may negatively affect the overall franchise relationship.

#### **4.5.2.3 Confidentiality Obligation**

Article 18(2) stipulates that franchisees are prohibited from sharing or permitting the use of the franchisor's business secrets. To protect these trade secrets, a confidentiality clause is generally included in franchise agreements. This clause ensures that the franchisee safeguards confidential information, such as trade secrets, technical specifications, business models, pricing structures, investment strategies, procurement methods, and customer lists, which are critical to the franchisor's competitive advantage. The franchisee is responsible for maintaining the confidentiality of this information during the franchise term and is liable for any breach. Additionally, upon contract termination, the franchisee must discontinue the use of any proprietary technology or information, ensuring the continued protection of the franchisor's intellectual property after the conclusion of the business relationship.<sup>436</sup>

#### **4.6 Granting of Franchise Rights**

The grant terms in a franchise contract outline the scope and geographical limitations of the rights bestowed by the franchisor. These terms are fundamental to franchising, as they establish the conditions under which franchisees are permitted to operate.

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<sup>436</sup> Article 558 of the *Civil Code*: After the termination of claims and debts, the parties shall abide by the principles of good faith and perform obligations such as notification, assistance, confidentiality, and recycling of old materials in accordance with trading practices.

Franchisees can commence business operations only after being granted the specific business resources and territorial rights by the franchisor.

#### **4.6.1 Defects in Granted Resources**

The grant allows franchisees to use the franchisor's business resources, including registered trademarks, corporate logos, patents, and proprietary knowledge, all within a standardized business model. The granted rights encompass a comprehensive license to a suite of business resources with intellectual property attributes. The effectiveness of these grant terms is crucial, as they reflect the maturity of the franchisor's business model and their ability to provide ongoing support and services.<sup>437</sup> In China, trademark rights are primarily acquired through a formal registration process, adhering to the "first-to-file" principle. A registered trademark confers an exclusive right, which can be granted to franchisees through a franchise contract.

However, the *CFAR 2007* does not explicitly address the use of unregistered trademarks as franchise resources, leading to concerns that allowing unregistered trademarks into the franchise market could increase the risk of commercial fraud. Unlike trademark rights, patent rights are not renewable once they expire, at which point they enter the public domain and can be used freely by anyone.

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<sup>437</sup> Steven C. Michael, "Entrepreneurial Signaling to Attract Resources: The Case of Franchising," *Managerial and Decision Economics* 30, no. 6 (2009): 405-422.

In franchising, the patent granted by the franchisor to the franchisee must remain exclusive throughout its validity period. According to the MOC, many franchise contracts primarily focus on granting franchise resources, particularly registered trademarks. However, these contracts often omit crucial details, such as the registration number of the trademark, and the franchisor may fail to guarantee the trademark's validity or ownership.

In practice, the trademarks or patents granted by the franchisor are unregistered, insufficiently authorized, or involved in legal disputes, leading to compromised franchisee rights to use these resources. Respondent emphasized the common shortcomings in franchisors' business resources, noting that,

*"These defects typically include: (1) The franchisor's intellectual property rights, such as registered trademarks and patents, being deemed invalid or revoked; (2) Disputes arising over the franchisor's registered trademarks, patents, and other intellectual property rights; (3) The franchisor's intellectual property rights being suspected of infringement or plagiarism; and (4) The franchisor's proprietary technology having significant flaws, rendering it inadequate to support operations."<sup>438</sup>*

Although *CFAR 2007* does not specifically address this situation, Article 563(4) of the *Civil Code* provides that if a party's breach of contract makes it impossible to achieve the purpose of the contract, the non-breaching party may terminate the contract.

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<sup>438</sup> R 20 (Regulator), physical at the office, April 5, 2024.

Therefore, if the franchisor's defects in operating resources are severe enough to prevent the franchisee from fulfilling the purpose of the contract, the franchisee is entitled to terminate the franchise agreement. The franchisee may also demand a refund of the franchise fee and seek compensation from the franchisor for breach of contract.

#### **4.6.2 Encroachment on Granted Territorial Rights**

The granted territory usually refers to the geographical scope in which the franchisee has the right to use the franchise rights.<sup>439</sup> It is usually used to limit the geographical scope and the number of franchisees. Franchising includes various models, such as individual franchises, area development franchises and master franchises.

An individual franchise grants the franchisee the right to operate a single unit without the ability to transfer or sublicense it. An area development franchise allows the franchisee exclusive rights to open multiple units within a specified region, often covering larger areas like counties or provinces. A master franchise gives the master franchisee exclusive rights to develop and operate franchises in a broader territory, which can include international expansion. This model also allows the master franchisee to authorize and manage sub-franchisees within that area. Each type of franchise ensures territorial exclusivity, protecting franchisees from competition

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<sup>439</sup> Robert W. Emerson, "Franchise Territories: A Community Standard," *Wake Forest Law Review* 45 (2010): 779.

within their designated area and preventing excessive franchise development by the franchisor that could lead to internal competition and harm the franchisees' interests.

Geographical protection in franchising can be implemented through methods such as center-plus-radius approaches, administrative region divisions, territorial markings on maps, regional development rights buyouts, or specifying designated stores.<sup>440</sup> An exclusive franchise grant ensures that the franchisee has sole rights to use the franchise resources within a designated area. This exclusivity is important to prevent excessive competition within the same region, which could harm the franchisee's business.

The encroachment of franchisors on the business activities of franchisees has become a significant problem. In the case of *Kang Meijuan v. Guangzhou Ganglong Catering Management Co., Ltd.*, the contract required the plaintiff to open a branch of the "Mingji Dessert" brand in Fuzhou, Fujian Province, and the defendant promised not to authorize additional franchised stores within the plaintiff's designated area. Despite this agreement, the defendant violated the contract by permitting a third party to open a competing branch in the same territory. The court ruled to terminate the contract under Article 563 of the *Civil Code*, ordered the return of the franchise fee of 280,000 yuan, and awarded compensation of 50,000 yuan for losses incurred.<sup>441</sup>

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<sup>440</sup> Etienne Pfister, Bruno Deffains, Myriam Doriat-Duban, and Stéphane Saussier, "Institutions and Contracts: Franchising," *European Journal of Law and Economics* 21 (2006): 54, <https://doi.org/10.1007/s10657-006-5671-4>.

<sup>441</sup> Guangzhou Tianhe District People's Court. First Instance Civil Judgment No.960, 2015.

The court typically protects a franchisee's exclusive territorial rights based on what is agreed upon in the franchise contract. If the contract does not clearly state these rights, determining the franchisee's exclusive region becomes challenging. Chinese franchise specific regulations currently do not provide clear rules on this matter, which leaves it to the courts to interpret or decide on a case-by-case basis.

In the case of *Li Yuanyan v. Yijiale Real Estate Brokerage Consulting Co., Ltd.*, Yijiale, as the franchisor, encroached on the franchisee's business territory by operating a self-managed branch within the franchisee's designated area. Specifically, Yijiale established a direct branch only about 200 meters away from the franchisee's location, within the same community. The court found that even though the franchise agreement did not specify the scope of the franchise grant, the franchisor's operation of its own business within the franchisee's area encroached on the franchisee's business space. This conduct was considered a breach of the principle of good faith in contractual relationships. Consequently, the court ordered Yijiale to cease its operations in the area.<sup>442</sup>

These cases illustrate that geographical protection for franchisees are largely dependent on contractual agreements rather than strict legal enforcement. Unfortunately, contracts often lack clarity, with franchisors using their dominant position to impose vague terms. To protect their interests, franchisees must ensure that

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<sup>442</sup> Beijing Supreme People's Court. *50 Typical Intellectual Property Cases of Chinese Courts in 2012*. Jinan Intermediate People's Court. Civil Final Judgment No.233, 2011.

their contracts explicitly prohibit the franchisor from opening additional franchise or direct stores using the same brand, offering similar products, and competing in the same area. Without clear geographical protection clauses, franchisees may find themselves at a disadvantage in disputes over contract breaches and unable to secure adequate protection.

## **4.7 Renewal, Transfer and Termination of Contracts**

### **4.7.1 Renewal**

Under *CFAR 2007*, Article 13 establishes a minimum franchise term of three years. However, exceptions allow for shorter terms if agreed upon by the franchisee. Franchisors often prefer shorter terms to capitalize on opportunities for transferring or renewing franchises, potentially securing additional fees. In contrast, franchisees generally favor longer terms, which provide more time to recoup their substantial initial investments. A typical franchise cycle comprises two phases: the investment recovery period and the profit period. Given the significant upfront costs—including franchise fees, deposits, and other expenses—short contract terms may impede investment recovery and compromise the overall efficacy of the franchise model.<sup>443</sup>

Respondents highlight that franchisees often find themselves at a disadvantage during contract negotiations, primarily due to the pressure to secure immediate financial returns. Despite acknowledging the advantages of longer contract terms, franchisees

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<sup>443</sup> William L. Killion, "The Modern Myth of the Vulnerable Franchisee: The Case for a More Balanced View of the Franchisor-Franchisee Relationship," *Franchise Law Journal* 28 (2008): 23.

frequently lack the bargaining power needed to negotiate better terms. As observed by Respondent 10:

*"The franchise contract we entered into was a pre-drafted standard form provided by the franchisor. It is heavily biased toward the franchisor's interests, with minimal opportunity for negotiation, resulting in inadequate protection for our interest."<sup>444</sup>*

In franchise agreements, there is often no explicit provision ensuring the franchisee's right to renew the contract upon its expiration. Franchisors refuse to renew the contract upon expiration without valid justification, denying franchisees the opportunity to continue their business. Given the substantial initial investment made by franchisees—covering costs such as premises lease, equipment, and other setup expenses—short-term contracts can leave franchisees at a disadvantage. If the duration of the franchise contract is too brief for the franchisee to recover their investment, they may face significant financial losses. To safeguard the franchisee's interests and provide a fair opportunity to recoup their investment, it is crucial to incorporate a right to renewal in the franchise contract.

To protect the franchise brand's reputation and value, franchisors often include conditional renewal clauses to exclude underperforming franchisees. While government guidelines recommend clear negotiations regarding renewal terms, many

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<sup>444</sup> R 10 (Franchisee), physical at the office, March 15, 2024.

franchise contracts fail to specify these conditions explicitly, leading to disputes between the parties.

For instance, in 2020, Huanya Company granted an exclusive franchise for its toy mall for three years, including trademark use and a fee waiver for renewal. However, when the franchisee did not renew the contract upon expiration and later found other stores selling Huanya products within their territory, they sued for infringement. The court ruled that the franchise rights had expired due to the lack of a formal renewal, and thus dismissed the franchisee's claim.<sup>445</sup>

#### 4.7.2 Transfer

Article 18 of the *CFAR 2007* stipulates that franchisees cannot transfer the franchise without the franchisor's consent. The franchisor typically retains the final decision on franchise transfers to protect its intellectual property rights and ensure the consistency of the franchise system. This can create tension between the franchisor's control over the transfer process and the franchisee's desire for flexibility. Franchisors often impose stringent procedures and standards for transfers, or may even prohibit them altogether, while franchisees seek greater freedom to transfer the franchise to minimize losses and facilitate a smooth exit.

Typically, franchise contracts impose strict restrictions on franchisee transfer, often including liquidated damages for unauthorized transfers. In *Yang Guo v. Zhejiang King*

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<sup>445</sup> Beijing Haidian District People's Court (2021). Beijing 0108 Civil Case No. 34202.

of *Beasts Shoes Co., LTD.*, the franchisee transferred the franchise to a third party without the consent of the franchisor. The Supreme People's Court holds that the franchisee has violated the contract and is liable for breach of contract.<sup>446</sup>

In another case of *Yuan Yubo v. Li Guihua Lai Changxiang*, the franchisee failed to obtain the franchisor's consent prior to transferring the franchise. As a result, the franchisor issued a Notice of Breach of Contract, terminating the agreement and reclaiming the franchise rights. Although the transferee had operated the business for a period and had paid franchise fees in advance—payments acknowledged by the franchisor—the court held that the franchise relationship remained exclusively between the franchisor and the original franchisee until formal consent was provided. Given that the franchisor had already withdrawn the franchise rights, the purpose of the contract between the original franchisee and transferee could not be fulfilled, leading the court to terminate the agreement.<sup>447</sup>

Based on the above discussed, it is evident that in China, a franchise transfer made without the franchisor's consent is generally deemed invalid. This allows the franchisor to reclaim the franchise rights and hold the franchisee liable for breach of contract. However, the issue of whether the franchisor's right to refuse consent is arbitrary and unlimited remains unaddressed in current legislation. If the franchisor holds an absolute right to deny consent, even in cases where the franchisee's transfer is

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<sup>446</sup> Beijing Supreme People's Court. Civil Ruling No.4194, 2019.

<sup>447</sup> Chongqing Higher People's Court. Civil Ruling No.2233, 2017.

necessary and reasonable, the franchisee may be left unable to transfer the franchise, severely compromising their interests.

Respondents have expressed that franchisees should have the right to transfer their franchise within reasonable limits. They argue that it is unfair to leave the final decision on franchise transfers entirely to the franchisor. They note that in countries like the USA and Australia, franchisors must provide good cause for refusing a transfer, and they suggest that China could benefit from adopting similar regulations.<sup>448</sup>

#### 4.7.3 Termination

Article 562 of the *Civil Code* permits parties to stipulate specific grounds for unilateral contract termination, allowing either party to end the contract under specified conditions. In franchising, however, most contracts are standard templates drafted by the franchisor, often favor the franchisor's interests. Franchise contracts typically grant the franchisor extensive unilateral termination rights, placing franchisees at a disadvantage.<sup>449</sup>

Respondents noted that franchise contracts frequently include clauses allowing for contract termination at will, placing franchisees under persistent risk of being forced out of the franchise system.<sup>450</sup> While *CFAR 2007* grants franchisees the right to

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<sup>448</sup> R 12 (Franchisee), physical at the office, March 23, 2024; R 18 (Lawyer), physical at the office, May 15, 2023; R 7 (Franchisee), physical at the office, March 30, 2024.

<sup>449</sup> Birkeland, Peter M. *Franchising dreams: The lure of entrepreneurship in America*. University of Chicago Press, 2004.

<sup>450</sup> R 18 (Lawyer), physical at the office, May 15, 2023; R 20 (Regulator), physical at the office, April 5, 2024.

unilaterally terminate the contract during a cooling-off period, the duration of this period remains ambiguous. One respondent stated that,

*"Franchisor is typically the dominant party in franchise relationships, and franchise contracts are often standard form contracts, heavily favoring the franchisor. Expecting franchisors to voluntarily include clauses that restrict their own rights in these contracts is hard."<sup>451</sup>*

The franchisee's substantial sunk costs create a dependency on the franchisor, making arbitrary termination particularly damaging. To prevent franchisors from abusing their termination rights, federal and state legislatures in the USA have implemented numerous regulations governing franchise termination. These laws generally require that the termination of a franchise agreement must be for a good cause, particularly in the absence of specific contractual provisions detailing the grounds for termination. Respondents also recommended that, instead of immediately terminating the contract for a breach, the franchisor should issue a written notice to the franchisee, providing an opportunity to remedy the breach.<sup>452</sup>

#### **4.8 Restrictive Covenants**

In the context of competition law, a restriction on competition occurs when two or more parties collaborate to limit market competition, typically through agreements or

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<sup>451</sup> R 18 (Lawyer), physical at the office, May 15, 2023.

<sup>452</sup> R 18 (Lawyer), physical at the office, May 15, 2023; R 20 (Regulator), physical at the office, April 5, 2024.

other coordinated actions.<sup>453</sup> Franchising, as a business model centered around intellectual property, inherently involves competitive restrictions due to the exclusive nature of intellectual property rights. The franchise agreement often imposes competition-related restrictions on the franchisee, making it subject to antitrust scrutiny.<sup>454</sup>

Moreover, franchisors typically hold a dominant position in franchise relationships, which can lead to the imposition of stringent and unfair conditions on franchisees in order to safeguard their own interests. For instance, franchisors may include restrictive clauses in franchise contracts, such as resale price maintenance and tying arrangements. These clauses are common examples of anticompetitive restrictions.<sup>455</sup>

#### **4.8.1 Maintaining Resale Prices**

Maintaining resale prices, or resale price maintenance (hereinafter referred to as "RPM"), in franchising refers to the franchisor's control over the pricing at which franchisees sell products or services.<sup>456</sup> This control can manifest in several ways, such as setting a maximum resale price limit, a minimum resale price limit, or imposing a fixed resale price. This means franchisees have little to no discretion in pricing, as the

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<sup>453</sup> Valentine Korah, *Competition Law of Britain and the Common Market* (Martinus Nijhoff Publishers, 2024).

<sup>454</sup> Alan B. Krueger and Orley Ashenfelter, "Theory and Evidence on Employer Collusion in the Franchise Sector," *Journal of Human Resources* 57, no. S (2022): S324-S348.

<sup>455</sup> Jingyuan Ma, "Vertical Restrictions," in *Competition Law in China: A Law and Economics Perspective* (2020): 81-93.

<sup>456</sup> Markus Dertwinkel-Kalt and Christian Wey, "Resale Price Maintenance in a Successive Monopoly Model," *The Journal of Industrial Economics* 72, no. 2 (2024): 729-761.

franchisor dictates the price points. While this can ensure uniform pricing and protect brand value, it can also limit franchisees' pricing flexibility and affect their profitability.

In franchising, when a franchisor enforces a recommended price as mandatory for all franchisees, it constitutes RPM. While RPM ensures consistent pricing and avoids destructive price competition among franchise locations, it can significantly restrict franchisees' operational autonomy.<sup>457</sup> Given the varying local conditions such as customer flow and market demand, a fixed price may not be optimal for every franchise. This rigidity can hinder franchisees' ability to adapt pricing strategies to their specific market conditions. Additionally, by setting fixed prices, RPM undermines the competitive principle of market-driven pricing, which typically encourages businesses to innovate and adjust to survive in the marketplace.

#### **4.8.2 Tie-in**

Franchise enterprises frequently utilize a standardized operational model, including centralized procurement and distribution of raw materials or products. This standardization helps maintain a consistent market image and ensures the quality of products or services across all franchise locations. As part of this model, franchise agreements often mandate that franchisees purchase goods or raw materials exclusively from the franchisor or approved suppliers. For instance, franchisors might require franchisees to buy machinery and equipment essential for production,

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<sup>457</sup> Kong Xiangjun, *Principles of Anti-monopoly Law* (Beijing: China Legal Publishing House, 2001).

particularly if these items incorporate proprietary intellectual property crucial for the franchise's success.

Franchising often involves tying arrangements, where the franchisor not only licenses intellectual property but also mandates the use of additional services or products. This may include stipulations on sales plans, store locations, promotions, operation manuals, and supply chain requirements. Tying occurs when a dominant market player forces buyers to accept additional, unrelated goods or services.<sup>458</sup> According to Article 17 of the *Anti-Monopoly Law*, business operators with a dominant market position are prohibited from engaging in tying practices or imposing unreasonable trading conditions without justifiable reasons.

Despite this, franchisors sometimes exploit their control by requiring franchisees to purchase non-essential products or bundle other goods.<sup>459</sup> Respondents noted that franchisors often sell lower-quality products or services to franchisees at inflated prices, limiting franchisees' ability to choose higher-quality or more cost-effective options.<sup>460</sup> This restriction can lead to missed profit opportunities for franchisees and diminish their commercial competitiveness.

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<sup>458</sup> Daniel A. Hanley, "Per Se Illegality of Exclusive Deals and Tyings as Fair Competition," *Berkeley Technology Law Journal* 37 (2022): 1057.

<sup>459</sup> Brian Callaci, "Control without Responsibility: The Legal Creation of Franchising, 1960–1980," *Enterprise & Society* 22, no. 1 (2021): 156-182.

<sup>460</sup> R 12 (Franchisee), physical at the office, March 23, 2024; R 7 (Franchisee), physical at the office, March 30, 2024.

### 4.8.3 Non-competition

Non-competition clauses in franchise agreements are designed to protect the franchisor's intellectual property and market position by restricting franchisees from engaging in similar business activities during and after the term of the franchise agreement. While these clauses are intended to mitigate competitive threats and prevent the franchisor from facing new competitors, they can sometimes be overly restrictive. According to feedback from respondents, franchisors may abuse their position by imposing excessively broad non-compete terms that extend beyond reasonable durations, geographic areas, and industry sectors.<sup>461</sup> This overreach can infringe upon franchisees' rights to engage in competitive activities and limit their opportunities in new markets.

Article 23 of *Labor Contract Law* permits the inclusion of non-competition clauses for employees who are subject to confidentiality obligations. In the context of franchising, non-compete agreements may be applied due to similarities between the franchise relationship and employment. However, unlike employees, franchisees typically do not receive compensation for complying with non-compete clauses. Given that franchisees invest significant resources and develop expertise within the franchising system, it is crucial that non-compete clauses are applied within a reasonable scope and duration, ensuring fairness and balance between the interests of both parties.

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<sup>461</sup> R 12 (Franchisee), physical at the office, March 23, 2024; R 7 (Franchisee), physical at the office, March 30, 2024.

## 4.9 Implementation of Dispute Resolution Mechanisms

In China, litigation is the most common method for parties to resolve franchise disputes. Beyond traditional litigation, ADR mechanisms such as negotiation, mediation and arbitration are increasingly utilized to address these disputes.<sup>462</sup> Franchise contracts create a shared interest between parties, where one party's misconduct can harm the other. Maintaining trust and self-restraint is key to sustaining long-term cooperation. While litigation is an option for resolving disputes, its adversarial nature often ends the relationship, making it less ideal for preserving ongoing partnerships and franchise system stability. A diversified dispute resolution mechanism is advocated by Chinese government to address franchising disputes, resolving conflicts while preserving the franchise system's integrity.<sup>463</sup>

### 4.9.1 ADR Mechanisms

Franchise disputes often stem from poor communication, with franchisors focusing on expansion and franchisees on operations. However, the shared interests of both parties form the foundation of their collaboration. To address disputes effectively and support long-term cooperation, it is crucial to establish detailed communication mechanisms during contract formation. Negotiation, as a flexible and collaborative approach, offers an effective pathway to resolving disputes by fostering mutual understanding and preserving the relationship.<sup>464</sup>

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<sup>462</sup> Jeff Jianfeng Wang, et al., "Conflict Aftermath: Dispute Resolution and Financial Performance in Franchising," *Journal of Retailing* 96, no. 4 (2020): 548, <https://doi.org/10.1016/j.jretai.2020.03.001>.

<sup>463</sup> Yuwen Li and Cheng Bian, "China's Stance on Investor-State Dispute Settlement: Evolution, Challenges, and Reform Options," *Netherlands International Law Review* 67 (2020): 503-551, <https://doi.org/10.1007/s40802-020-00182-3>.

<sup>464</sup> Bhupinder Singh, "Unleashing Alternative Dispute Resolution (ADR) in Resolving Complex

Negotiation lacks a fixed definition, but its essence lies in the disputing parties engaging directly with each other to resolve their conflict. With negotiation skills, both sides seek to influence one another to reach a mutually agreeable outcome. Unlike other dispute resolution methods, negotiation involves no intervention by a neutral third party; instead, the parties themselves take responsibility for resolving the dispute. The primary advantage of negotiation is its low economic cost.<sup>465</sup>

First, it eliminates the need to pay fees to third-party facilitators. Second, negotiation is free from the constraints of complex legal procedures, saving both time and financial resources. Third, it can be conducted flexibly without the need for specific venues, thereby avoiding transportation costs and other ancillary expenses. However, the lack of procedural standards in negotiation may pose challenges, particularly when power imbalances or unclear agreements arise.

Some scholars view mediation as an extension of negotiation, with the key distinction being the involvement of a neutral third party.<sup>466</sup> The mediator serves as a trusted intermediary between the disputing parties, ensuring impartiality and guiding the process without taking sides. Mediation has become the preferred way to resolve

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Legal-Technical Issues Arising in Cyberspace Lensing E-Commerce and Intellectual Property: Proliferation of E-Commerce Digital Economy," *Revista Brasileira de Alternative Dispute Resolution-Brazilian Journal of Alternative Dispute Resolution-RBADR* 5, no. 10 (2023): 81-105.

<sup>465</sup> Carrie J. Menkel-Meadow, Andrea Kupfer Schneider, and Lela Porter Love, *Negotiation: Processes for Problem Solving* (Aspen Publishing, 2020).

<sup>466</sup> Constantin Ruhe, "Impeding Fatal Violence Through Third-Party Diplomacy: The Effect of Mediation on Conflict Intensity," *Journal of Peace Research* 58, no. 4 (2021): 687-701, <https://doi.org/10.1177/0022343320930072>.

franchise disputes. Mediation is voluntary and enables both parties to communicate and reach an agreement, avoiding complex litigation procedures and saving time and costs. Its flexibility and ease of acceptance make it particularly suitable for international franchises, alleviating the trust issues that come with different legal systems.

In addition, mediation focuses on maintaining long-term cooperation and friendly relationships, helping to protect the overall reputation of the franchise system while efficiently resolving disputes.<sup>467</sup> However, a notable limitation in China is the absence of a mandatory mediation mechanism, which could enhance the accessibility and effectiveness of mediation as a dispute resolution tool.

Arbitration represents a delegation of state judicial authority to non-governmental entities, functioning as a form of "quasi-judicial" activity.<sup>468</sup> It is a dispute resolution method voluntarily chosen by both parties through mutual agreement. Compared to litigation, arbitration lacks procedural rigor and relies heavily on the parties' agreement.<sup>469</sup> Its confidentiality, characterized by closed hearings and restricted access to case documents, inherently reduces external oversight. While this ensures the privacy of the parties involved, it simultaneously limits the transparency necessary for thorough evaluation and accountability in the arbitration process. In addition,

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<sup>467</sup> Dewi Puspaningtyas Faeni, "Green Practices and Employees' Performance: The Mediating Roles of Green Human Resources Management Policies and Knowledge Development," *Journal of Infrastructure, Policy and Development* 8, no. 8 (2024): 4924.

<sup>468</sup> Stephen B. Goldberg, Frank E. A. Sander, Nancy H. Rogers, et al., *Dispute Resolution: Negotiation, Mediation, and Other Processes* (Aspen Publishers, 2002).

<sup>469</sup> Sarah Rudolph Cole, "The Lost Promise of Arbitration," *SMU Law Review* 70 (2017): 849.

arbitration institutions cannot enforce awards independently, requiring court intervention.<sup>470</sup> In contrast, litigation ensures transparency, with public trials and published judgments as mandated by *Civil Procedure Law*.

#### 4.9.2 Traditional Litigation

Although litigation remains the most selected method for dispute resolution, it presents significant drawbacks in the context of franchise disputes, particularly regarding efficiency and cost.<sup>471</sup> Its initiation depends on one party, leading to uncertainty, and the three-year statute of limitations under Article 188 of the *Civil Code* can prolong instability. Appeals and potential retrials further extend the process, often taking at least nine months. Economically, litigation requires separate fees for each trial stage, along with higher attorney fees due to its complexity and duration.

In contrast, arbitration, being final in one instance, is faster and more cost-effective, making litigation the most resource-intensive dispute resolution method. Respondents have consistently noted that litigation is often protracted and inefficient, with cases requiring substantial time to reach resolution.<sup>472</sup>

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<sup>470</sup> Mitch Zamoff, "Safeguarding Confidential Arbitration Awards in Uncontested Confirmation Actions," *American Business Law Journal* 59, no. 3 (2022): 508.

<sup>471</sup> Robert W. Emerson and Zachary Hunt, "Franchisees, Consumers, and Employees: Choice and Arbitration," *William & Mary Business Law Review* 13 (2022): 487, <http://dx.doi.org/10.2139/ssrn.4099957>.

<sup>472</sup> R 18 (Lawyer), physical at the office, May 15, 2023; R 10 (Franchisee), physical at the office, March 15, 2024; R 12 (Franchisee), physical at the office, March 9, 2024.

The dispute resolution clause in many franchise contracts typically requires that either party shall file a lawsuit in the place where franchisor is located. Such clauses are common in standardized contracts, often drafted unilaterally by franchisors. The designation of the franchisor's location as the exclusive jurisdiction for legal proceedings creates a significant power imbalance. While this arrangement offers procedural convenience for the franchisor, it imposes substantial burdens on franchisees, both in terms of cost and logistics. By forcing franchisees to file lawsuits in the franchisor's location, which is often far from where the franchisee operates, this practice makes it harder for franchisees to take legal action. This creates an unfair disadvantage for franchisees, potentially making it difficult for them to get justice and protect their contractual rights.

#### **4.10 Summary**

This chapter examines how franchisee protection mechanisms are implemented in China's contractual practices. It begins by examining the theoretical and practical advantages of franchising for franchisees, including access to established business models, reduced operational risks, cost efficiency and broader market opportunities. However, these benefits are often tempered by the inherent risks faced by franchisees, particularly the imbalance of power between franchisors and franchisees, which is exacerbated by standard-form contracts that limit the autonomy of franchisees and create challenges in obtaining accurate and reliable information.

The chapter further explores the actual enforcement of franchise contracts, highlighting key issues in the current regulatory environment. One significant concern is the misuse of franchise contracts by franchisors to evade oversight, often misclassifying agreements to avoid franchise-specific supervision. This not only complicates the identification of franchise contracts in legal practice but also leaves franchisees vulnerable to exploitation. In addition, an examination of actual franchise contracts shows that franchisees are typically subject to more extensive obligations than franchisors, whose duties are often limited to basic legal requirements such as disclosure and limited support. These legal obligations are not clearly defined or consistently reflected in contractual terms, which may impact the protection of franchisee rights.

The analysis also identifies issues with the granting of franchise rights, particularly regarding the inadequacy of intellectual property provisions and territorial rights, which are often flawed or encroached upon by franchisors. The chapter addresses the restrictive practices surrounding the renewal, transfer, termination and competition of franchise agreements, revealing that franchisors frequently impose arbitrary conditions on franchisees, preventing them from renewing or transferring their rights without valid justification, or prematurely terminating contracts.

In addition, the complex competition issues in franchising, such as fixed pricing requirements, tying arrangements and non-compete clauses, reflect the significant restrictions imposed by franchisors on franchisees, often reinforcing the franchisor's

monopolistic control. Finally, the chapter assesses the effectiveness of dispute resolution mechanisms, concluding that ADR, such as mediation and arbitration, offers significant advantages over litigation. ADR not only reduces costs and time but also helps preserve and repair the franchise relationship, enabling it to continue, whereas litigation typically exacerbates conflict and leads to termination of the franchise agreement.

In summary, Chapter four highlights an examination of the current practices of franchisee protection under contractual mechanisms through an analysis of actual contract clauses. It complements Chapter three, which focused on franchisee protection under the legal and regulatory framework. Together, these two chapters contribute to achieving the second research objective—analysing the current protection of franchisees in China. Building on the identified limitations in China's current protection of franchisees, the following chapter examines well-established practices in other jurisdictions, offering insights from which China may draw valuable lessons to improve franchisee protection.

## CHAPTER FIVE

### FRANCHISEE PROTECTION IN THE USA, AUSTRALIA AND MALAYSIA

#### 5.1 Introduction

This chapter employs critical analysis to address the third research objective, examining franchisee protection practices in the USA, Australia and Malaysia to offer valuable insights for China. These countries were chosen for their strong franchising systems: the USA and Australia have well-established legal frameworks, while Malaysia offers a model for emerging economies like China.

Table 5.1  
*Overview of the franchise industry in selected jurisdictions*

	<b>Countries</b>			
	China	USA	Australia	Malaysia
Number	9,549 (Registered franchise)	792,000 (Franchise units)	96,598 (Franchise units)	1,110 (Registered franchise)
Economic Output	No statistics	USD 827 billion	USD 170 billion	USD 7.7 billion
Contribution to GDP	No statistics	3%	10%	2%
Regulatory Framework	<i>CFAR 2007, Civil Code</i>	<i>FTC Franchise Rule, State franchise rule</i>	<i>The Franchising Code of Conduct</i>	<i>Franchise Act 1998</i>

The analysis focuses on the *Franchise Rule* in the USA, the *Franchising Code of Conduct* in Australia, and Malaysia's *Franchise Act*. Each jurisdiction offers distinct strengths: the USA provides a comprehensive regulatory approach through the *Franchise Rule*, focusing on detailed disclosure requirements; Australia emphasizes franchisee protection through the *Franchising Code of Conduct*, which regulates the franchise relationship; and Malaysia enforces strict registration and regulatory procedures under the *Franchise Act*, ensuring franchise system compliance. Finally, this chapter critically analyses the lessons in disclosure, registration and contracts from franchisee protection in the three selected jurisdictions, providing relevant insights for China.

## 5.2 Franchisee Protection in the USA

### 5.2.1 Regulatory Framework

The franchising regulatory framework in the USA operates at both state and federal levels. California introduced the first franchise law, the *Franchise Investment Law*, in 1970. Several states, including California, Hawaii, Illinois, and New York, have franchise disclosure laws. Oregon stands out by requiring franchisors to provide a *Franchise Disclosure Document* (hereinafter referred to as "FDD") but does not mandate registration.<sup>473</sup> At the federal level, the FTC develops the *FTC Franchise*

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<sup>473</sup> *Basic Track: Registration and Disclosure*, International Franchise Association's 54th Annual Legal Symposium, May 15-17, 2022.

*Rule*.<sup>474</sup> It was designed to provide minimum protection to the franchisee and do not preclude stricter disclosure obligations imposed by state laws.

Since 30 December 1993, the FTC permitted franchisors to use disclosure documents under one of two disclosure formats: the *FTC Franchise Rule 1979* or the *Uniform Franchise Offering Circular* (hereinafter referred to as "UFOC") *Guidelines*. The *UFOC Guidelines* adopted by the North American Securities Administrators Association (hereinafter referred to as "NASAA") on 23 April 1993. It prescribes the content and format of disclosures and is intended to provide states with uniform disclosure requirements.<sup>475</sup> Most franchisors now use the UFOC format to comply with state laws. In 2007, the FTC amended the Franchise Rule to align it with state laws, following the *UFOC guidelines*, which include 23 specific information items.<sup>476</sup>

In addition, franchise associations in the USA also play a role in franchisee protection. Many countries have franchise associations or organizations that provide industry information, franchise opportunities, and legal guidance. Founded in 1960 and headquartered in Washington, D.C., the IFA is a global leader in franchising. The IFA promotes industry growth through advocacy, education, and policy development. It emphasizes fairness and transparency in franchise relationships, ensuring that

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<sup>474</sup> *Code of Federal Regulations*, Title 16, Part 436, Section 436.1 (1978).

<sup>475</sup> Gerald C. Wells and Dennis E. Wiczorek, "A Road Map to the New FTC Franchise Rule," *Franchise LJ* 27 (2007): 105.

<sup>476</sup> Federal Trade Commission, "Disclosure Requirements and Prohibitions Concerning Franchising," *Federal Register* 72 (2004).

contracts are clear and enforceable. The IFA also has the authority to review franchisors and take corrective actions for code violations.

### 5.2.2 Disclosure

The *FTC Franchise Rule* is considered a disclosure law that provides minimum information disclosure requirements for franchising throughout the USA.<sup>477</sup> It was codified in 1979 and amended in 2007.<sup>478</sup> The *FTC Franchise Rule* mandates that franchisors deliver an FDD to prospective franchisees in a specified format (known as the FTC format), but do not require registration with a government agency. Fifteen states have established their own franchise disclosure laws that provide broader protections for franchisees. In 2019, to harmonize federal and state disclosure requirements, NASAA issued new guidelines that revised the uniform disclosure format (known as the UFOC format) for states. The states generally adopt the UFOC format prescribed by NASAA, while the FTC allows franchisor to choose between the FTC format and the UFOC format. In practice, most franchisors prefer to adopt the UFOC format to facilitate the acceptance of information disclosure documents.<sup>479</sup>

The *FTC Franchise Rule* specifies the content of 20 items of information that franchisors must disclose to prospective franchisees as required in the FDD. This

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<sup>477</sup> W. Andrew Scott, Jeffrey H. Wolf, and Allan P. Hillman, "Franchising from A (Arbitration) to T (Termination)," *Franchise Law Journal* 22 (2002): 192.

<sup>478</sup> *Code of Federal Regulations*, Title 16, Part 436, Section 436.1 (1978).

<sup>479</sup> Peter C. Lagarias, "Franchise Sales Laws Need Revisions to Further Their Objectives, but Federal Preemption Is Not the Solution," *Franchise Law Journal* 40, no. 2 (2020): 201-220.

means that the franchisor may not, by contract or otherwise, exclude any of the 20 disclosures required by the FDD. Otherwise, the franchisor incurs penalties for violating franchise laws. Notably, the *FTC Franchise Rule* prohibits franchisors from disclosing any information beyond what is required by law.<sup>480</sup> The *UFOC format* requires richer disclosure, with a total of 23 items, but the content is basically like that of the FTC format. Below is a list of the 23 items that franchisors are required to disclose under the federal disclosure requirements.

Table 5.2  
*The Contents of Information Disclosure under the Federal Law*

Item	Type of Disclosure	Specific Content
1	The Franchisor and its Affiliates	<ul style="list-style-type: none"> <li>- Summary of the franchise operation for the franchisee</li> <li>- Background details of the franchisor and affiliated entities.</li> <li>- Analysis of the franchise market, potential challenges, and applicable franchise laws.</li> </ul>
2	Business Background	<ul style="list-style-type: none"> <li>- Management experience of the individual in charge over the last five years.</li> <li>- Pending administrative, criminal, and material civil proceedings.</li> </ul>
3	Litigation	<ul style="list-style-type: none"> <li>- Significant civil lawsuits involving franchise relationships initiated in the last fiscal year.</li> <li>- Lawsuits involving felony charges or franchise deceptive practices within the last 10 years.</li> </ul>

<sup>480</sup> Perry C. Siatis, "[www.FranchiseDisclosure.com](http://www.FranchiseDisclosure.com): Assessing the FTC's Proposed Franchise Rule Provisions Involving Electronic Disclosure," *BYU Law Review* 2000 (2000): 713, <https://digitalcommons.law.byu.edu/lawreview/vol2000/iss2/7>.

4	Bankruptcy History	All bankruptcy information for franchisors and related parties in the last ten years.
5	Initial Fees	<ul style="list-style-type: none"> <li>- Amount and type of franchise fees.</li> <li>- Whether the collection is unified and the amount calculation formula.</li> <li>- Whether to return.</li> <li>- Ongoing fees, like royalties and advertising contributions.</li> </ul>
6	Other Fees	<ul style="list-style-type: none"> <li>- One-time fees, including transfer or renewal fees</li> <li>- Estimated cost type.</li> </ul>
7	Estimated Initial Investment	<ul style="list-style-type: none"> <li>- Payment amount and method.</li> <li>- Payment timing and recipient.</li> <li>- Items the franchisee must buy or lease.</li> </ul>
8	Restrictions on Sources of Products and Services	<ul style="list-style-type: none"> <li>- Approved suppliers and related interests.</li> <li>- Specifications and standards of the items.</li> <li>- Procedures for granting and revoking approvals for specific suppliers</li> </ul>
9	Franchisee's Obligations	Both the franchise agreement obligations and those required by the FDD must be clearly outlined.
10	Financing	<p>Any financing information provided to franchisees.</p> <ul style="list-style-type: none"> <li>- Specific types of assistance such as advertising programs.</li> </ul>
11	Franchisor Support, Marketing, IT Systems, and Training	<ul style="list-style-type: none"> <li>- Computer systems and ongoing maintenance;</li> <li>- Training programs.</li> <li>- A table of contents with page numbers for the business manual.</li> <li>- Location of the franchise business.</li> </ul>
12	Territory	<ul style="list-style-type: none"> <li>- Whether the territory is exclusive.</li> <li>- Availability of other distribution channels.</li> </ul>

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		<ul style="list-style-type: none"> <li>- Availability of regional development agreements.</li> <li>- Any conditions for relocation, establishment of new outlets, pre-emption rights and other additional franchise rights.</li> </ul>
13	Trademarks	Information on federally registered principal trademarks.
14	Patents, Copyrights and Proprietary Information	<ul style="list-style-type: none"> <li>- Description of the trade secret, if any.</li> <li>- Protection of the right to use patents and copyrights and any restrictions.</li> </ul>
15	Obligation to Participate in the Actual Operation of the Franchised Business	<ul style="list-style-type: none"> <li>- Minimum experience.</li> <li>- Equity requirement.</li> <li>- Confidentiality agreements.</li> <li>- Other documents mandated by third-party administrators.</li> </ul>
16	Restrictions on What the Franchisee May Sell	<ul style="list-style-type: none"> <li>- Whether only items approved by the franchisor can be sold.</li> <li>- Whether access to certain customers is restricted;</li> <li>- Whether the type of items can be changed.</li> </ul>
17	Renewal, Termination, Transfer, and Dispute Resolution	<ul style="list-style-type: none"> <li>- Duration of the franchise relationship.</li> <li>- Right to renew.</li> <li>- Circumstances of termination.</li> <li>- Any restrictions on transfer.</li> <li>- Non-competition.</li> <li>- Dispute resolution procedures.</li> </ul>
18	Public Figures	Any association of a public figure with the franchise system.
19	Financial Performance Representations	Any actual or potential sales, profits, and revenues.
20	Outlets and Franchisee Information	- Changes in franchise outlets for the last three fiscal years.

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		- Projected franchise outlets and franchise agreements signed in the next fiscal year.
		- Contact information for current and previous franchisees.
		- Franchisor's balance sheets for the last two years
21	Financial Statements	- Franchisor's income statement, shareholders' equity, and cash flow for the past three years.
22	Contracts	All proposed agreements relating to franchising and finally actual samples attached.
23	Receipts	Details on the receipt page include franchisor and potential franchisee signatures.

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**Source:** UFOC

The *FTC Franchise Rule* mandates that franchisors disclose information at least 14 calendar days in advance of signing a franchise agreement or obtaining franchise fees.<sup>481</sup> In addition, the franchisor must deliver a copy of FDD if a potential franchisee who has paid the franchise consideration makes a reasonable request to disclose the franchise information.<sup>482</sup> With respect to the delivery of the disclosure, both paper and electronic disclosure are allowed under the *FTC Franchise Rule*.<sup>483</sup> Franchisor must present the disclosure in clear and concise English and allow franchisee to store, download, or print it.<sup>484</sup> It is important to note that *FTC Franchise Rule* also provide for exemptions from franchisor disclosure. The most common exemptions include

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<sup>481</sup> Gerald C. Wells and Dennis E. Wiczorek, "A Road Map to the New FTC Franchise Rule," *Franchise Law Journal* 27 (2007): 105.

<sup>482</sup> *Code of Federal Regulations*, Title 16, Part 436, Section 436.9 (1978).

<sup>483</sup> *Code of Federal Regulations*, Title 16, Part 436, Section 436.2 (1978).

<sup>484</sup> *Code of Federal Regulations*, Title 16, Part 436, Section 436.6 (1978).

fractional franchise exemption, minimum franchise fee exemption, large franchisee exemption, and large investment exemption.<sup>485</sup>

For noncompliance with disclosure, the FTC has the authority to file lawsuits and apply for court rulings, including preliminary or permanent injunctive relief, public notice of violation, and civil penalties.<sup>486</sup> It is worth noting that U.S. courts do not allow private suits for violations of *FTC Franchise Rule*. The FTC can provide relief to the injured party, such as damages, return of property, retract agreement, etc.<sup>487</sup> However, 15 states in the USA that allow private suits for violations. State laws employ different civil sanctions, such as injunctions, damages, and revocations. If the violation is serious, the franchisor or responsible person may be subject to criminal sanctions as a result.<sup>488</sup> In addition, Article 17 of the UFOC format also stipulates the means of dispute settlement, such as arbitration or mediation.

### 5.2.3 Registration

Although the *FTC Franchise Rule* does not require franchisor registration, 14 U.S. states mandate both disclosure and registration.<sup>489</sup> These states include California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota,

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<sup>485</sup> Karen B. Satterlee and Leslie D. Curran, "Exemption-Based Franchising: Are You Playing a Minefield," *Franchise Law Journal* 28 (2008): 191.

<sup>486</sup> Daniel J. Solove and Woodrow Hartzog, "The FTC and the New Common Law of Privacy," *Columbia Law Review* 114 (2014): 583.

<sup>487</sup> Uri Benoliel and Jenny Buchan, "Franchisees' Optimism Bias and the Inefficiency of the FTC Franchise Rule," *DePaul Business & Commercial Law Journal* 13 (2014): 411.

<sup>488</sup> Aaron Xavier Fellmeth, "Civil and Criminal Sanctions in the Constitution and Courts," *Georgetown Law Journal* 94 (2005): 1.

<sup>489</sup> Stanley M. Dub, "What's in a Name: State Business Opportunity Statutes as Franchise Disclosure Laws," *Franchise Law Journal* 38 (2018): 105.

Rhode Island, Virginia, Washington, and Wisconsin. Additionally, states like Connecticut, North Carolina, South Carolina, and Maine require FDD registration if the franchisor's trademarks are not federally registered.<sup>490</sup> In these registration states, franchisors must submit their registration applications and obtain approval before offering franchises.<sup>491</sup>

The registration process typically involves submitting the FDD, completing an application form, and paying the required fees. State regulators then review the FDD to ensure it meets local requirements, such as financial disclosures and litigation history. While the FTC enforces federal franchise laws, these state-specific regulations impose additional compliance obligations. For example, in California, franchisors must register with the Department of Business Oversight, submitting their proposed FDD along with other necessary documentation.<sup>492</sup> State agencies can deny registration if they determine the franchise poses a risk to potential franchisees.

Certain franchises, such as those involving large franchisors or franchisees, are specifically exempted from registration requirements. Exemptions for franchise registration are not uniform across states. But the exemption is usually based on a certain amount of net worth (\$5 million to \$10 million) or a certain number of years of business experience (usually five years).<sup>493</sup> Even though some franchisors in

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<sup>490</sup> Abhishek Dube and Colin Krull, "Basic Track: Registration and Disclosure," *International Franchise Association's 54th Annual Legal Symposium*, May 15-17, 2022, Dallas, Texas and Chicago, Illinois.

<sup>491</sup> *California Corporation Code*, Section 31110 (West 1977).

<sup>492</sup> *California Corporation Code*, Section 31114 (West 1977).

<sup>493</sup> Honey V. Gandhi, "Franchising in the United States," *Law & Business Review of the Americas* 20

registration states are exempt from franchise registration, disclosure is not. Therefore, the franchisor is obligated to file an FDD for disclosure when applying for an exemption. Franchise registration is usually valid for one year. The renewal of franchise registration requires the addition of application materials for changes within the year.

#### **5.2.4 Contract**

In the USA, the franchise relationship is not governed by federal laws but is instead regulated and enforced at the state level. The terms of franchise agreements may differ across states based on varying franchise regulations. For instance, California's *Investment Law* outlines franchise disclosure and registration requirements,<sup>494</sup> while the *California Franchise Relations Act* governs termination, non-renewal, buyback, and transfer of franchise agreements between franchisors and franchisees.<sup>495</sup>

In terms of franchise renewal, some states in the USA have imposed restrictions on the refusal of franchise renewal to protect franchisees from arbitrary termination or non-renewal.<sup>496</sup> California, for example, requires that a franchisor reject a renewal with good cause or buyback the inventory of the franchise. It prescribes that the franchisor must give at least 120 days' notice to the franchisee not to renew.<sup>497</sup> Generally,

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(2014): 3.

<sup>494</sup> *California Corporations Code*, Section 31000 (West 2020).

<sup>495</sup> *California Business and Professions Code*, Section 20000 (West 1981).

<sup>496</sup> Robert W. Emerson and Michala Meiselles, "US Franchise Regulation as a Paradigm for the European Union," *Washington University Global Studies Law Review* 20 (2021): 788

<sup>497</sup> *California Business and Professions Code*, Section 20025.

renewing or extending a franchise relationship does not necessitate FDD disclosure unless there are significant changes to the original agreement's terms.<sup>498</sup>

Franchisors usually restrict franchisees from transferring franchise rights in franchise agreements. Franchisees are required to obtain franchisor consent for the transfer. Some states in the USA consider the franchisor's refusal to transfer without good cause unfair to the franchisee.<sup>499</sup> The franchisor's good cause can be that the potential transferee cannot meet the franchisor's required standards in terms of business experience or financial ability. Regarding termination, states typically mandate that franchisors must have valid reasons, such as the franchisor's bankruptcy, franchisee-caused damage to the franchise, or voluntary abandonment by the franchisee.<sup>500</sup>

### **5.3 Franchisee Protection in Australia**

#### **5.3.1 Regulatory Framework**

Similar to the USA, Australia operates as a common law country with federal, state, and local legal systems. However, most of the legislation relating to franchising in Australia is derived from federal law. The *Franchising Code of Conduct 1998* was the first legal instrument enacted to regulate franchising practices in Australia.<sup>501</sup> Its introduction in 1998 marked the modification of Australian franchise regulation from

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<sup>498</sup> Craig R. Tractenberg, Robert B. Cauhan, and Ann-Marie Luciano, "Legal Considerations in Franchise Renewals," *Franchise Law Journal* 23 (2003): 198.

<sup>499</sup> *California Business and Professions Code*, Section 20028(a)-(b).

<sup>500</sup> *California Business and Professions Code*, Section 20021 (detailing the twelve permissible grounds for early termination).

<sup>501</sup> Stephen Giles and Nigel Jones, "Franchising Law and Practice in Australia," *Franchise LJ* 38 (2018): 583.

the earlier voluntary regulation to the mandatory regulation now in place. The good intentions of the former voluntary regulation to effectively regulate franchising and promote its development through a self-regulatory mechanism ultimately proved to be a failure.<sup>502</sup> It was heavily criticized from various quarters and was eventually replaced by the *Franchising Code of Conduct 2014*, which remains in force today and has been amended several times (notably in 2021, 2022, and 2025). Over nearly three decades, Australia's franchising sector has seen extensive regulatory reviews aimed at balancing franchisee protection with franchisor flexibility. It enhances franchisee protection by providing regulatory tools such as cooling-off periods, disclosure, and mandatory dispute resolution.<sup>503</sup>

In addition, competition and consumer law provisions regulate business activities in Australia including franchising. It aims to promote fair competition and consumer protection.<sup>504</sup> It is subject to the administration of the ACCC, which has a wide range of enforcement, monitoring, prosecution, education, and advisory powers. The ACCC is a primary government agency for franchisee protection in Australia.<sup>505</sup> The Franchising Policy Committee is the organization that oversees franchising regulation in Australia. Its role includes assessing the effectiveness of the franchising law's implementation and offering recommendations for its improvement.

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<sup>502</sup> Robert Gardini, *Review of the Franchising Code of Practice: Report to Senator the Hon Chris Schacht, Minister for Small Business, Customs and Construction* (AGPS, 1995).

<sup>503</sup> Stephen Giles and Nigel Jones, "Franchising Law and Practice in Australia," *Franchise LJ* 38 (2018): 586.

<sup>504</sup> *Competition and Consumer Act 2010*.

<sup>505</sup> Australian Competition and Consumer Commission (ACCC), *Franchising Code of Conduct*, <https://www.accc.gov.au/business/industry-codes/franchising-code-of-conduct/beginning-a-franchise-agreement/key-facts-sheet-for-a-franchise> (accessed 10, January 2024).

### 5.3.2 Disclosure

In Australia, the *Franchising Code of Conduct* mandates franchisors to fulfill comprehensive information disclosure obligations, requiring them to provide prospective franchisees with all necessary information strictly in accordance with the prescribed content and format of the franchising disclosure document. Regarding the delivery of disclosure, it does not prohibit disclosure in electronic form. The franchisor may adopt electronic disclosure on the premise of complying with the electronic transaction law in Australia.

In addition, franchisors are also required to submit copies of the key fact sheet, the final franchise agreement, and the *Franchising Code of Conduct*. The key fact sheet, which is required to be provided to franchisees in a prescribed format, provides an overview of important information in disclosure document. Both key fact sheet and disclosure document must be updated annually. In addition, significant franchise system details must be accessible to the public through the Franchise Disclosure Register. Franchisor will not be deemed to have fulfilled its disclosure obligation until franchisee has signed a written confirmation. The confirmation verifies that the franchisee has received, read, and understood the disclosure document and the *Franchising Code of Conduct*.

The disclosure document must cover 23 items in Schedule 1, which is further broken down into more than 200 details. In this section, some of these items are listed, including:

the background information of the franchisor and all persons who assume management responsibility for the franchise business, such as directors, secretaries and partners; the record of felony convictions of franchisor and director in the past ten years, and the final judgment of civil proceedings in the past five years; contact information of current and former franchisees; estimated initial investment; supply restrictions and rebates; earning information; site or territory; financial details; intellectual property details; obligations of both parties; dispute resolution.<sup>506</sup>

The *Franchising Code of Conduct* requires franchisors to continuously disclose information. Disclosure is categorized into regular and irregular. Regular disclosure involves updating the document within four months after each financial year's end. Irregular disclosure requires the franchisor to notify the franchisee in writing about significant changes within a reasonable time. These changes may include shifts in ownership or control of the franchisor or major lawsuits against the franchisor.<sup>507</sup> Moreover, it requires the franchisor to disclose information at least 14 days before signing any franchise-related contract or receiving any nonrefundable fees. It also includes a 14-day cooling-off period, allowing franchisees to terminate the

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<sup>506</sup> Schedule 1 of the Competition and Consumer (Industry Codes—Franchising) Regulation 2024.

<sup>507</sup> Peter Buberis, "Disclosure Document," in *Australian Franchising Code of Conduct: A Critical Analysis with Current Case Law* (Emerald Publishing Limited, 2020), 57-154.

franchise agreement without legal consequences. If the franchisee exercises this right, the franchisor must refund the franchise fee within 14 days.<sup>508</sup>

Regarding liability and remedies for failing to meet disclosure obligations, franchisees are entitled to bring civil actions and obtain remedies, such as damages, injunctions, revocation of franchise agreements, and other orders. The ACCC, responsible for enforcing the *Franchising Code of Conduct*, can take action against non-compliant disclosures. For example, it is possible to issue a notice of infringement to the franchisor and order correction without going through the courts. The ACCC can initiate a civil action on behalf of the franchisee against a non-compliant franchisor.<sup>509</sup>

### 5.3.3 Registration

The Australian government has developed a free online registration system, the Franchise Disclosure Register.<sup>510</sup> Franchisors must create a franchise profile and disclose high-level information on the Franchise Disclosure Register in compliance with the *Franchising Code of Conduct*. In addition, all information in the Franchise Disclosure Register is published by the franchisor. Franchisors can also voluntarily published disclosure documents and sample franchise agreements. Franchise registration must be completed at least 14 days before signing a franchise agreement

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<sup>508</sup> *Competition and Consumer (Industry Codes – Franchising) Regulation 2024 (Cth)*, *Franchising Code of Conduct*, Part 4, Division 5, Section 50.

<sup>509</sup> Richard Devlin and Ora Morison, "Access to Justice and the Ethics and Politics of Alternative Business Structures," *Canadian Bar Review* 91 (2012): 483.

<sup>510</sup> Stephen Giles and Nigel Jones, "Franchising Law and Practice in Australia," *Franchise Law Journal* 38 (2018): 593.

with a prospective franchisee. The franchisor is obligated to update or confirm the registration information annually.

#### **5.3.4 Contract**

It is believed that opportunism can be greatly reduced due to the experience of both parties, so some exemptions are provided in the *Franchising Code of Conduct*. The following franchise agreements are exempt,

The goods or services provided to the franchisee are substantially the same as before entering the franchise contract; The Franchisee has supplied those goods or services for at least 2 years prior to signing the franchise agreement; In the first year of the franchise, sales are expected to be no more than 20% of the franchisee's total turnover of such goods or services.<sup>511</sup>

It seeks to prevent unfair practices in franchise agreements by prohibiting franchisors from relying on broad liability exclusion clauses. The *Franchising Code of Conduct* also prohibits the inclusion of unfair terms in standard form contracts, specifically identifying trade restrictions as an example of such terms. Furthermore, the *Franchising Code of Conduct* requires that the principle of good faith be observed throughout the entire duration of the franchise relationship.<sup>512</sup>

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<sup>511</sup> *Competition and Consumer (Industry Codes—Franchising) Regulations 2024 (Cth), Preliminary, Chapter 1, Part 3, Section 10(3).*

<sup>512</sup> *Competition and Consumer (Industry Codes—Franchising) Regulations 2024 (Cth), Franchising Code of Conduct, Chapter 2, Part 2, Section 18.*

In practice, most franchise agreements have a term of 5 to 10 years in Australia. But franchisees have no right to extend and claim compensation under the *Franchising Code of Conduct*.<sup>513</sup> Before the franchise agreement expires, the franchisor must inform the franchisee in writing at least six months in advance about the decision to extend or renew the agreement. If renewed, the franchisor is still required to meet the disclosure obligations. Even if the franchise is renewed, the franchisor must continue to fulfill disclosure obligations.<sup>514</sup>

With respect to transfer, a franchisor cannot refuse a franchisee's transfer request without good cause.<sup>515</sup> In relation to the termination of the franchise, the *Franchising Code of Conduct* makes the following mandatory provisions,

...unilateral termination without penalty by the franchisee within a cooling-off period of 14 days after signing the franchise agreement; if the franchisee breaches the franchise agreement, the franchisor has the right to terminate with notice and provide a suitable remedial period; franchisee has the right to propose early termination and franchisor shall respond within 28 days; the franchisor is entitled to terminate the franchise agreement upon 7 days' prior notice due to certain specific events such as franchisee bankruptcy, danger to public safety or fraud; the franchisor has the right to terminate under the franchise agreement by giving reasonable notice.<sup>516</sup>

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<sup>513</sup> Stephen Giles and Nigel Jones, "Franchising Law and Practice in Australia," *Franchise Law Journal* 38 (2018): 583.

<sup>514</sup> *Competition and Consumer (Industry Codes – Franchising) Regulation 2024 (Cth)*, *Franchising Code of Conduct*, Part 4, Division 2, Subdivision B, Section 36.

<sup>515</sup> *Competition and Consumer (Industry Codes – Franchising) Regulation 2024 (Cth)*, *Franchising Code of Conduct*, Part 4, Division 4, Section 49.

<sup>516</sup> *Competition and Consumer (Industry Codes – Franchising) Regulation 2024 (Cth)*, *Franchising*

## 5.4 Franchisee Protection in Malaysia

### 5.4.1 Regulatory Framework

In Malaysia, the regulation of franchising mainly derived from the *Franchise Act 1998*, which has been amended as the *Franchise Act 2020*. It addresses issues such as the definition of franchising, registration of franchises, disclosure of information, termination of agreements, and penalties.<sup>517</sup> It provides regulatory approaches such as mandatory registration procedures, cooling-off periods, information disclosure and non-discrimination requirements to protect franchisees. The *Franchise Act 1998* provides for mandatory pre-registration requirements, which is a major feature of franchising regulation in Malaysia. Both domestic and foreign franchisors must apply for registration with the Registrar before entering into a franchise agreement.<sup>518</sup>

The regulatory body for franchising is the Franchise Development Division, headed by the Registrar of Franchises. The Registrar has the discretion to approve or deny the application of registration.<sup>519</sup> Furthermore, the *Malaysia Franchise Act 2020* also establishes the Franchise Advisory Board, comprised of seasoned business professionals appointed by the Minister. The Board provides counsel to the government on enhancing industry promotion and competitiveness.<sup>520</sup>

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*Code of Conduct*, Part 4, Division 5-6.

<sup>517</sup> Radwa Elsaman, "What Would the Malaysian Law Teach Us About Franchising?" *Journal of the Patent & Trademark Office Society* 103 (2023): 291.

<sup>518</sup> *Malaysian Franchise Act 1998*, Section 6.

<sup>519</sup> *Malaysian Franchise Act 1998*, Section 8.

<sup>520</sup> *Malaysian Franchise Act 1998*, Section 35.

### 5.4.2 Disclosure

Under the Malaysian *Franchise Act 1998* (as amended in 2022), franchisors are required to provide disclosure documents and sample franchise contract to potential franchisees. In Malaysia, the registration of disclosure documents with the Registrar of Franchises is a mandatory requirement for franchising, serving as a key mechanism to ensure transparency and regulatory compliance under the Franchise Act 1998. Importantly, the disclosure documents for the franchisees should be consistent with those approved by the Registrar during the registration period. The franchise contract to the franchisees shall be based on the template franchise contract submitted to the Registrar during registration. Any person who submits false or misleading information or documents in this context commits an offence.<sup>521</sup>

The disclosure document includes details about the franchise business, estimated initial investment, and franchise terms like renewal and termination. Key components of the disclosure document are as follows,

...the name, business address, and type of business, including the franchisor's business experience; details of the intellectual property rights granted to the franchisee; the types and amount of fees imposed on franchisees; details of other financial obligations, including advertising, training or service fees payable; whether the franchisee is required to purchase equipment or products from the franchisor or a source designated by the franchisor and, if so, to identify the source; the obligations of the franchisor, before operating or during operation, in determining the business site; the

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<sup>521</sup> *Malaysian Franchise Act 1998*, Section 7.

territorial rights granted to the franchisee and circumstances of when the boundary of the territory may be altered; and the franchise term, and the terms for renewal and termination of the agreement by the franchisor or franchisee, and the parties' obligations upon termination. The franchisor must submit audited financial statements for the past three financial years and forecasts for five years...<sup>522</sup>

### 5.4.3 Registration

The *Franchise Act* 1998, which aims to register and regulate franchises in Malaysia, has undergone major amendments in 2012 and minor amendments in 2020.<sup>523</sup> Under the *Franchise Act* 1998, any local franchisor or foreign franchisor must apply to the Registrar to register their franchise before starting franchise business or offering the franchise for sale.<sup>524</sup> A franchisee granted by a foreign franchisor must register with the Registrar before commencing the franchise business. For franchisees granted by a local franchisor or local master franchisee, registration with the Registrar is required within 14 days from the signing of the franchise agreement.<sup>525</sup>

In Malaysia, the entire process of franchise registration takes between two and six months to complete. Materials required for registration include complete disclosure documents, sample franchise agreements, operating manuals, and training manuals,

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<sup>522</sup> Radwa Elsaman, "What Would the Malaysian Law Teach Us About Franchising?" *Journal of the Patent & Trademark Office Society* 103 (2023): 291.

<sup>523</sup> Hua Siong Wong, "Issues and Challenges of Unregistered Franchise Business: A Malaysian Legal Perspective," *Studies of Applied Economics* 39, no. 4 (2021): 2, <https://doi.org/10.25115/eea.v39i4.4481>.

<sup>524</sup> *Malaysian Franchise Act 1998*, Section 6.

<sup>525</sup> *Malaysian Franchise Act 1998*, Section 6A and Section 6B.

updated audited accounts and financial statements, and other documents that may be required by the Registrar.<sup>526</sup> The Registrar has the authority to approve or reject a registration application and must provide reasons for any refusal.<sup>527</sup> A franchisor or franchisee who receives a notice of refusal to register from the Registrar has the right to appeal to the Minister, whose decision shall be final.<sup>528</sup>

The renewal of franchise registration is required within 30 days after the registration expires, along with the payment of the prescribed fee.<sup>529</sup> A copy of all the documents submitted to the Registrar for approval must be provided to the prospective franchisee at least ten days before signing the franchise agreement. The franchisor or franchisee whose registration is approved must display the franchise registration in a prominent position on its place of business.<sup>530</sup> Otherwise, an offence will be committed and subject to penalties. Franchisors or franchisees, whether local or foreign, may be committing an offence if they violate the Malaysian *Franchise Act*. A body corporate is fined between RM10,000 and RM50,000 for committing an offence. An unincorporated body committing the offence will be fined between RM5,000 and RM25,000 or jailed for not more than six months. Heavier punishment for second and subsequent offenses.<sup>531</sup>

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<sup>526</sup> *Malaysian Franchise Act 1998*, Section 7.

<sup>527</sup> *Malaysian Franchise Act 1998*, Section 8.

<sup>528</sup> *Malaysian Franchise Act 1998*, Section 17.

<sup>529</sup> *Malaysian Franchise Act 1998*, Section 10A.

<sup>530</sup> *Malaysian Franchise Act 1998*, Section 10B.

<sup>531</sup> *Malaysian Franchise Act 1998*, Section 39.

#### 5.4.4 Contract

In Malaysia, a franchise agreement must include the following elements,

...the name and description of the goods or services; the territorial rights granted to franchisees; estimated franchise fees, promotion fees and any related expenses; obligations of franchisor and franchisee; the right to use trademarks or any intellectual property rights; cooling-off period statement; the type and details of assistance provided by the franchisor; the term of the franchise and the terms of renewal and extension of the franchise agreement; validity of the termination or expiration of the franchise agreement.<sup>532</sup>

The *Franchise Act* 1998 requires franchise agreements to have a minimum term of five years, with failure to comply constituting an offence.<sup>533</sup> The franchisee's right to renew is also protected in Malaysia. Franchisors typically cannot deny franchise renewal unless the franchisee defaults or fails to notify the franchisor about renewal six months before the agreement ends. Additionally, franchisees have the right to extend the agreement before termination, and franchisors cannot refuse unless there is evidence of a breach. It is an offence for a franchisor to refuse renewal or extension without offering a buyback or other compensation.<sup>534</sup>

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<sup>532</sup> *Malaysian Franchise Act 1998*, Section 18.

<sup>533</sup> *Malaysian Franchise Act 1998*, Section 25.

<sup>534</sup> *Malaysian Franchise Act 1998*, Section 32.

A franchisor cannot terminate the franchise agreement before its expiration unless there is good cause, such as a breach of contract by the franchisee that is not remedied within fourteen days of written notice.<sup>535</sup> Additionally, franchisees are granted a cooling-off period of at least seven working days, during which they may terminate the agreement.<sup>536</sup> If the franchise agreement is terminated, the franchisor must refund all payments made by the franchisee. A franchisor who fails to comply with this obligation commits an offence.<sup>537</sup>

## **5.5 Lessons for China**

### **5.5.1 Disclosure Practices**

It is important for potential franchisees to know the necessary information about the franchise to make a decision about whether to invest. The USA, Australia and Malaysia all impose pre-contractual information disclosure obligations on franchisors in their respective franchise laws. By comparing the franchise disclosure regulations in selected jurisdictions, this study finds similarities and differences between China and the USA, Australia and Malaysia. The similarity is that franchising regulation in each country imposes pre-contractual disclosure obligations on franchisors.

The content of disclosure includes basic information about the franchisor and its affiliates, litigation history, franchise fees, investment budgets, financial information, restrictions on the source of goods and services, types of support from the franchisor,

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<sup>535</sup> *Malaysian Franchise Act 1998*, Section 31.

<sup>536</sup> *Malaysian Franchise Act 1998*, Section 18(4).

<sup>537</sup> *Malaysian Franchise Act 1998*, Section 18(5) and Section 18(6).

etc. But franchise disclosure requirements in the USA and Australia are more comprehensive and specific than in other countries. Both the USA and Australia require disclosure of information on former franchisors and franchisee, renewal termination and transfer terms of franchise contracts, estimated initial investment costs, and dispute resolution. But China has no such disclosure requirements. The USA also requires disclosure of public figures that other countries do not. China's disclosure requirements are relatively broad compared to those in the selected jurisdictions. For example, the specific years of disclosure of financial information and the specific personnel of related parties are not specified in detail.

In terms of disclosure time, the disclosure time in China is 30 days prior to the signing of the franchise agreement, which is longer than the disclosure time in other selected jurisdictions. This 30-day period provides franchisees with adequate time to make informed decisions. Additionally, the franchisor's obligation to fulfill the disclosure requirements in Australia is more favorable to franchisee protection, as the disclosure period is calculated from the date the franchisee pays any non-refundable amount or enters into the franchise agreement.

There is no fixed format for information disclosure in China, but the USA, Australia and Malaysia all provide a unified fixed format. Malaysia also requires the registration of disclosure documents with the government, which undoubtedly contributes to the normalization of disclosure documents. The practice of registering disclosure documents is beneficial to prevent franchisor fraud and promote fair trading, which is

worth learning from. In the information age, the disclosure method of electronic carrier is more convenient for the public. The USA and Australia both allow electronic disclosure, but China's mandatory requirement of written disclosure is not in line with practical needs.

Although China, the USA, Australia and Malaysia all provide for the right of franchisees to unilaterally terminate the contract during the cooling-off period, the length of the cooling-off period in the selected jurisdictions is inconsistent. In China, the cooling-off period is defined as a reasonable period but lacks a specific duration. In contrast, Australia and Malaysia have set a specific cooling-off period, offering a clear timeframe for franchisees to exercise their right to terminate the contract.

In addition, the exemption from information disclosure represents a significant gap in China's information disclosure system. While China has not established a comprehensive disclosure exemption system like that in the USA, the current franchising legislation only exempts franchisors from disclosure obligations when both parties renew the contract under the original terms. The establishment of information disclosure exemption system under specific circumstances is conducive to reducing the burden of the franchisor and making the franchisee more clearly grasp the key information.

In view of the USA, the disclosure exemption is motivated by the following considerations. The first is the subject factor. Experienced and capital-rich franchisees

or transferees can be exempted from disclosure because it is relatively easy for them to grasp information and make accurate judgments. In addition, small investments are exempt from disclosure, as the costs of a cumbersome process outweigh the benefits, hindering the development of small and medium-sized franchises. Significant investments are also exempt from disclosure, as the franchisee can negotiate on equal terms with the franchisor.

### **5.5.2 Registration Practices**

By comparing the registration systems in China with those in selected jurisdictions, the study found that franchising regulations in China, the USA, Australia and Malaysia all impose registration obligations on franchisors. But except for the franchisor in China, which is post-contract registration, the franchisor in the other three selected jurisdictions is pre-contract registration. The franchisor shall register within 15 days after the first signing of the franchise contract in China. In addition, both Malaysia and registration states in the USA require registration disclosure documents to the government. This is conducive to preventing the franchisor's deceptive behavior, which is worth learning from the Chinese government.

In respect of the liability for non-performance of registration, the franchisors may face administrative penalties such as fines and restraining orders in China. It is worth noting that the failure to comply with the registration requirement did not affect the validity of the contract itself. In contrast, the registration requirements in Malaysia are very strict. Franchise registration has become the main regulatory model for franchising in

Malaysia. Both franchisor and franchisee must fulfill their registration obligations to Registrar. Failure to register may constitute a crime, and the court further invalidates the franchise agreement. Criminal penalties not exceeding RM500,000 are imposed on corporate bodies, while unincorporated bodies face fines of up to RM250,000 or imprisonment of up to three years.

In China, the information provided to the public through the franchise information Management system is largely consistent with the registration materials submitted by the franchisor. This includes details such as the franchisor's business name, registered trademark, patent, date of registration, place of business and contact information, all of which are disclosed through the Ministry of Commerce website. In contrast, Malaysia requires both franchisees and franchisors to publicly display their franchise registration, making it easier for authorities to monitor compliance with franchise regulations. Malaysia's approach offers a more proactive model, as public display of franchisors and franchisees' registrations can increase transparency and promote greater enforcement of franchise regulations, which is where China could consider further strengthening the franchise regulatory system.

### **5.5.3 Contract Practices**

Key aspects of franchise agreements in the USA, Australia and Malaysia are discussed. It mainly relates to the requirements of the respective franchise regulations on the term, renewal, transfer, and termination of franchise contract. Through the above discussion, this study finds that there are similarities and differences in the requirements of the

selected jurisdictions in terms of franchise contracts. Neither the USA nor Australia has a maximum franchise period. The term of franchise agreement in Malaysia shall not be less than 5 years and in China shall not be less than 3 years. In other words, the franchisor cannot exclude the minimum term requirement for the duration of the franchise agreement by entering into a franchise agreement in China and Malaysia. In general, the longer the contract term, the more likely the franchisee is to recover its costs and make a profit.

Regarding franchise renewal, most countries allow the parties to decide whether to renew through contractual negotiations. Normally, the franchisor who refuses to renew should have good cause and fulfill the obligation of advance notice. The franchisor's refusal to renew the contract without buyback the franchisee's inventory or providing any compensation is a crime in Malaysia and will be subject to severe penalties. Franchising regulations in China and some US states such as California provide franchisees with the right of first refusal to protect the interests of original franchisees. It is worth noting that franchisors renewing or extending franchise agreements in China and the registration states in the USA are not required to comply with the disclosure obligation unless the agreement is materially changed but are required to re-disclose in Australia.

In terms of franchise transfer, the franchisee shall obtain the consent of the franchisor to transfer the benefits of the franchise agreement. Both the USA and Australia require that there must be a good cause for the franchisor to refuse the transfer, such as that

the transferee does not meet the franchisor's requirements. In China, franchising regulation imposes strict restrictions on franchisees' transfer of franchise and tends to protect franchisors' intellectual property rights.

In addition, both China and the selected jurisdictions provide franchisees with the right to unilaterally terminate the contract during the cooling-off period. Generally, the franchisor may not terminate the franchise agreement during the term of the franchise without reasonable cause and prior notice to the franchisee. Reasonable grounds for termination include bankruptcy of the franchisor, damage to the interests of the franchise by the franchisee, termination of the agreement, etc.

## 5.6 Summary

This chapter examines franchisee protection practices in the USA, Australia and Malaysia. Through critical analysis, this chapter explores franchisee protection practices in selected jurisdictions to offer insights for improving franchising regulation in China, particularly in disclosure, registration and contract.

The USA is a typical disclosure law country. The *FTC Franchise Rule* is essentially a disclosure law governing franchises across the USA. The timing, content, format, cooling-off period and exemption of disclosure have detailed and determined requirements in the USA. In addition, franchising laws in some U.S. states include registration requirements, disclosure requirements and contractual requirements. Australia and the USA have a similar regulatory system because they are both common

law countries. The Australian *Franchising Code of Conduct* deals primarily with the disclosure and contract relationship. Malaysia's registration system is the highlight of franchising regulation. There are also registration requirements for disclosure documents.

In terms of disclosure, China should learn from the practice of the USA and Australia, refine the content of disclosure, and provide a fixed disclosure format. The cooling-off period could be modeled on Australia's and Malaysia's seven-day periods instead of the vague "reasonable period" clause. The US disclosure exemption system and Malaysia's practice of registering disclosure documents can be referenced by China. In terms of registration, China can learn from the practice of Malaysia and California, that is, to implement pre-contract registration or pre-sale registration. In addition, China should strengthen the supervision of unregistered behavior and improve the registration rate. In terms of contracts, China could learn from Australia or California, which regulate the entire life cycle of the franchise relationship. In summary, the franchisee protection practices adopted in the USA, Australia and Malaysia provide significant insights. These examples can help predict how China might benefit in its franchise reform efforts.

## **CHAPTER SIX**

### **CONCLUSION AND RECOMMENDATIONS**

#### **6.1 Introduction**

This chapter presents the conclusion and recommendations of this study, as well as the summary of key findings, and possible aspects for future research. Specifically, this study examines the current practice of franchisee protection in three aspects: disclosure, registration and contract, and makes recommendations to improve franchisee protection in China. In addition, the study analyses the franchise regulation in three selected jurisdictions in the USA, Australia and Malaysia to explore practices that China can learn from. Finally, the fourth research objective, to recommend a possible solution to protect franchisees in China better, is discussed in this chapter.

#### **6.2 Summary of the Study**

The six chapters of this study are: Introduction; Legal and Regulatory Framework for Franchising in China; Legal Regulation and Mechanism on Franchisee Protection in China; The Current Practice of Franchisee Protection in Contractual Mechanisms; Franchisee Protection in the USA, Australia and Malaysia; and Conclusion and Recommendations. This section provides a summary of each chapter.

Chapter one is the introduction, which lays the foundation for the whole study. This study first introduces the research background of franchising. Then three factors motivating this study are discussed. The first is the lack of clear legal protection for franchisees, the second is the unbalanced franchise relationship in the contract, the third is the weak enforcement of franchising regulations.

Based on the problem statement, four research questions and four research objectives of this study are determined. In addition, the contributions and limitations of the research are discussed. In order to achieve the four objectives, doctrinal research and qualitative research are used. Doctrinal research is based on library data while qualitative research is based on interviews. Franchising related laws, regulations, court cases and interview data are the primary data sources for this study. Journals, books, thesis, reports, online resources, etc., are secondary sources of data. Content analysis and critical analysis are used to examine primary legal sources. Thematic analysis is used to analyse qualitative interview data, while critical analysis is used to analyse legal practice in other countries. Further, a literature review is discussed, including operational definitions, the laws and regulations of franchising in China, the franchise relationships under the private law, the overview of franchising regulation in selected jurisdictions.

Chapter two analyses the legal and regulatory framework of franchising in China. This chapter addresses the first research question and achieves the first research objective. To provide context, this chapter introduces China's legal system, offering a foundation

for understanding the country's franchising regulations. It also traces the historical development of these regulations through a review of legal documents and related literature. This chapter then introduces the key elements of franchising, including its characteristics, types, and how it differs from other business models. This chapter focuses on specific regulatory tools, such as disclosure requirements, registration requirements and franchise contracts. Finally, contract theories, particularly fairness and relational contract theory, provide the theoretical foundation for the study of franchisee protection. Additionally, information asymmetry and agency theory are explored, providing an economic perspective on the importance of franchise regulation.

Chapter three examines the franchisee protection under China's legal and regulatory framework, focusing specifically on disclosure, registration and contractual requirements. This chapter, together with Chapter Two, directly addresses the second research question and achieves the second research objective. It provides an in-depth analysis of key franchising legislation, including *CFAR 2007*, *CFRAM 2011*, *CFIDAM 2012* and relevant provisions of the *Civil Code*. Disclosure regulations are analysed in terms of timing, manner, content, cooling-off periods and the liabilities associated with non-disclosure. The registration requirements are examined in relation to timing, organizational procedures, necessary submission materials, the registration process, franchisee eligibility and penalties for non-compliance with registration obligations. Contractual legal norms are also examined in the context of the *CFAR 2007* and the general provisions of *Civil Code*.

This chapter also incorporates empirical data from interviews with franchisees, prospective franchisees, franchisors, lawyers and regulators, identifying current practices regarding franchisee protection. The analysis is structured around the themes of franchisee protection and subthemes of disclosure, registration, and contract aspects. Based on interview analysis, this chapter outlines three key aspects of franchisee protection and summarizes several legal insufficiencies. Disclosure regulations tend to be vague and uncertain, offering limited protection for franchisees. Registration rules appear to be weakly implemented and insufficiently supervised, which affects their practical effectiveness. Contract regulation largely relies on party autonomy, with limited specific regulatory guidance.

Chapter four investigates the current practice of franchisee protection within the context of the contractual mechanisms, and together with Chapter Three, contributes to achieving the second research objective and addressing the second research question.

This chapter begins by discussing the benefits and risks of franchising for franchisee. The analysis then focuses on the nature of franchise contract and key terms in contractual practice, which operates as a form of private regulation based on the principle of private autonomy. This includes examining the obligations of both franchisors and franchisees, as well as provisions related to franchise grants, contract terms, transfers, renewals, terminations and restorations.

Lastly, this chapter explores the dispute resolution mechanisms for franchise contracts, highlighting the advantages of ADR methods. These approaches not only reduce costs

and improve efficiency but, more importantly, facilitate the repair of franchise relationships, enabling continued collaboration. Using data from interviews, along with an analysis of actual contract clauses, this chapter identifies key themes and subthemes related to franchisee protection and contractual practices. The analysis shows that current contract terms often include significant loopholes, placing strict restrictions on franchisees while primarily serving the interests of franchisors.

Chapter five examines franchisee protection practices in three selected jurisdictions: the USA, Australia and Malaysia. This chapter answers the third research question and achieves the third research objective. This paper begins with an overview of the franchising industry in the selected jurisdictions. The franchise industry contributes significantly to the GDP of these selected jurisdictions and is also regulated by franchise legislation. This study examines the disclosure, registration and contractual requirements of franchising legislation in three selected jurisdictions— the USA, Australia and Malaysia—highlighting their strengths in franchisee protection. The insights gained offer valuable lessons for enhancing China's franchising legislation.

Chapter six reviews the study as a whole and discusses possible directions for future research. It brings together key findings and recommendations. Based on insights from interviews with industry stakeholders and experiences from the USA, Australia and Malaysia, this chapter proposes recommendations for franchisee protection, achieving the fourth research objective. This study offers targeted recommendations for improving China's franchising regulations, focusing on disclosure, registration and

contract practices to better protect franchisees. Recommendations include establishing clear and detailed disclosure requirements, enforcing stricter registration processes, and revising unfair contract terms to create a more equitable regulatory environment for franchisees.

Therefore, this section provides the overall summary of the entire study including the contents of each chapter. It explains the existing legal and regulatory framework of franchising in China, analyse the current protection for franchisees in China, examine the practice of franchisee protection in the USA, Australia and Malaysia, and recommend improvements to franchising regulation for franchisee protection. To achieve these research objectives, a combination of doctrinal research and qualitative interviews is employed. The key findings of this study are summarized in the next section.

### **6.3 Summary of the Findings**

The following summarizes the key findings of this study, including the current franchising regulation in China, the legal requirements in franchisee protection and the real contract practices, as well as insights drawn from the experiences of selected jurisdictions. This study conducts a critical analysis of franchisee protection under China's franchising regulation through doctrinal legal research and qualitative interviews. The findings indicate that China's current franchise regulation is primarily based on three approaches: disclosure, registration and contracts, each with its own limitations in protecting franchisees.

### 6.3.1 The Current Franchising Regulation in China

This section summarizes the research findings on the current franchising regulation in China, which achieves the first research objective in chapter two. Table 6.1 below explains the findings of current franchising regulation.

Table 6.1  
*Findings on the Current Franchising Regulation in China*

Aspects	Key Findings	Gaps & Challenges
Institutional and Legislative Structure	<ul style="list-style-type: none"> <li>- NPC holds supreme legislative power but has not enacted franchise-specific laws.</li> <li>- State Council issues administrative regulations, including <i>CFAR 2007</i></li> <li>- ADR mechanisms, such as arbitration and mediation, are increasingly used.</li> </ul>	<ul style="list-style-type: none"> <li>- Lack of national legislation on franchising, the <i>CFAR 2007</i>, <i>CFRAM2011</i> and <i>CFIDAM 2012</i> are administrative rather than legislative.</li> <li>- Lack of a dedicated franchise law results in weak enforcement and legal uncertainty.</li> </ul>
Historical Development of Franchise Regulation	<ul style="list-style-type: none"> <li>- <i>CFAM 1997</i> (first recognition).</li> <li>- <i>CFAM 2004</i> (strengthened regulation).</li> <li>- <i>CFAR 2007</i> (current framework).</li> <li>- <i>CFRAM 2011</i> and <i>CFIDAM2012</i> (supplementary measures)</li> </ul>	<ul style="list-style-type: none"> <li>- No substantive franchise law from NPC</li> </ul>
Regulatory approaches	<ul style="list-style-type: none"> <li>- Disclosure: <i>CFAR 2007</i> &amp; <i>CFIDAM 2012</i> mandate pre-contractual disclosure to provide franchisees with critical information.</li> <li>- Registration: <i>CFAR 2007</i> &amp; <i>CFRAM 2011</i> mandate post-contractual registration to ensure oversight but is not an approval system</li> </ul>	<ul style="list-style-type: none"> <li>- Vague disclosure rules; No standard format; Weak penalties for false disclosures.</li> </ul>

- Contract: *CFAR 2007* requires written franchise contracts; general contract rules from the *Civil Code* govern agreements.

- Registration is not an approval process, No post-registration supervision.  
- *CFAR 2007* lacks detailed contract provisions; No franchise-specific protections under contract law.

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**Source:** Researcher

This study analyses the specific legal and regulatory framework of franchising in China, especially in terms of franchisee protection, to achieve the first research objective. The researcher found that the *Civil Code* and *CFAR 2007* play a major role in the process of franchising regulation. Although *CFAR 2007* is a specialized franchise regulation issued by the State Council, it is administrative in nature rather than a law enacted by the NPC. This study examines the current franchising regulation in China from three aspects: disclosure, registration and contract.

Disclosure and registration are administrative requirements stipulated in *CFAR 2007* issued by the State Council. *CFIDAM2012* and *CFRAM 2011* are supplementary measures on disclosure and registration, respectively, developed by the MOC. Chapter two finds that China has introduced a regulatory approach to franchising that relies on a disclosure system. This system requires franchisors to fulfill statutory disclosure obligations before signing a franchise contract to address information asymmetry. Additionally, China has adopted a relatively relaxed registration system, which mandates that franchisor complete registration after signing the contract. Disclosure

and registration are two key regulatory tools used by the Chinese government to oversee franchising and are central to *CFAR 2007*.

However, the current legal framework does not regulate franchise contract relationships directly, leaving them subject only to the general provisions of the *Civil Code* on contracts. *CFAR 2007* has been largely silent on contracts, dealing only with very broad franchise contract requirements. For example, although *CFAR 2007* stipulates that the contract term shall not be less than three years and a reasonable cooling-off period, exceptions are provided, giving both parties greater contractual freedom. However, the *Civil Code* does not make special provisions on franchise contracts for the application of general contracts.

While the *Civil Code* and *CFAR 2007* establish a legal foundation for franchise regulation in China, the legal and regulatory framework remains inadequate in certain aspects. This study identifies several legal and regulatory challenges related to franchising, which are explored in Chapters two. China's franchise regulation imposes vague disclosure requirements, loose registration rules with weak penalties, and grants broad contractual freedom without adequate franchisee protections.

### **6.3.2 The Protection for Franchisees in China**

This section summarizes the research findings of Chapter three and Chapter four. They achieve the second research objectives. Chapter three and Chapter four investigate the

current franchisee protection in China. Table 6.2 below outlines the findings of Chapter three and Chapter four from the legal analysis and interview insights.

Table 6.2  
*Findings on the Current Protection for Franchisees in China*

Aspect	Legal Analysis	Interview Insights
Disclosure	<p>- <i>Civil Code</i>:            Good Faith: Article 7 mandates honesty but offers no concrete protections.            Revocation: Article 148 allows fraud-based revocation, but its application is unclear.            Civil Liability: Articles 157, 500, 566 and 577 provide general remedies but lack franchise-specific rules.</p> <p>- <i>CFAR 2007</i>:            Who: Only franchisor, lacks clarity on master franchisor and regional franchisor.            Time: 30 days before contract and update timely, but no specific guidelines. (Article 21).            Form &amp; Deliverer: Written; No electronic (Articles 21).            Criteria: Truthful, accurate and complete, but still vague (Articles 23).            Content: 11 items, but some terms are too broad, lacks clarity on</p>	<p>-Unclear and Uncertain Rules: Disclosure provisions are too broad and lack clarity.            -Limited Accessibility: Disclosed information is not always reliable or easily available to franchisees.            - Misleading Practices: Franchisors may provide false or incomplete information or withhold unfavorable details.            - Complexity Issues: Some disclosures are too technical for franchisees to fully understand and use.            - Legal Uncertainty: No clear provision on whether false or delayed disclosure affects contract validity</p>

support, termination, cooling-off period, and specifics (Articles 23).

- *Civil Code:*

Invalidity of contract: violate the mandatory provisions of laws and administrative regulations (Article 153).

- *CFAR 2007:*

Timing: 15 days after contract (Article 8).

Required Documents: Business license, contract sample, manual, market plan, etc. (Article 8). But scope of franchise resources is unclear; trade secrets and trade names are used but not legislated; Authority: MOC & provincial departments (Article 5).

Annual Report: Mandatory (Article 19).

Franchise Qualification: Franchisor identity, business resources and business model (Articles 3, 7, 15).

Unclear if unregistered trademarks qualify as franchise resources.

Process of Registration: Online.

Liability: Order correction, fines, public notice of violations (Articles 24-25). Post-contract registration is weakly enforced; many businesses operate without registration.

-Limited Protection: Registration is for regulatory purposes only, not to protect franchisees.

-Widespread Non-Compliance: Many businesses operate franchises without registration.

- Weak Oversight: Lack of enforcement allows franchisors to bypass requirements.

- Legal Uncertainty: Courts struggle to determine the impact of non-registration on contract validity.

Registration

Contract	<p>- <i>Civil Code:</i> The right to rescind a contract (Article 562 and 563); The obligation to keep trade secrets (Article 501 and 509).</p> <p>- <i>CFAR 2007:</i> Must be in writing (Article 21); Must include cooling-off period (Article 20), but no clear specification of the duration; Ongoing guidance and support (Article 14), but no detailed provisions on implementation or enforcement.</p>	<p>- Severe Power Imbalance: Contracts favor franchisors, limiting franchisees' rights and protections.</p> <p>- Non-Negotiable Terms: Franchisees must accept pre-drafted contracts with no bargaining power.</p> <p>- Unclear and Incomplete Terms: Key aspects like franchise scope, product/service standards are vague or missing; no oversight on advertising fees; unclear refund policies.</p> <p>- Excessive Franchisor Control: Franchisors can easily terminate or transfer contracts, while franchisees face strict restrictions.</p> <p>- Unfair Risk Allocation: Franchisees bear sole responsibility for third-party liabilities.</p>
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**Source:** Researcher

### 6.3.2.1 Legal Requirements of Disclosure, Registration and Contracts

The disclosure regime imposes requirements on timing, form, content, standards, cooling-off periods and liability. The disclosure time is 30 days before the signing of the franchise contract. Disclosure must be in writing and electronic form is not allowed. The criteria for disclosure are truthfulness, accuracy and completeness. The disclosures involved 11 important items of information. Cooling-off periods are mandatory for franchisees, but there is no specific duration. Liability for disclosure of violations includes fines, orders for correction, and announcements of violations. It is important to note that breach of disclosure and cooling-off period requirements may also result in termination of the contract. If it constitutes fraud, it is subject to criminal

liability. In addition, general provisions of the *Civil Code* such as the principle of good faith also apply to franchise disclosure.

The registration system in China is post-contract filing rather than pre-contract approval. Franchisors are required to register with the registration authority within 15 days after signing the franchise contract. The registration departments are the MOC and the commercial departments of each province. Materials required for registration include copies of business licenses, sample franchise contracts, franchise manuals, market plans, etc. Franchisors are required to renew their registrations every year. It is important to note that franchisors must be qualified prior to registration. It can be summarized as three conditions. First, the franchisor must have mature commercial resources, especially the requirement of two stores for one year. Second, the franchisor must be a business, not an individual. Third, franchisors must have a unified business model. Only if these three conditions are met, franchisors are allowed to enter the franchise market.

In terms of contract, the franchising parties agree on the granting, transfer, renewal, and termination of the franchise through the franchise contract. Although the franchise contract is protected by the principle of contract in the *Civil Code*, it is still subject to statutory intervention. To balance the disadvantage of unfair contract terms to franchisees, *CFAR 2007* specifies certain terms that must be included in franchise contracts, such as cooling-off periods. In addition, the general provisions of the *Civil Code* on contracts also apply to franchise contracts.

### **6.3.2.2 Legal Loopholes of Disclosure, Registration and Contracts**

The study found that there are still some legal loopholes in the franchisee protection. In terms of disclosure, many requirements are overly broad and vague. The cooling-off period is only described as "reasonable," without a specific timeframe. The scope of required disclosures is unclear, as the legislation does not specify the details of basic information to be disclosed or what guidance and support franchisors must offer. The criteria for disclosure also lack further clarification. Although it stipulates the franchisor's obligation to update disclosure information in a timely manner when franchise information changes significantly, "significant change" and "timely" are too subjective and lack a clear description. Additionally, the law mandates only written disclosure, overlooking the benefits of electronic disclosure.

Respondents highlighted that franchisors often provide incomplete, misleading, or overly complex information, making it difficult for franchisees to assess risks effectively. Some franchisees reported that key details, such as changes in franchise policies, were withheld or unclear, leading to disputes. The findings also reveal that whether disclosure violations affect contract validity remains uncertain, as there is no explicit legal provision that false or delayed disclosure invalidates a franchise contract.

For disclosure to protect franchisees effectively, they must be able to receive, understand, and act on the disclosed information. However, this study finds that the current disclosure regime has failed to achieve this goal. The provisions remain unclear

and uncertain, as also demonstrated in Chapter 3. The lack of a standardized disclosure format further weakens its effectiveness, and the vague definition of the cooling-off period adds to the uncertainty. These gaps allow franchisors to exploit information asymmetry, further disadvantaging franchisees in negotiations and contractual obligations.

The enforcement of franchise registration is weak, leading to widespread non-compliance. Respondents acknowledged that registration allows franchisees to access officially confirmed information, but in practice, very little information is publicly available. Many franchisors are unaware of their registration obligations or mistakenly believe that failing to register does not impact their franchise operations. The findings of this study reflect ongoing debate over whether non-registration affects the validity of franchise contracts, as there is no clear legal provision on this matter.

Legally, the scope of franchise resources remains ambiguous. While trade secrets and trade names are commonly treated as franchise resources in practice, they are not explicitly included in the legislation. Registered trademarks are clearly recognized as franchise resources, but it is uncertain whether unregistered trademarks qualify. Furthermore, China's registration system is a post-contract requirement, making it less stringent than disclosure regulations. As a result, many franchising enterprises operate without completing registration, reducing its effectiveness as a regulatory tool for franchisee protection.

The current franchise regulation provides broad contractual freedom but lacks specific protections for franchisees. This regulatory gap enables franchisors to exploit their dominant position, leading to imbalanced franchise relationships. Many franchise contracts include restrictive clauses, particularly regarding competition. While some restrictions are necessary to maintain system consistency, franchisors often impose excessive limitations. The franchise contract has become a key tool for franchisors to control competition, yet neither the *Civil Code* nor *CFAR 2007* effectively regulates these agreements. The *Civil Code* does not address franchise contracts, while *CFAR 2007*, as administrative legislation, is not designed to determine contract validity. This lack of clarity creates legal uncertainty regarding whether violations of disclosure and registration requirements affect contract enforceability.

Judicially, courts struggle to assess whether franchisors fulfill their disclosure and registration obligations, leading to frequent disputes. There is no clear legislative guidance on whether non-compliance affects contract validity, further complicating judicial decisions. Respondents noted that franchise contracts often fail to protect franchisees and may even reinforce existing power imbalances. Franchisees bear heavy obligations while having limited bargaining power. Standardized contracts are drafted solely by franchisors, leaving franchisees with no opportunity for negotiation.

Key contractual terms affecting franchisees—such as the scope of granted rights, the composition of franchise fees and refund conditions—are often vague or omitted entirely. Additionally, contract provisions tend to favor franchisors, offering little

protection to franchisees. An analysis of sample contracts confirms that franchisors frequently use their dominant position to impose one-sided terms, further exacerbating contractual imbalances.

### 6.3.3 The Practice of Franchisee Protection in the USA, Australia and Malaysia

This section summarizes the research findings of Chapter five and achieves the third research objective. The researcher uses critical methods to analyse the practice of franchisee protection in the USA, Australia and Malaysia, and finally provides valuable lessons for China. Table 6.3 below summarizes the findings of Chapter 5 through critical analysis.

Table 6.3  
*Findings on the practice of Franchisee Protection in the USA, Australia and Malaysia*

Countries	Disclosure	Registration	Contract
USA	<ul style="list-style-type: none"> <li>- Time: At least 14 calendar days before signing the franchise agreement or collecting the franchise fee.</li> <li>- Format: UFOC or FTC format</li> <li>- Delivery: Written or electronic</li> <li>- Contents: 23 disclosures including franchise profile, business experience, litigation, bankruptcy, franchise fees, obligations, finance, renewal, transfer and termination, final contract, public figures, etc.</li> </ul>	<ul style="list-style-type: none"> <li>- Time: Franchisors must register before selling the franchise</li> <li>- Registration materials: Must include FDD</li> <li>- Validity: 1 year.</li> <li>- Exemption: Large franchisors or franchisees (Registration is only available in 14 US states)</li> </ul>	<ul style="list-style-type: none"> <li>- Renewal: Refusal to renew must be for good cause or to repurchase the franchise's inventory or at least 120 days' notice.</li> <li>- Transfer: There must be good cause for refusal of transfer.</li> <li>- Termination: There must be good cause, such as bankruptcy of the franchisor. (Applicable to individual states)</li> </ul>

	<ul style="list-style-type: none"> <li>- Exemptions: Fractional franchise exemption, minimum franchise fee exemption, large franchisee exemption and large investment exemption, etc.</li> <li>- The FTC has the authority to provide relief to injured parties but does not allow private litigation under <i>FTC Franchise rule</i>.</li> </ul>	
	<ul style="list-style-type: none"> <li>- Time: 14 days before signing a franchise agreement or paying a non-refundable fee.</li> <li>- Format: Annexes 1 to the <i>Franchising Code of Conduct</i>.</li> <li>- Delivery: Written or electronic</li> <li>- Content: 25 disclosures, including franchise profile, business experience, litigation, payments and earnings, intellectual property, obligations.</li> <li>- Update: Annually or a reasonable time when franchisor is aware of significant changes.</li> <li>- Cooling-off period: 14 days.</li> <li>- ACCC has a role in enforcement and dispute resolution.</li> </ul>	<ul style="list-style-type: none"> <li>- Prohibit unfair contract terms in stander form contract.</li> <li>- Act in good faith.</li> <li>- Renewal: Notification requirements.</li> <li>- Transfer: There must be good cause for refusal of transfer.</li> <li>- Termination: Early termination with good cause; Notification requirements; Compensation.</li> </ul>
<b>Australia</b>		
<b>Malaysia</b>	<ul style="list-style-type: none"> <li>- Time: 10 days before signing a franchise agreement.</li> <li>- Content: Disclosure includes description of the franchise</li> </ul>	<ul style="list-style-type: none"> <li>- Time: Franchisor must register within 14 days prior to starting the business or selling the</li> <li>- Validity: At least five years.</li> <li>- Renewal: Franchisor cannot refuse unless in</li> </ul>

<p><b>Lessons for China</b></p>	<p>business, estimated initial investment cost, and franchise terms such as renewal and termination, etc.</p> <ul style="list-style-type: none"> <li>- Cooling-off period: 7 days.</li> <li>- The disclosure documents submitted to franchisee must be the same as those submitted for registration.</li> <li>- Non-compliance with disclosure is a crime.</li> <li>- Uniform disclosure format and electronic delivery shall be stipulated.</li> <li>- Content of disclosure should be detailed.</li> <li>- Cooling-off period shall be modified into a specific period.</li> <li>- Disclosure exemption shall be provided</li> <li>- Disclosure time can be calculated from paying a non-refundable fee</li> <li>- Multi-party dispute resolution shall be provided.</li> </ul>	<p>franchise; Franchisee who granted by local franchisor or master franchisee must register within 14 days before signing a franchise agreement.</p> <ul style="list-style-type: none"> <li>- Registration Materials: Disclosure documents, sample agreements, operating and training manuals, updated audited accounts and financial statements.</li> <li>- Validity: 5 years.</li> <li>- Non-compliance with registration is a crime.</li> <li>- The registration time shall be amended to be before franchising.</li> <li>- Disclosure documents shall be registered.</li> <li>- Enforcement should be strengthened.</li> </ul>	<p>default or without prior notice.</p> <ul style="list-style-type: none"> <li>- Buybacks or compensation.</li> <li>- Termination: Franchisor may not terminate earlier, except for good cause. Upon termination, the franchisor shall refund all payments.</li> <li>- Contract terms shall be disclosed.</li> <li>- Franchisor cannot refuse requests for transfer, renewal, or termination without good cause.</li> <li>- Unfair terms should be reviewed.</li> <li>- Additional protections such as notification requirements, buybacks, compensation and good cause should be provided.</li> <li>- Term mandatory.</li> </ul>
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**Source:** Researcher

The researcher critically examined franchising regulation regarding franchisee protection in the USA, Australia and Malaysia to achieve the third research objective. This study focused on reviewing franchisee protection practices in selected jurisdictions with respect to disclosure, registration and contracts. Disclosure requirements are an important regulatory tool for franchising in Australia and the USA. It can be found that the *FTC Franchise Rule* in the USA is essentially a disclosure law. They all provide a uniform disclosure format and detailed disclosure content. Disclosure requirements in the USA and Australia are clearer and more enforceable than in China. Registration, as another important tool in franchise regulation, is highly valued in Malaysia. There are no registration requirements at the federal level in the USA, but registration requirements exist in the 14 registered US states, all of which require registration of disclosure documents. Australia pays more attention to franchise relationship regulation than registration. Franchise contracts are an important regulatory tool in Australia. The *Franchising Code of Conduct* provides additional protections for franchisees including notice requirements, compensation and buybacks. In addition, *Australian Consumer law* prohibits unfair contract terms in standard form contracts. Good faith plays a role throughout the life cycle of franchise contract in Australia.

Regarding the disclosure, the study finds that China can learn from the USA and Australia to refine the content of disclosure and provide a fixed disclosure format. Compared to the USA and Australia, China's disclosures are too broad to be accurately applied. In response, a uniform disclosure model could be developed that would

require franchisors to make disclosures in strict accordance with the required disclosure format and content. Some information regarding franchisee's rights and interests should be further clarified. For example, what guidance and support the franchisor should provide. Franchisor's restrictions on the origin of products or services should be clear. The specific information of the former franchisee should be provided to the investor. How to use the franchise fee, whether to return and how to return it should be clear. The cooling-off period should be clear, for example, drawing on Australia's 14-day cooling-off period.

As for registration, the 14 US states, Australia and Malaysia all require franchisors to register before selling the franchise or entering a franchise contract. However, franchisors are required to register after signing a franchise agreement under the *CFAR 2007*, which results in registered enterprises in China are far less than the actual. In this regard, China should learn from the practice of selected jurisdictions, which require franchisors to be registered before selling their franchises or signing a franchise contract. In addition, registration of disclosure documents is a common practice in selected jurisdictions to enhance transparency. However, China does not require registration of disclosure documents, which is not conducive to franchisees making decisions based on publicly available information. The practice of registering disclosure documents is worth China's reference and learning, and the information disclosed through registration has stronger reliability and authenticity.

In terms of contracts, Australia emphasizes the regulation of franchise relationships through contracts. It is recommended to regulate the entire life cycle of a franchise, including renewal, transfer and termination. The USA, Australia and Malaysia provide additional protection to franchisees through notice requirements, compensation or buyback measures. Franchisor must provide probable cause for early termination of the contract or refusal of franchisee's request to transfer the franchise contract. Malaysia also provides for the return of franchise fees upon termination of the contract. Both Malaysia and China require a minimum term for franchise agreements to give franchisees enough time to obtain a return on the investment. In addition, Australia prohibits the use of unfair clauses in standard form contracts, which provides a possible solution to the application of standard form contracts in China.

#### **6.4 Recommendations of the Study**

This section proposes solutions to improve the protection of franchisees. The key to the solution lies in how to balance the relationship between franchisor and franchisee. Respondents emphasized that achieving a balanced franchise relationship should be the core objective of franchise regulatory reform. Legislation should prioritize franchisee protection and refine the rules on disclosure, registration and contracts. The following suggestions are put forward from three aspects: disclosure, registration and contract.

#### **6.4.1 Clarifying Disclosure Requirements**

*CFAR 2007* stipulates the information disclosure system, but there are loopholes in the relevant provisions, which need to be improved. This study refines and supplements some of the provisions of *CFAR 2007*, which will promote franchisee protection in China. Disclosure requirements must be clarified by adopting good practices from the USA and Australia. A standardized disclosure format should be mandated to ensure uniformity, and franchisors should be required to disclose information strictly in accordance with this format. The language of disclosure must be clear and accessible, with technical terms explained where necessary.

It is suggested to establish an information disclosure procedure with the Information Disclosure Letter as the core content. Franchisor shall provide Franchisee with the Information Disclosure Letter 30 days prior to signing the franchise contract or paying any non-refundable fees. The information disclosure procedure is based on the preparation of the Information Disclosure Letter, which is followed by strict review, publicity, confirmation and signing. Franchisee must confirm in writing that it has received, read, and understood the contents of the Information Disclosure Letter. The Information Disclosure Letter shall be allowed in written or electronic form. A uniform disclosure template, the Information Disclosure Letter, should be developed to specify the content and format of disclosure and be mandatory for franchisor to use.

After the franchisor has disclosed the initial information to the franchisee, subsequent information is also required to be continuously disclosed. The "initial information"

here refers to the information that the franchisor should disclose to potential franchisees before signing of the franchise agreement or paying any non-refundable fees, which plays a key role in their decision to enter the franchise system. The "subsequent information" means that during the franchising process, the franchisor regularly or irregularly provides the franchisee with information that is critical to the franchisee in terms of the events that occur in the franchising system. Specifically, the franchisor shall update the Information Disclosure Letter to the franchisee on a regular basis each year or notifies the franchisee within 30 days of a material change in the franchise.

Some restrictions are recommended when it comes to cooling-off periods. The setting of "cooling-off period" provides a haven for the franchisees to avoid investment risks. The time limit of the cooling-off period becomes the key to protect the interests of franchisor and franchisee. A short cooling-off period is not conducive to the protection of the franchisee. However, a long cooling-off period may cause the right to be abused and damage the rights and interests of the franchisor. Following the example of Australia, the cooling-off period could be set at 14 days from the date of signing the franchise contract.

Furthermore, cooling-off rights can only be applied when the contract is first signed, not when it is renewed or transferred. Finally, the franchisee does not actually use the franchisor's operating resources. The following Table 6.4 describes the current disclosure requirements of *CFAR 2007* and the proposed amendments.

Table 6.4

*The Current Disclosure Requirements of CFAR 2007 and the Proposed Amendments*

Current Disclosure Requirements	Proposed Amendments
<p>Article 21</p> <p>"The franchisor shall provide the franchisee with the information provided in Article 22 of <i>CFAR 2007</i> in writing within 30 days prior to the conclusion of the franchise contract"</p>	<ul style="list-style-type: none"> <li>- The franchisor shall provide the franchisee with the Information Disclosure Letter in writing or electronically within 30 days prior to signing the franchise contract or paying any non-refundable fees.</li> <li>- Franchisor must make disclosures in strict accordance with the format and content of Information Disclosure Letter set forth in Appendix 1.</li> <li>- Written or electronic disclosure is allowed.</li> </ul>
<p>Article 23, paragraph 2</p> <p>"Where there is a major change in the information provided by the franchisor to the franchisee, it shall promptly notify the franchisee."</p>	<ul style="list-style-type: none"> <li>- The franchisor shall confirm and update the Information Disclosure Letter annually. If the information provided by the franchisor changes significantly, it shall notify the franchisor within 30 days from the date on which the franchisor becomes aware of the significant change. Significant changes such as a change in ownership or control of the franchisor or franchise system; the Franchisor is subject to litigation or administrative penalties.</li> </ul>
<p>Article 12</p> <p>"The franchisor and the franchisee shall agree in the franchise contract that the franchisee may unilaterally terminate the contract within a certain period of time after the conclusion of the franchise contract."</p>	<ul style="list-style-type: none"> <li>- After the conclusion of the franchise contract, the franchisee is entitled to a 14-day cooling-off period, during which the franchisee can unilaterally terminate the contract without penalty.</li> <li>- Except that the franchisee has utilized the business resources.</li> </ul>

**Source:** Researcher

In addition to some of the proposed amendments to the disclosure provisions in Table 6.4 above, the researcher also suggests adding some provisions to improve the current disclosure requirements of *CFAR 2007*.

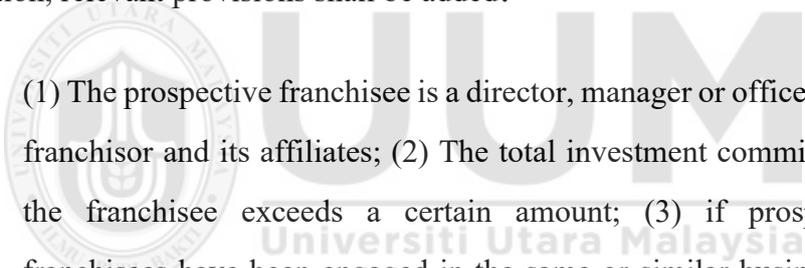
Regarding the content of disclosure, the provisions of *CFAR 2007* are too general. With reference to the provisions of the UFOC format, at least the following contents should be added in the Information Disclosure Letter:

- (1) Basic information of the franchisor's predecessor and related parties;
- (2) The basic information of the franchisor's directors, partners, senior management and other key personnel and their business experience in the past five years;
- (3) the involvement of the franchisor, its predecessor, related parties, directors and senior management in the past ten years;
- (4) the bankruptcy experience of the franchisor, its predecessor, related parties, directors and senior management in the past ten years;
- (5) The number of franchisees and the total number of directly operated stores owned by Franchisor and its affiliates;
- (6) Information and contact details of franchisees who have withdrawn from the franchise system within the last three fiscal years.

Given that the impact of non-compliance disclosure on the validity of a contract remains contentious in judicial practice, legislation should clarify this matter further. Legislation should explicitly stipulate that if a franchisor conceals relevant information or provides false information, materially affecting the formation of the contract, the franchisee has the right to initiate litigation or arbitration for rescission of contract. However, rescission of contract may result in unrecoverable costs incurred by the

franchisee. Therefore, legislation should grant the franchisee the option to either cancel the contract or continue its performance.

Franchisor respondents pointed out that the more information disclosure is not the better, when the cost of information disclosure is greater than the benefit, the enthusiasm of franchising is greatly discouraged. Therefore, it is necessary to balance the disclosure cost of franchisors and the informed protection of franchisees. For this reason, the USA exempted the franchisor from the obligation of information disclosure in the certain cases, which is worth learning from China. Regarding the disclosure exemption, relevant provisions shall be added:

- 
- (1) The prospective franchisee is a director, manager or officer of the franchisor and its affiliates;
  - (2) The total investment committed by the franchisee exceeds a certain amount;
  - (3) if prospective franchisees have been engaged in the same or similar business for two years or more;
  - (4) In the case of franchise renewal, transfer, extension, etc., the original franchise agreement has performed the disclosure procedure and regularly updated the disclosure information.

#### **6.4.2 Strengthening Registration Requirements**

Article 3 of *CFAR 2007* only lists four franchised business resources, namely registered trademarks, corporate logos, patents, and proprietary technology. However, the Beijing High Court held that business resources also include business name, trade secrets, unique overall business image, and unregistered trademarks that have been

used first and have certain influence, which can form a certain market competitive advantage. The Shanghai High Court also held that business resources with intellectual property attributes such as trade secrets, trade names and unregistered trademarks that have been utilized previously and possess a certain influence should be included. To unify court practice and franchise legislation, the researcher suggests adding types of business resources, especially business names, trade secrets, and unique overall business images. An unregistered trademark that meets both the conditions of prior use and certain influence shall also be regarded as a business resource.

According to the current disclosure requirements of *CFIDAM 2012*, franchise registration is what the franchisor should disclose to the franchisee before entering a franchise contract. However, the current registration requirements of *CFAR 2007* stipulate that the franchisor performs the registration obligation after the franchise contract is signed, which contradicts the disclosure requirements. This study finds all selected jurisdictions require franchises to be registered before entering the franchise agreement. Due to the current post-contract registration regulations, franchise registration rates are low in China. Some businesses start franchising directly without registering to avoid regulation, which brings great risks to franchisees. It is necessary to revise the registration time to before signing a franchise contract or selling a franchise. Stricter enforcement of franchise registration is essential. Drawing from Malaysia's experience, authorities should strengthen compliance measures to ensure franchisors fulfill their registration obligations.

In addition, Article 8 of *CFAR 2007* specifies the materials to be submitted for registration. Some franchisees interviewed indicated that disclosure information provided by franchisors was inconsistent with *CFAR 2007* regulations. It is suggested that the registration department urge the franchisor to improve the registration information in strict accordance with the statutory requirements. The implementation of registration requirements can be strengthened by learning from Malaysia. For example, disclosure documents provided to franchisees must be consistent with those submitted for registration; Severely punish registration noncompliance. In view of the common practice in selected jurisdictions, it is recommended that China introduce requirements for registration disclosure documents to increase the transparency of the franchise regulatory process. The following Table 6.5 describes the current registration requirements of *CFAR 2007* and the proposed amendments.

Table 6.5  
*The Current Registration Requirements of CFAR 2007 and the Proposed Amendments*

<b>Current Registration Requirements</b>	<b>Proposed Amendments</b>
<p>Article 3</p> <p>"Franchising refers to the business activities in which an enterprise (franchisor), which owns registered trademarks, enterprise logos, patents, proprietary technologies and other business resources..."</p>	<p>Amend the text of article 3 to specify the types of other business resources. It becomes as follows:</p> <p>"Franchising refers to the business activities in which an enterprise (franchisor), which owns registered trademarks, enterprise logos, patents, proprietary technologies, business name, trade secrets, unique overall business image, and unregistered trademarks that have been used first and have certain influence..."</p>
<p>Article 8, paragraph 1</p> <p>"The franchisor shall, within 15 days from the date of the first signing of the franchise</p>	<p>Amend the text of Article 8, paragraph 1 to make the time of registration of a franchise read as follows:</p>

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contract, register with the competent department of commerce..."

"The franchisor shall register with the competent department of commerce within 15 days before signing the franchise contract or selling the franchise..."

Amend the text of article 8, paragraph 2, by adding registration Information Disclosure Letter to enhance transparency, to read as follows:

Article 8, paragraph 2

"The franchisor shall submit the following materials for registration:

- (1) A copy of the business license.
- (2) Sample franchise contract.
- (3) Franchise operation manual.
- (4) Market plan..."

"The franchisor shall submit the following materials for registration:

- (1) A copy of the business license.
- (2) Sample franchise contract.
- (3) Franchise operation manual.
- (4) Market plan.
- (5) Information Disclosure Letter..."

Article 25

"Where the franchisor fails to register with the competent department of commerce in accordance with Article 8, the competent department of commerce shall order the registration within a time limit and impose a fine of not less than 10,000 yuan but not more than 50,000 yuan; Those who still fail to register within the time limit shall be imposed a fine of not less than 50,000 yuan but not more than 100,000 yuan, and a public announcement shall be made."

Amend the text of Article 25 to increase the amount of fines for non-compliance with registration and impose a ban on franchisors who refuse to make corrections, to read as follows:

"If the franchisor fails to register with the competent department of commerce in accordance with Article 8, the competent department of commerce shall order it to put on record within 15 days, impose a fine of not less than 50,000 yuan but not more than 100,000 yuan, and announce the illegal acts; Those who fail to register more than 15 days will be fined between 100,000 and 300,000 yuan and banned from franchising for 5 years."

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**Source:** Researcher

### 6.4.3 Refining Contractual Requirements

Franchisees' right to participate in contract negotiations should be safeguarded. Given their weaker bargaining position, franchisees should be granted greater contractual

protection to ensure fairness in agreements. Contracts should be based on equality and voluntariness, in line with the principle of contract fairness. It should also provide clearer guidance on the legal framework applicable to franchise disputes, while *CFAR 2007*, as an administrative regulation, should avoid excessive interference in private contractual matters.

Because of its intellectual property attributes, franchise contracts are similar to traditional types of contracts such as intellectual property license contracts, which brings challenges to the court's trial of relevant cases, especially in the judgment of the nature of contracts and the confirmation of jurisdiction. A more typical example is that the grassroots court recognizes such cases as intellectual property dispute cases, arguing that they do not belong to their own jurisdiction but should be under the jurisdiction of the intellectual property court. In addition, *CFAR 2007* is an administrative regulation issued by the State Council, rather than national legislation of the NPC, leading to its limited scope of application. Therefore, this study suggests that China should provide for franchise contracts separately in the *Civil Code* contracts.

Under Article 13 of *CFAR 2007*, the minimum term of the franchise agreement is three years, but the parties are allowed to agree in the contract for a shorter term. In practice, franchise agreements are mostly standard form contracts offered unilaterally by franchisors, and franchisees rarely have the possibility to negotiate. This results in the franchise term being determined by the franchisor rather than based on negotiation between the parties to the contract. Malaysia provides for a mandatory period of not

less than five years for franchise contracts. Although China has made a franchise contract period of no less than 3 years, but it is not mandatory. Franchising is a continuous investment business. The longer the term of the franchise contract, the greater the probability that the franchisee will receive a return on its investment. Therefore, it is proposed that the provisions of Article 13 of *CFAR 2007* on the duration of franchise agreements be made mandatory to avoid franchisors intentionally shortening the duration of franchise agreements.

Article 18 of *CFAR 2007* sets out the franchisor's obligation to provide support and guidance to franchisees. Unfortunately, the legislation is silent on exactly what kind of support franchisors should provide. The franchisor uses a standard form contract, where the details of support and guidance are set by the franchisor in advance, and the franchisee can only take it or leave it without bargaining. Since the franchisee has no bargaining and negotiation ability, it is impossible for the two parties to agree on the content and method of support in the contract through friendly negotiation.

It is suggested that legislation should set up mandatory support clauses to clarify the specific content of support provided by franchisors. The following is a Support Schedule proposed in this study for legislative reference.

Table 6.6  
Proposed Support Schedule

Time	Type of Support	Details of Support
Pre-operational support	Site selection	- Market research evaluation.
		- Business circle analysis.
	Decoration design	- Market competition analysis.
		- Store location evaluation.
		- Provide uniform store design.
		- Provide uniform shelves.
Information system installation	- Decoration guidance, supervision, and review.	
	- Purchase-sales-inventory management system.	
Pre-opening support	Information system installation	- Sales analysis system.
		- Member management system.
		- Offer opening program.
	Pre-opening support	- Planning and supporting opening promotion activities.
		- Pre-opening staff training.
		- Pre-opening management. information system training.
Support during operation	Operation training	- Opening ceremony assistance.
		- Daily operation management training.
		- Regular supervision and guidance.
	Advertising	- Provide operational guidance reports.
		- Provide on-site training.
		- Organize industry exhibitions.
Product configuration	Advertising	- Maintain and upgrade the store image.
		- Media advertising in the store.
		- Promotional support.
Product configuration	Product configuration	- The origin of the product, service, or equipment
		- Prices and conditions of products, services, or equipment.

Source: Researcher

Notably, neither the *Civil Code* nor *CFAR 2007* are silent on the renewal of franchise agreements. Article 18 of *CFAR 2007* provides that the franchisee may transfer the franchise to a third party with the consent of the franchisor. However, franchisees are in a weak position, and it is difficult to negotiate a transfer agreement from the franchisor. The researcher suggests that legislation should allow franchisees to transfer franchises while giving franchisors the right of first refusal if the conditions are the same for transferees and franchisees.

In addition, Chapter 5 indicates that in the selected jurisdiction, the franchisor may not deny a franchisee's request for renewal or transfer without good cause and provides for a notice requirement. China can learn from this and provide additional protection to franchisees by setting reasonable cause, notice requirements and compensation clauses. The following Table 6.7 describes the current contractual requirements of *CFAR 2007* and the proposed amendments.

Table 6.7  
*The Current Contractual Requirements of CFAR 2007 and the Proposed Amendments*

<b>Current Contractual Requirements</b>	<b>Proposed Amendments</b>
Article 13 "The franchise term stipulated in the franchise contract shall not be less than three years. Except with the consent of the franchisee."	It should be amended as a mandatory provision to read as follows: "The term of the franchise contract shall not be less than three years. Otherwise, the contract is void."

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#### Article 14

"The franchisor shall provide the Franchisee with the franchise operation manual, and continue to provide the franchisee with business guidance, technical support, business training and other services in accordance with the agreed contents and methods."

It should be amended as a mandatory provision to read as follows:

"The franchisor shall provide the franchisee with the franchise Operation Manual and the Support Schedule to clarify the items supported by the franchisor."

- If the transferee meets the requirements of the franchisor, it shall allow the franchisee to transfer. Under the same conditions, Franchisor has the right of first refusal.

- Franchisee shall give 30 days' written notice of transfer to franchisor.

- Franchisor shall not refuse franchisee's transfer request without good cause. The good cause can be that the potential transferee cannot meet the franchisor's required business experience or financial ability standards.

#### Article 18

"Without the consent of the franchisor, the franchisee shall not transfer the franchise right to another person."

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**Source:** Researcher

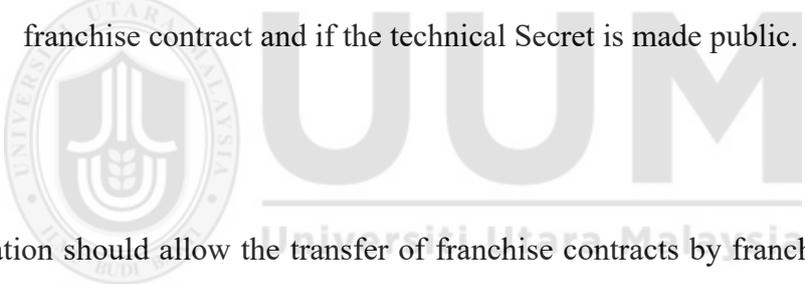
In addition to some of the proposed amendments to the contract provisions in Table 6.7 above, the researcher also suggests adding some provisions to improve the current contractual protection for franchisees. The legislation should require the franchisor or supplier to supply the franchisee and disclose the purchase agreement to the franchisee within a reasonable period. When the franchisor requires Franchisee to purchase products only from its designated suppliers, the franchisor shall be jointly and severally liable for the quality of the products. Regarding the restrictions on competition, the following provisions are permitted:

- (1) necessary for the protection of intellectual property rights and the maintenance of the identity and reputation of the franchise

system; (2) The franchisor does not abuse its dominant market position; (3) The franchisor has no object or intention to exclude or restrict competition.

The following provisions shall be prohibited:

(1) directly or indirectly restrict the franchisee from determining the price of the franchised product or service; (2) Restrict Franchisee to purchase and use only products or services provided by franchisor or third parties designated by Franchisee, not to guarantee the quality of the franchise products or services; (3) Restrict the franchisee to sell outside the agreed territory; (4) Prohibit Franchisee from continuing to use the technical secret after the expiration of the franchise contract and if the technical Secret is made public.



Legislation should allow the transfer of franchise contracts by franchisees. First, the franchisee should apply to the franchisor in writing for the transfer of the franchise contract and provide the relevant information of the transferee. Secondly, the franchisor has the right to refuse the transfer if the transferee does not meet the Franchisor's reasonable qualifications, provided that the reason is given, and Franchisee is notified in writing. Thirdly, the franchisor shall be deemed to agree to the transfer if he does not reply within 30 days after receiving the application. Fourth, where the franchisee transfers the franchise contract, the franchisor or the third party designated by the franchisor shall enjoy the priority of assignment under the same conditions.

Most franchisee respondents indicated that they would like to renew their franchise contract after its term expires because of the long payback period required for the large upfront investment. This study recommends that this legitimate request be allowed. The USA requires the franchisor to give a good reason for refusing the renewal request of the franchisee, which is worth learning from China. The expiration of the term is one of the legal circumstances of the termination of the contract. If the party want to renew the contract, it shall apply and obtain the consent of the other party. Therefore, to protect the autonomy of the parties, the franchisee should apply for renewal within 3 months before the expiration of the contract, and the franchisor should not refuse to renew the contract without good reason. The franchisor shall give franchisee at least 3 months 'notice of non-renewal and repurchase of the Franchisee's inventory.

To balance the contractual relationship, legislation often gives the weak party the right to terminate the contract arbitrarily. For example, to protect the workers in a vulnerable position, the labor law only stipulates the right of the workers to terminate the contract arbitrarily, preventing the employer from arbitrarily terminating the contract and harming the interests of the workers. Similarly, franchisees in franchise contracts are in a vulnerable position and need special protection by legislation. Therefore, drawing on the legislative experience of the USA and Australia, the franchisor must have a good cause for termination. Good cause include:

- (1) The franchisee is bankrupt;
- (2) The franchisee gives up continuing business during the contract period;
- (3) The franchisee seriously denigrates or damages the business and goodwill of the

franchise system in the course of operating the franchise business;

(4) The franchisee continues to commit the same breach within 30 days after the material breach is corrected; (5) The franchisee violates the terms of the contract twice or more consecutively; (6) The franchise business or premises are seized, taken over or confiscated by government authorities or creditors; (7) The franchisee has committed a serious crime or other criminal offense in connection with the franchising business.

Franchisee shall be compensated for termination of the contract for reasons not attributable to the franchisee. The respondents stated that after the termination of the contract, the franchisee faced losses such as that the previous equipment investment could not be recovered as planned, and the inventory could not be properly disposed of. In order to minimize the loss caused by the termination of the contract to the franchisee without fault, it is proposed to legislate the franchisor's obligation to buy back the equipment and inventory purchased by the franchisee. For example, when the franchisor's trade name, trademark and other intellectual property rights are changed, it will endanger the interests of the franchisee. At this point, the Franchisee has the right to terminate the contract and ask the franchisor to buy back the equipment and inventory.

### **6.5 Possible Aspects for Future Studies**

Although the issue of franchisee protection has been increasingly concerned by the society, the research on the franchising regulation from the perspective of franchisee protection is still blank in China. From the perspective of franchisee protection, this

study analyses the current franchise regulatory framework and franchisee protection practices through doctrinal and qualitative legal research. However, this study used the interview method in qualitative research to collect data, which has limitations. It is difficult to conduct quantitative research on the interview results, which limits the generalization of the survey results. Future research suggests a combination of qualitative and quantitative data collection methods to confirm and statistically validate the results of this study.

Furthermore, there is currently no specific legislation in China that clarifies the external liability of the franchisor for damages caused by the franchisee to third parties in franchise operations. One respondent referred to actual situations in which franchisees may be held liable for damages to third parties caused by the franchisor's improper control of the franchise system. This involves the issue of vicarious liability of the franchisor to the third party. However, China's existing legislation and theory are silent on this issue. This could be a meaningful area for future research. Whether or not the franchisor should bear external liability, what form of liability the franchisor should bear under the claim of external liability, and how to define liability, are worthy of further discussion. Future studies can start from this perspective to discuss the vicarious liability that the franchisor should bear externally and analyses the various aspects that must be involved in the legislation of franchisee vicarious liability.

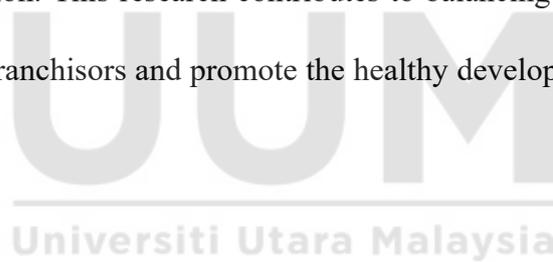
Finally, while this study selected franchising industries with well-represented sectors beverage, retail and hospitality, future research suggests focusing on specific

industries and being more targeted. To establish and perfect the legal framework of the protection of franchisees needs more in-depth research and argumentation. Despite the initial attempt of this study, the regulatory approach to franchisee protection proposed in this study may not be applicable to all franchise sectors, and specific franchise sectors need to be specifically discussed in future studies. The establishment of compulsory franchise dispute mediation system and special franchisee association, etc., need to be further explored in the future study. However, the researcher attempted to provide an in-depth analysis of important regulatory means to protect franchisees in the areas of disclosure, registration and contracting. Finally, it contributes to improving the legal and regulatory framework for franchisee protection in China.

## **6.6 Conclusion**

Franchising, as a successful business model in market economies, plays a crucial and positive role in promoting the socio-economic development of China. However, the current legal and regulatory framework governing franchising requires further refinement to address the unfair practices against franchisees in practical operations. This study aims to enhance the current franchisee protection under the franchising regulation in China. By studying the current regulation of franchising, examining the current protection of franchisees, analysing the protection practices of franchisees in selected jurisdictions and putting forward suggestions for improvement, this study answers four research questions and achieves four research objectives accordingly.

This study has systematically analysed the legal and regulatory framework for franchising in China, focusing on disclosure, registration and contract means for franchisee protection. The research finds that the current legal documents of franchise regulation are mainly *CFAR 2007* and supplemented by the *Civil Code*. Nevertheless, the current legal and regulatory framework still has legal loopholes in franchisee protection that require further legislative improvement. Additionally, by reviewing practices from jurisdictions such as the USA, Australia and Malaysia, this research highlights valuable lessons that can be adapted to China's legal and regulatory environment. Finally, this study provides legislative suggestions for improving the current franchisee protection. This research contributes to balancing the relationship between franchisees and franchisors and promote the healthy development of China's franchise market.



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## APPENDICES

### Appendix A

#### Informed Consent Form



College of Law, Ghazali Shafie Graduate School of Government

#### INFORMED CONSENT FORM

Title: A Study on Franchisee Protection under the Franchising Regulation in China

Thank you for affording me the opportunity to meet with you today. My name is Huang Xinbo, and I am pursuing my PhD at the Universiti Utara Malaysia. My research focuses on examining Franchisee Protection under the Franchising Regulation in China. I cordially invite your participation in this study. Your cooperation would be greatly appreciated.

If you decide to participate, please suggest the most convenient time and venue. It will take approximately one hour to complete the interview. Attached herewith the guided questions for my study for your attention and pursual.

The completion of this consent form is essential for us to ensure your comprehension of the purpose of your participation and agreement to the terms thereof. Therefore, your signature indicates that, you acknowledge and accept the following:

	<b>I agree to participate in the interview.</b>
	I agree to my interview being recorded.
	I agree to be quoted directly.
	I agree to be quoted directly if my name is not published, and a made-up name (pseudonym) is used.
	I agree that the researcher may publish documents that contain quotations by me.
	I agree to being contacted again by the researcher if my responses give rise to interesting findings.

Mark (✓) in the available column

With full knowledge of all foregoing, I have read the information sheet and verified the interview transcript.

<b>Consent taken by</b>	
Occupation	
Signature	
Date	

## **Appendix B**

### **Interview Protocol**

#### **Introduction**

This interview is part of a study that focuses on legal issues related to franchisee protection under franchising regulation in China. The objectives of the thesis are to analyse the current franchising regulation in China; to examine how franchising regulation in China protects franchisees; to analyse the practices of franchisee protection in the UAS, Australia and Malaysia; and to propose recommendations for improving the franchising regulation to better protect franchisees. Twenty-one respondents were selected, including franchisors, potential franchisees, franchisees, lawyers and regulators.

#### **Interview Process**

1. Interviews will be conducted by way of a mixture of face to face and online interviews.
2. Each respondent will be provided with an informed consent form. Each respondent will be required to sign this form and be given a copy of the signed form.
3. The researcher plans to translate the consent form and interview questions into Mandarin and present them to each respondent. (Mandarin was used during the interviews).
4. All interviews began with a brief introduction to the research project.

5. Interviews are based on an interview guide that included key questions prepared in advance by the researcher.
6. During the interaction with the respondent, permission will be given to talk about further questions that were not foreseen by the researcher but would be useful for the study.
7. The researcher plans to authenticate and strengthen the data from the interviews with data collected from the franchisor's existing franchise agreements. Data from franchise agreements are used to support the findings of the interviews.

### **Interview Questions**

#### Questions for Franchisors

1. How long have you been franchising?
2. Why did you franchise your business?
3. How would you describe your relationship with the franchisee?
4. Do you use standard form contracts? Why?
5. What do you think of the current regulatory environment for franchisors?
6. What do you think of the current franchise disclosure, registration and contract?
7. What aspects of franchising regulation do you think have had the most impact on your business activities?
8. Do you have any suggestions on disclosure, registration and contractual aspects?  
Why?

#### Questions for Franchisees or Potential Franchisees

1. Why choose to become a franchisee instead of starting your own business?
2. Do you have any previous business experience?
3. How would you describe your relationship with the franchisor?
4. Do you feel disadvantaged as a franchisee? Why?
5. What do you think of the current franchise disclosure, registration and contract?
6. Did you read and understand the disclosure statement before signing the franchise contract?
7. Do you think the franchise agreement protects your rights?
8. What do you think of the current regulatory environment for franchisees?
9. Do you have any suggestions on disclosure, registration and contractual aspects?

Why?

Questions for Lawyers



1. When do lawyers begin to intervene in franchising businesses?
2. What do you think are the main issues in the franchise relationship?
3. What do you think of the current franchise disclosure, registration and contract?
4. To what extent do you think current franchising regulation protects franchisees?
5. What are your suggestions to improve the current situation?

Questions for regulators

1. Is the plaintiff in a franchise case usually the franchisor or the franchisee? What are their requests?
2. What do you think are the main issues in the franchise relationship?

3. What do you think of the current franchise disclosure, registration and contract?
4. What are the main violations of franchisors?
5. What are the responsibilities for violations?
6. To what extent do you think current franchising regulation protects franchisees?
7. What are your suggestions to improve the current situation?

