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## Disclosure and Registration Requirements in Franchising: Common Law or Civil Perspective?

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# DISCLOSURE AND REGISTRATION REQUIREMENTS IN FRANCHISING: COMMON LAW OR CIVIL PERSPECTIVE?

Radwa Elsaman\*

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## I. INTRODUCTION

Disclosure and registration are critical steps in the process of franchising for countries where franchise laws are essentially disclosure laws. Disclosure laws require franchisors to disclose to potential franchisees specific, material information that would materially affect the franchisee's decision of whether to invest.<sup>1</sup> In addition, registration rules require registering disclosure documents with the competent governmental agency.<sup>2</sup>

Disclosure and registration requirements give franchisees access to necessary information about the franchised business, the franchisor, and the potential franchise agreement.<sup>3</sup> Having access to such information assists potential franchisees in reaching an informed investment decision and helps the franchisor to be more confident that the franchisee meets his requirements, as he concludes the transaction knowing that all the necessary information has been disclosed by the franchisor.<sup>4</sup> Moreover, disclosure and registration reduce the risk of fraud, misunderstanding between the contracting parties, and false expectations based on uncertain assumptions.<sup>5</sup> In short, disclosure and registration reduce the chances the franchise will fail, as both parties come to know all the necessary information about the other.

Franchise disclosure laws vary from country to country, and there is no uniformity on what issues must be disclosed, the format of disclosure, or the language of disclosure.<sup>6</sup> The most common issues requiring disclosure include information about the franchisor—such as the background of its officers and directors, litigation history, bankruptcy history, and financial statements. Disclosed issues also include information on the franchised system such as intellectual property information, advertising programs, and training programs.<sup>7</sup> Moreover, these requirements include information such as site selection, restrictions on sales, and initial investment.<sup>8</sup> Finally, information on the proposed agreement such as initial fees, territorial rights, dispute resolutions, term, transfer, and termination of the agreement are usually included.<sup>9</sup>

The United States is one of four leading common-law countries that have franchise legislation, and one of six countries that has revised its legislation since 2000.<sup>10</sup> As a civil-law country, China has both disclosure laws and rules that regulate the substantive

1. See, e.g., 16 C.F.R. pts. 436–37 (setting forth the Federal Trade Commission's ("FTC") "Franchise Rule" on disclosures to prospective purchasers).

2. See, e.g., Anthony J. Marks, *An Overview of U.S. Franchise Laws*, in REPRESENTING THE GROWING BUSINESS: TAX, CORPORATE, SECURITIES, AND ACCOUNTING ISSUES 622–24 (2008) (noting and describing the various state registration laws in the United States).

3. See, e.g., 16 C.F.R. § 436.5 (giving extensive requirements on what a franchisor is required to disclose).

4. Jay Clayton & William H. Hinman, *The Importance of Disclosure For Investors, Markets and Our Fight Against COVID-19*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 10, 2020), <https://bit.ly/3M5R6PC> (observing that "[h]igh quality disclosure . . . provide[s] benefits to investors and companies . . .").

5. Karen B. Satterlee & Kerry L. Bundy, "You Made Me Do It": Reliance in Franchise Fraud Cases, 26 FRANCHISE L.J. 191, 196 (2007).

6. See discussion *infra* Part II.

7. See, e.g., 16 C.F.R. § 436.5(b)–(d).

8. See, e.g., *id.* at (i), (g).

9. See, e.g., *id.* at (e), (l), (q).

10. ELIZABETH CRAWFORD SPENCER, THE REGULATION OF FRANCHISING IN THE NEW GLOBAL ECONOMY 212–18 (2010).

relationship of a franchising agreement's parties.<sup>11</sup> The U.S. law on franchising is sophisticated, including federal and state franchise rules.<sup>12</sup> U.S. federal law is mainly disclosure law, while state law includes both disclosure and registration law, as well as relationship law.<sup>13</sup> The U.S. also has business opportunity laws<sup>14</sup> and specialized laws regulating specific franchising industries.<sup>15</sup> In China, as in other civil-law countries, the hierarchy of legal rules begins with laws or codes that set forth the general rules applicable to different aspects of legal transactions, followed by guiding and explanatory regulations, decrees, orders, and ordinances.<sup>16</sup> Like the U.S., Chinese franchising law regulates all aspects of franchising, including disclosure, registration, and the relationship between the parties.<sup>17</sup> In addition to the franchise-specific regulations and measures, franchise agreements in China are usually subject to the general rules of certain bodies of law, like contract law.<sup>18</sup> The fact that both countries have disclosure laws on franchising does not mean that both systems are similar. Disclosure formats, language, term, and document requirements vary from one jurisdiction to another, resulting in various impacts on the businesses and investors in the franchising industry.<sup>19</sup>

This Article compares disclosure rules in the United States and China—two countries that comprise the largest franchise markets in the world. The U.S. economy is the world's second largest franchise market, after the European Union, with up to seven percent of its GDP coming from franchising.<sup>20</sup> For instance, in 2022, the US had more than 792,000 franchising establishments.<sup>21</sup> Similarly, China has a very promising economy—the world's largest by GDP (PPP)—and one of the largest franchise markets in the world.<sup>22</sup> That said, this Article first lists the laws regulating disclosure in both systems. It then analyzes the legal nature and scope of application of disclosure laws in both countries before it examines disclosure mechanisms and content. Finally, this Article elaborates on the related issue of registration requirements under both systems.

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11. Paul Jones, *The Regulation of Franchising in China and the Development of a Civil Law Legal System*, 2 CHINESE L. & POL'Y REV. 78, 82–90, 93–94 (2006).

12. *See, e.g.*, Marks, *supra* note 2, at 622–24.

13. *Id.* at 622.

14. *Id.* at 625–26.

15. *See generally* 15 U.S.C. §§ 1221–25 (codifying the Petroleum Marketing Practices Act and the Automobile Dealer Franchise Act).

16. Paul Jones & Erik Wulff, *Franchise Regulation in China: Law, Regulations, and Guidelines*, 27 FRANCHISE L.J. 57, 57 (2007).

17. *See generally* Jones, *supra* note 11.

18. *See, e.g.*, Zhōnghuá rénmín gònghéguó hétóng fǎ (中华人民共和国合同法) [Contract Law of The People's Republic of China] (promulgated by the Nat'l People's Cong., Mar. 15, 1999, effective Oct. 1, 1999) (Lawinfochina) (China) (hereinafter Chinese Contract Law).

19. *See id.*

20. *A Look at How Franchises Impact the Economy*, FRANCHISE DIRECT (July 26, 2022), <https://www.franchisedirect.com/information/a-look-at-how-franchises-impact-the-economy>.

21. INTERNATIONAL FRANCHISE ASSOCIATION, 2022 FRANCHISING ECONOMIC OUTLOOK ii, <https://www.franchise.org/sites/default/files/2022-02/2022%20Franchising%20Economic%20Outlook.pdf> (last accessed May 7, 2023).

22. *China*, in THE WORLD FACT BOOK, <https://www.cia.gov/the-world-factbook/countries/china/> (last updated Apr. 26, 2023); *Market Intelligence: China Franchising Market*, INT'L TRADE ADMIN. (Jan. 6, 2022), <https://www.trade.gov/market-intelligence/china-franchising-market>. Many well-known American franchises have already entered the Chinese market, including KFC, McDonalds, Pizza Hut, and Taco Bell. Ilan Alon & Michael Alexander Kruesi, *The enigma of franchising in China*, J. BUS. STRAT., Nov. 2019, at 1–2.

## II. AN OVERVIEW OF THE LAWS REGULATING DISCLOSURE IN CHINA AND THE U.S.

On the federal level, the Federal Trade Commission's ("FTC") "New Rule" governs franchising in the U.S.<sup>23</sup> In addition, the Federal Disclosure Documents account for disclosure standards across the various state regulations.<sup>24</sup> Beyond the federal requirements, many states have pre-sale disclosure and registration laws.<sup>25</sup> State laws work as gap fillers for the federal disclosure and registration laws<sup>26</sup> and generally follow federal law, with some differences regarding the definition and elements of a franchise, disclosure requirements, and exemptions.<sup>27</sup> Though federal franchise rules regulate only disclosure and registration, some state laws regulate the relationship between the franchising parties in addition to disclosure.<sup>28</sup> Conflicts of law may arise between federal franchise rules and state disclosure and registration laws. The New Rule addressed this issue by clarifying that it does not prevent application of any state franchise law, unless the state law contradicts the New Rule.<sup>29</sup> States must accept the federal rules as baseline protections but are free to promulgate more restrictive rules.<sup>30</sup> Conflicts will not occur, therefore, so long as the state laws confer equal or better protection than that provided by the New Rule.<sup>31</sup>

In China, the Regulations on Administration of Commercial Franchise, or the "Chinese New Regulations," regulate franchising transactions.<sup>32</sup> In addition, franchisors in China should consider the Company Law<sup>33</sup> and the Arbitration Law.<sup>34</sup> Moreover, Chinese intellectual property laws are closely connected to franchising, and consist of the

23. 16 C.F.R. § 436.

24. Rochelle B. Spandorf & Mark B. Forseth, *Franchise Registration*, in *FUNDAMENTALS OF FRANCHISING* 154–55 (Rupert M. Barkoff & Andrew C. Selden eds., 3d ed. 2008).

25. Brian B. Schnell & Sarah J. Yatchak, *Let's Make a Deal: Developing a Successful Franchise Resale Program*, 27 *FRANCHISE L.J.* 215, 217 (2008).

26. Rupert M. Barkoff, *Franchise Sales Regulation Reform: Taking the Noose off the Golden Goose*, 3 *ENTREPRENEURIAL BUS. L.J.* 233, 246 (2009).

27. *Id.* at 249–50.

28. See SPENCER, *supra* note 10, at 222.

29. Gerald C. Wells & Dennis E. Wieczorek, *A Road Map to the New FTC Franchise Rule*, 27 *FRANCHISE L.J.* 105, 105 (2007). See also Karen B. Satterlee & Leslie D. Curran, *Exemption Based Franchising: Are You Playing in a Minefield?*, 28 *FRANCHISE L.J.* 191, 195 (2009).

30. Wells & Wieczorek, *supra* note 29, at 105.

31. *Id.* See also David W. Oppenheim, *Changes in State Franchising Registration and Disclosure Laws as a Result of the Federal Trade Commission's Revised Franchise Rule*, 6 *INT'L J. FRANCHISING L.* 37 (2008).

32. Shāngyè tèxǔ jīngyíng guǎnlǐ tiáolì (商业特许经营管理条例) [Regulations on Administration of Commercial Franchises] (promulgated by the State Council of China, art. 5, Jan. 31, 2007, effective May 1, 2007) (Lawinfochina) (China) (hereinafter Chinese New Regulations). See also Philip F. Zeidman, *China: 2010 and Beyond*, *FRANCHISING WORLD* (Jan. 2010) (on file with author); Bryan W. Blades, *Franchising in China: A Current Perspective*, 14 *CURRENTS INT'L TRADE L.J.* 20, 22–28 (2005).

33. Zhōnghuá rénmín gònghéguó gōngsī fǎ (中华人民共和国公司法) [Company Law of the People's Republic of China] (promulgated by the Standing Comm. of the Nat'l People's Cong., Dec. 29, 1993, effective Jan. 1, 2006) P.R.C. Laws (China).

34. Zhōnghuá rénmín gònghéguó zhòngcái fǎ (中华人民共和国仲裁法) [Arbitration Law of the People's Republic of China] (promulgated by the Standing Comm. of the Nat'l People's Cong., Aug. 31, 1994, effective Sept. 1, 1995) P.R.C. Laws (China).

Copyright Law,<sup>35</sup> the Law on Unfair Competition,<sup>36</sup> the Patent Law,<sup>37</sup> the Trademark Law,<sup>38</sup> and the Anti-Monopoly Law.<sup>39</sup>

### III. THE LEGAL NATURE AND SCOPE OF DISCLOSURE LAWS

As explained earlier, in the United States the New Rule is essentially a disclosure law, and it applies to all franchise transactions located in the United States or any of its territories.<sup>40</sup> The New Rule, however, exempts various transactions from its scope of application that merit discussion here.<sup>41</sup> These exemptions are:

#### A. Minimum Payment Exemption

The FTC excludes transactions where required payments to the franchisor, made from any time before the transaction until six months after commencing operation of the franchised business, is less than \$500.<sup>42</sup> In other words, if the franchisor does not ask his franchisee to pay him or any of his affiliates more than \$500 within the first six months of operation, the deal is exempt under the FTC rule.<sup>43</sup> Though these kinds of transactions constitute franchise transactions, they include low risk of financial loss.<sup>44</sup>

#### B. Fractional Franchise

A fractional franchise is an extension of, or an addition to, a product or service that the franchisee already offers to the public.<sup>45</sup> Fractional franchises commonly include grocery stores, hotels, universities, airports, or facilities where the product or service offered is within the confines of another business.<sup>46</sup> The rationale for this exemption is the prospective franchisee should have the business acumen necessary to evaluate the costs,

35. Zhōnghuá rénmín gònghéguó zhùzuòquán fǎ (中华人民共和国著作权法) [Copyright Law of the People's Republic of China] (promulgated by the Standing Comm. of the Nat'l People's Cong., Sept. 7, 1990, effective Oct. 1, 1999) P.R.C. Laws (China).

36. Zhōnghuá rénmín gònghéguó fǎn bù zhèngdàng jìngzhēng fǎ (中华人民共和国反不正当竞争法) [Anti-Unfair Competition Law of the People's Republic of China] (promulgated by the Standing Comm. of the Nat'l People's Cong., Sept. 2, 1993, effective Dec. 1, 1993) P.R.C. Laws (China) (hereinafter Chinese Unfair Competition Law).

37. Zhōnghuá rénmín gònghéguó zhuānlǐ fǎ (中华人民共和国专利法) [Patent Law of the People's Republic of China] (as amended 2008) (promulgated by the Standing Comm. of the Nat'l People's Cong., Mar. 12, 1984, effective Oct. 1, 2009) P.R.C. Laws (China).

38. Zhōnghuá rénmín gònghéguó shāngbiāo fǎ (中华人民共和国商标法) [Trademark Law of the People's Republic of China] (promulgated by the Standing Comm. of the Nat'l People's Cong., Aug. 23, 1982, amendments effective Dec. 1, 2001) P.R.C. Laws (China) (hereinafter Chinese Trademark Law).

39. Zhōnghuá rénmín gònghéguó fǎn lǒngduàn fǎ (中華人民共和國反壟斷法) [Anti-Monopoly Law of the People's Republic of China] (promulgated by the Standing Comm. of the Nat'l People's Cong., Aug. 30, 2007) P.R.C. Laws (China) (hereinafter Chinese Anti-Monopoly Law).

40. See generally W. Andrew Scott et al., *Franchising from A (Arbitration) to T (Termination)*, 22 FRANCHISE L.J. 192 (2003).

41. FED. TRADE COMM'N, FRANCHISE RULE COMPLIANCE GUIDE ii (2008).

42. *Id.* at 7.

43. *Id.* at 4–5.

44. Satterlee & Curran, *supra* note 29.

45. *Id.*

46. Leonard D. Vines et al., *Fractional Franchise Exemption: Friend or Foe?*, 30 FRANCHISE L.J. 72, 73 (2010).

profits, and potential risks and benefits of the franchised business.<sup>47</sup> Accordingly, the franchisee is unlikely to be misled through an incomplete or inaccurate disclosure.<sup>48</sup>

For a franchise to be fractional, and accordingly exempted from disclosure, it has to satisfy two conditions: (1) “[t]he franchisee, any of the franchisee’s current directors or officers, or any current directors or officers of a parent or affiliate, has more than two years’ experience in the same type of business;” and, (2) “[t]he parties have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20% of the franchisee’s total dollar volume in sales during the first year of operation.”<sup>49</sup> Starbucks is a prime example of fractional franchising, with almost 4,000 franchised outlets existing in various stores, hotels, and airports without submitting disclosure documents.<sup>50</sup> Starbucks can follow this business model because it accepts applications from franchisees that already have their own business, like bookstores, where the cost of extending the services of Starbucks inside is low.<sup>51</sup> Thus, all that the franchisee incurs is the payment of royalties and other fees to the franchisor in addition to facility costs, such as specific equipment, because the franchisee already has the storefront, utility connections, employees, and other required facilities.<sup>52</sup>

### C. Leased Departments Exemption

The leased department franchise relationship is also exempted from disclosure.<sup>53</sup> The leased department exemption refers to independent retailers who lease space from other larger businesses to sell their own goods and services, such as photography stores or beauty salons, in return for fees where the host businesses have some degree of control.<sup>54</sup> This exemption is “similar to the fractional franchise,” but does not have a 20% cap on gross sales.<sup>55</sup> However, a leased department franchise is not exempted if the retailer asks the lessee to buy goods directly from it or its suppliers.<sup>56</sup>

### D. Oral Contracts

The FTC excludes oral franchises that lack written evidence of the terms of the franchise agreement from the duty of disclosure.<sup>57</sup> The logic behind this exemption seems to be the difficulty of proving this type of agreement, particularly when it comes to enforcement.<sup>58</sup> Accordingly, if there is any writing that may prove the terms of the agreement, the exemption would not apply, even if the agreement lacks signatures.<sup>59</sup>

47. *Id.*

48. *Id.*

49. FED. TRADE COMM’N, *supra* note 41, at 8; 16 C.F.R. § 436.8(a)(2).

50. Vines, *supra* note 46, at 73–74.

51. *Id.*

52. *Id.* at 73.

53. 16 C.F.R. § 436.8(a)(3).

54. Satterlee & Curran, *supra* note 29, at 193. *See also* 16 C.F.R. § 436.1(l).

55. Satterlee & Curran, *supra* note 29, at 193.

56. *Id.*

57. 16 C.F.R. § 436.8(a)(7).

58. Satterlee & Curran, *supra* note 29, at 193.

59. *See* 16 C.F.R. § 436.8(a)(7).

### E. Petroleum Marketers and Resellers Exemption

Any transaction covered by the Petroleum Marketing Practices Act (“PMPA”) is exempted from disclosure requirements.<sup>60</sup> The reason for this exemption is that the PMPA has its own disclosure system.<sup>61</sup>

### F. Sophisticated Investor Exemption

The sophisticated investor exemption means that franchisees—whether individuals or corporations—that have been in business for at least five years and who have net assets of at least \$6.165 million are exempted from the disclosure process.<sup>62</sup> The longevity and asset requirements can be satisfied by parents or affiliates of the franchisee.<sup>63</sup> The net assets of the franchisee are determined through a balance sheet.<sup>64</sup> The significance of this exemption to foreign franchisors is that it requires only one investor from a group of investors to meet the requirement.<sup>65</sup> The basis of this exemption is that large and experienced entities such as hotels, corporations, and others can protect their interests without the need for disclosure.<sup>66</sup>

### G. Large Investment Exemption

The large investment exemption applies in cases where the initial amount invested is at least \$1 million, excluding the cost of unimproved land and funds obtained from the franchisor or its affiliates.<sup>67</sup> In cases where a single franchisee is composed of more than one investor, at least one of the investors must invest \$1 million or more; thus, a group of ten investors investing \$100,000 each does not qualify for the exemption.<sup>68</sup> Additionally, the \$1 million is calculated in light of the costs provided by the New Rule, and not future

60. 16 C.F.R. § 436.8(a)(4).

61. See generally Wells & Wiczorek, *supra* note 29; see also Oppenheim, *supra* note 31.

62. The New Rule provides that “[t]he franchisee (or its parent or any affiliates) is an entity that has been in business for at least five years and has a net worth of at least \$6,165,000.” 16 C.F.R. § 436.8(a)(5)(ii).

63. *Id.*

64. See generally *id.*

65. Wells & Wiczorek, *supra* note 29, at 106.

66. Satterlee & Curran, *supra* note 29, at 193.

67. 16 C.F.R. § 436.8(a)(5)(i) provides:

The franchisee’s initial investment, excluding any financing received from the franchisor or an affiliate and excluding the cost of unimproved land, totals at least \$1.233 million and the prospective franchisee signs an acknowledgment verifying the grounds for the exemption. The acknowledgment shall state: “The franchise sale is for more than \$1.233 million—excluding the cost of unimproved land and any financing received from the franchisor or an affiliate—and thus is exempted from the Federal Trade Commission’s Franchise Rule disclosure requirements, pursuant to 16 CFR § 436.8(a)(5)(i) . . . .”

*Id.*

68. See FED. TRADE COMM’N, *supra* note 41, at 12. The rationale behind this rule, as articulated in the FTC Compliance Guide, is that,

[t]he large investment exemption is premised on the assumption that a franchisee’s ability to pay a large sum equates with sophistication. That assumption fails when no one investor standing alone is investing at the requisite threshold level. For purposes of this provision, a husband and wife can be considered a single individual since their assets are typically commingled.

*Id.*



franchisee obligations such as rent, royalties, or advertising.<sup>69</sup> The basis for this exemption is that franchisees initially investing large amounts of money are probably able to collect all the necessary information with regard to a franchised business, even without a disclosure requirement.<sup>70</sup> Finally, the prospective franchisee is required to sign an acknowledgment that the franchise is exempt from the New Rule because the franchisee will initially invest at least \$1 million.<sup>71</sup> Some scholars argue the acknowledgment should be part of the franchise agreement itself.<sup>72</sup>

#### *H. Officers, Owners, and Managers Exemption*

This rule exempts franchisors from disclosure when they sell at least 50% of the franchise to officers, owners, managers, general partners, or other individuals with management responsibility who, within sixty days of the purchase date, will have worked for the franchise for at least two years.<sup>73</sup> This exemption also applies when selling the franchise to people who have owned at least a 25% stake in the franchise for a two-year period ending no later than sixty days before the sale.<sup>74</sup> Thus, this exemption applies to any person who acquires 50% ownership in an American franchised company and operates it inside the United States.<sup>75</sup> The basis of this exemption is that the franchisee is familiar with the franchise and needs no disclosure.<sup>76</sup>

### IV. THE CHINESE MODEL

Chinese contract law provides a general rule of disclosure that, if a party causes loss to another by concealing information or providing false information, that party shall be liable for damages.<sup>77</sup> In *Huang Haiyan v. Beijing Hansen Cosmetology Co.*, the plaintiff claimed that the franchisor intentionally misrepresented that the trademark of the franchised cosmetic shop was internationally famous and officially registered.<sup>78</sup> The plaintiff claimed the defendant gave him misleading information in order to encourage him to enter the franchise agreement, and that this constituted a breach of the duty to disclose.<sup>79</sup> The Beijing Chaoyang District People's Court confirmed that the franchisor violated disclosure rules, and declared the agreement null.<sup>80</sup> The court explained that the purpose of disclosure is to help franchisees become more familiar with the franchised business and

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69. *Id.*

70. Satterlee & Curran, *supra* note 29, at 193.

71. *Id.* at 194.

72. *See id.* at 193.

73. 16 C.F.R. § 436.8(a)(6).

74. *Id.*

75. Carl E. Zwisler, *Amended FTC Franchise Rule Eases International Franchising*, FRANCHISING WORLD, Apr. 2007, at 47.

76. *Id.*

77. Chinese Contract Law, *supra* note 18, art. 42.

78. Jones & Wulff, *supra* note 16, at 60 (summarizing the case of *Huang Haiyan v. Beijing Hansen Cosmetology Co.*).

79. *Huang Haiyan v. Beijing Hansen Cosmetology Co.*, No. 486 (Beijing Chaoyang District People's Ct., 2005).

80. Jones & Wulff, *supra* note 16, at 61–62.

to help them decide whether to accept a franchise offer.<sup>81</sup> Accordingly, violating the duty to disclose is fraud.<sup>82</sup> Additionally, the Chinese New Regulations lay down the main principles governing disclosure, and refer to the Chinese Disclosure Measures for more details on how to establish a comprehensive disclosure system.<sup>83</sup>

## V. DISCLOSURE MECHANISM

In the United States, the New Rule requires that disclosure take place fourteen days<sup>84</sup> before executing the franchise agreement<sup>85</sup> or at any time earlier if the franchisee reasonably requires disclosure.<sup>86</sup> Though the New Rule does not define a reasonable request, it is argued that a request is not reasonable until purchase discussions begin.<sup>87</sup> Moreover, the New Rule provides that if the franchisor makes any material and unilateral changes, they have to be communicated to the franchisee seven days before signing the agreement.<sup>88</sup> Disclosure documents are considered delivered once they are faxed, emailed, delivered by hand, or sent to the address of the franchisee by first class mail three days before the required date.<sup>89</sup> The New Rule allows electronic disclosure through email or access to a website that has the disclosure documents.<sup>90</sup> In the case of electronic access, the New Rule requires that the franchisor use a format that allows the franchisee to store, download, or print the disclosure documents for future reference.<sup>91</sup>

The Chinese New Regulations and the Chinese Measures for the Administration of Information Disclosure require franchisors to submit both the franchise contract and disclosure documents thirty days before signing the contract.<sup>92</sup> Similarly, the Measures require the franchisor to give precise and confirmed information and to notify the franchisee of any changes in the disclosed information.<sup>93</sup>

Another relevant issue to the disclosure mechanism is protecting the disclosed information's confidentiality. Surprisingly, the United States' laws do not devote the same degree of attention to the issue of confidentiality of disclosed information as the Chinese Measures for Administration of Information Disclosure do. The Chinese Measures provide

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81. *Id.*

82. *Id.* at 61.

83. Chinese New Regulations, *supra* note 32, art. 20 (providing that “[a] franchisor shall set up and carry out a perfect information disclosure system in accordance with the provisions as prescribed by the commerce department of the State Council.”). *See also* MARTIN MENDELSON ET AL., FRANCHISING LAW 390–92 (Martin Mendelsohn ed., 2d ed. 2004).

84. Wells & Wiczorek, *supra* note 29, at 107.

85. 16 C.F.R. § 436.2(a).

86. 16 C.F.R. § 436.9(e).

87. Wells & Wiczorek, *supra* note 29, at 107.

88. 16 C.F.R. § 436.2(b).

89. 16 C.F.R. § 436.2(c).

90. *Id.*

91. 16 C.F.R. § 436.6(b).

92. Chinese New Regulations, *supra* note 32, art. 21; Shāngyè tèxǔ jīngyíng xīnxī pīlù guǎnlǐ bànfǎ (商业特许经营信息披露管理办公室法) [Administrative Measures for the Information Disclosure of Commercial Franchise] (promulgated by the Ministry of Commerce of the People's Republic of China, art. 4, Apr. 30, 2007, effective May 1, 2007) (Lawinfochina) (China) (hereinafter Information Disclosure Measures). *See also* SPENCER, *supra* note 10, at 182.

93. Chinese New Regulations, *supra* note 32, art. 23.

for a franchisor's right to conclude a confidentiality agreement with the franchisee before disclosing any information to him.<sup>94</sup> In the same context, the Measures require the franchisee to issue the franchisor a receipt, to be signed by both parties, indicating that the franchisee received the disclosure documents.<sup>95</sup>

A related issue is what remedies exist in the event that either party fails to comply with the basic disclosure requirements. In the United States, if a franchisor fails to comply with the basic disclosure requirements, it may be liable under FTC regulations.<sup>96</sup> The FTC Act empowers the FTC to impose civil penalties.<sup>97</sup> The FTC can also order rescission, reformation, damages, or a combination of these remedies.<sup>98</sup> Moreover, the FTC can issue cease-and-desist orders.<sup>99</sup> State laws regarding deceptive trade practices provide for private rights of action for incidental, consequential, and punitive damages.<sup>100</sup> Similarly, the Chinese New Regulations provide for a penalty in case of serious regulatory violations, in addition to requiring the franchisor take corrective action.<sup>101</sup> The Chinese Measures for the Administration of Information Disclosure provide for a similar sanction and allow the franchisee to terminate the franchise agreement.<sup>102</sup>

In conclusion, though United States law provides extra rules, such as requiring franchisors to inform franchisees of any changes taking place with respect to disclosed information and referring to methods appropriate for disclosure, one can argue that the Chinese perspective in terms of disclosure mechanisms is more efficient.<sup>103</sup> Concerning disclosure timing, the Chinese New Regulations' thirty-day rule sounds more reasonable than the fourteen days provided in the United States.<sup>104</sup> Also, requiring franchisees to issue franchisors a receipt for disclosure documents creates confidence in negotiations and encourages both parties to proceed with transactions.

## VI. CONTENT OF DISCLOSURE

United States franchising law is more comprehensive and organized than its Chinese counterpart regarding what information must be disclosed. On the one hand, the New Rule requires a cover page before receipt of the disclosure documents that provides information about the franchisor, a sample of the trademark, a description of the business, the initial investment, the franchisee's contact information, and information directing the franchisee to the FTC's public resources.<sup>105</sup> All information must be written in plain language in a single document.<sup>106</sup> The New Rule also requires that the franchisor place each item under

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94. See Information Disclosure Measures, *supra* note 92, art. 7.

95. *Id.* art. 8.

96. 16 C.F.R. § 436.6(a).

97. 15 U.S.C. § 45(m)(1).

98. 15 U.S.C. § 57(b). See also Wells & Wiczorek, *supra* note 29, at 110.

99. 15 U.S.C. § 45(b).

100. See, e.g., Sellinger v. Freeway Mobile Home Sales, Inc., 521 P.2d 1119 (Ariz. 1974) (a suit for deceptive trade practices under Arizona's version of the FTC Act).

101. Chinese New Regulations, *supra* note 32, art. 28.

102. Information Disclosure Measures, *supra* note 92, arts. 9–10.

103. See Wells & Wiczorek, *supra* note 29, at 107.

104. *Id.* at 106; Chinese New Regulations, *supra* note 32, art. 21.

105. 16 C.F.R. § 436.3.

106. *Id.* at (b).

the appropriate heading to clarify whether the item is applicable to the situation, and to avoid adding any information other than that required.<sup>107</sup> The franchisor must inform the franchisee of any “prerequisites for obtaining the disclosure document in a particular format, and any condition necessary for reviewing the disclosure document . . . .”<sup>108</sup>

Furthermore, the New Rule requires the franchisor to provide updated disclosure documents and to make revisions to the documents within 120 days of the most recent fiscal year.<sup>109</sup> Moreover, the franchisor is required to provide franchisees with quarterly updates on revisions to the disclosure documents.<sup>110</sup> The New Rule requires master franchisors to disclose “information about the franchisor, and, to the extent applicable, the same information concerning the sub-franchisor.”<sup>111</sup>

#### *A. Required Disclosures Under the New Rule*

The New Rule requires a specific table of contents with certain information to be included in a specific order after the cover page, and before mentioning disclosure items.<sup>112</sup> There are twenty-three items that require disclosure of different information.<sup>113</sup> Item one requires the disclosure of the franchisors’ and any predecessors’, affiliates’, or agents’ information.<sup>114</sup> It also requires disclosure of information about the franchised business, such as type of business entity, location, the market of the franchised goods and services, and laws and regulations.<sup>115</sup>

Item three requires disclosure of the litigation and arbitration history of the franchisor, and item four asks for disclosure of the franchisor’s bankruptcy history.<sup>116</sup> Items five, six, and seven demand disclosure of various financial information related to the franchisor, such as payments for goods or services provided by the franchisor, fees to be paid by the franchisee, and estimated initial investment amounts to be paid by the franchisee.<sup>117</sup> Item eight requires disclosure of the sources from which the franchisee is required to purchase or lease supplies and equipment.<sup>118</sup> Items nine through twelve deal with disclosure regarding franchise agreement information, such as the franchisee’s obligations, assistance provided by the franchisor, exclusivity, and any other territorial issues.<sup>119</sup> In addition, items thirteen and fourteen deal with aspects of intellectual property, such as trademarks, service marks, copyrights, and patents.<sup>120</sup>

Going back to the franchise agreement, item fifteen provides for disclosure of any

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107. 16 C.F.R. § 436(c).

108. 16 C.F.R. § 436.6(g).

109. 16 C.F.R. § 436.7(a).

110. § 436.7(b).

111. 16 C.F.R. § 436.6(f).

112. 16 C.F.R. § 436.4.

113. § 436.4.

114. 16 C.F.R. § 436.5(a).

115. *Id.*

116. 16 C.F.R. § 436.5(c)–(d).

117. § 436.5(e)–(g).

118. § 436.5(h).

119. § 436.5(i)–(l).

120. § 436.5(m)–(n).

obligations to participate in the operation of the franchised business.<sup>121</sup> In the same context, item sixteen requires disclosure of any restrictions with respect to the goods or services to be sold.<sup>122</sup> Likewise, item seventeen asks for disclosure of all information regarding renewal, termination, transfer, or dispute resolution.<sup>123</sup> Items eighteen and nineteen discuss miscellaneous issues such as information about public figures used in advertising and financial performance information such as past sales, income, and profits.<sup>124</sup> Item twenty concentrates on information about franchised outlets.<sup>125</sup> Item twenty-one goes back to financial issues and requires disclosure of the franchisor's financial statements for the last two years.<sup>126</sup> Item twenty-two asks for submission of a copy of all agreements related to the franchise offer such as the franchise agreement, any lease agreements, and purchase agreements. Finally, item twenty-three requests copies of the receipt of acknowledgment of the disclosure documents.<sup>127</sup>

### *B. Required Disclosures Under the Chinese New Regulations*

The Chinese New Regulations also provide a list of information required to be disclosed.<sup>128</sup> This includes information related to the franchisor's name, domicile, legal representative, registered capital, business scope, commercial franchise activities, and basic information on previously archived disclosures.<sup>129</sup> It also requires disclosure of all information on any associated company that provides goods or services to the franchisor, and bankruptcy information for the franchisor or its associated company for the previous five years.<sup>130</sup> Additionally, the New Regulations specifically require records of any illegal business operations, financial and accounting reports, audit reports from the last two years, and criminal convictions of the franchisor that resulted in fines.<sup>131</sup> Furthermore, the New Regulations require disclosure of financial statements for the last two years, the investment budget for the franchise outlet, quantity, distribution and business evaluation of franchisees currently existing in China, and information on the franchise agreement.<sup>132</sup> This includes the type and amount of franchising fees and payment methods, prices and requirements for providing the franchisee with products, services and equipment, a sample franchise contract, and basic information on franchise expenditures.<sup>133</sup>

Though the New Regulations' provisions on disclosure are self-explanatory, the list above is not exclusive.<sup>134</sup> That is especially important because Article 42 of the Contract Law of China provides that, if any of the contracting parties intentionally hide any relevant

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121. 16 C.F.R. § 436.5(o).

122. § 436.5(p).

123. § 436.5(q).

124. § 436.5(r)–(s).

125. § 436.5(t).

126. 16 C.F.R. § 435.6(u).

127. § 436.6(w).

128. Information Disclosure Measures, *supra* note 92, art. 22.

129. Chinese New Regulations, *supra* note 32, art. 22.

130. *Id.*

131. *Id.* arts. 22, 28.

132. *Id.* art. 22.

133. *Id.*

134. See SPENCER, *supra* note 10, at 201.

information or provide false information, he should be responsible for any losses.<sup>135</sup> A prime example is found in a decision of the Intermediate People's Court, in which the franchisee claimed that the franchisor had breached the franchise agreement because he did not provide financial statements for the two years preceding the agreement.<sup>136</sup> The court held that Article 23 of the Chinese New Regulations requires the franchisor to submit accurate, true, and complete information to the franchisee, and if any information is not available the franchisor must inform the franchisee.<sup>137</sup> The franchisor appealed, claiming that the franchisee did not ask for disclosure of the two financial statements in question.<sup>138</sup> The appellate court affirmed the trial court's decision, holding that the Chinese New Regulations impose an obligation on the franchisor to disclose all required items whether the franchisee asks for them or not.<sup>139</sup>

## VII. REGISTRATION AS A PAIRED MECHANISM

In the United States, neither the New Rule nor any federal agencies deal with registration requirements.<sup>140</sup> Federal laws, however, do not prevent states from requiring registration,<sup>141</sup> and fifteen states supplement federal registration requirements.<sup>142</sup> Most states exempt specific transactions from registration.<sup>143</sup> Exemptions vary between the states, with the most common being the large franchisor exemption—available to franchisors who meet specific minimum net worth and experience requirements.<sup>144</sup> Some states require a \$5 million net worth, while others require \$10 million.<sup>145</sup> Most states require five years of experience to qualify for this exemption.<sup>146</sup> Another common exemption includes the sale of a franchise made by a franchisee for his own account.<sup>147</sup>

In addition, in the United States franchisors submit registration applications to state agencies.<sup>148</sup> The registration application usually consists of a page giving information about the franchisor, a certification page signed by the applicant's representative before a notary public, an agreement for service of process which allows the service of documents upon the state authority as agent for the franchisor, and two copies of the disclosure documents.<sup>149</sup> This includes a supplemental information form that gives notice of any denial of registration previously issued in any other state, copies of advertisement

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135. Chinese Contract Law, *supra* note 18, art. 42.

136. Jones, *supra* note 11 (discussing the case of *Zou Jun v. Yicai Int'l Bus. Man. (Beijing), Inc.*, Beijing First Intermediate People's Court No. 1 (2010)).

137. *Id.*

138. *Id.*

139. *Id.*

140. SPENCER, *supra* note 10, at 147.

141. *Id.*

142. *Id.*

143. See Spandorf & Forseth, *supra* note 24, at 146–48.

144. *Id.*

145. *Id.* at 147.

146. See, e.g., CAL. CORP. CODE § 31101; N.D. CENT. CODE § 51-19-04; and Spandorf & Forseth, *supra* note 24, at 146–48.

147. Spandorf & Forseth, *supra* note 24, at 146.

148. *Id.* at 143.

149. *Id.* at 174–75.

literature, the auditor's consent, application fees, and the sales agent disclosure form for sales agents authorized by the franchisor to solicit the franchise in the state.<sup>150</sup> The application must also be accompanied by a cover page accompanied by statutory prescribed statements.<sup>151</sup> Usually the review process takes a statutorily mandated period of time, the day after which registration becomes automatically effective.<sup>152</sup>

The registration agencies are usually granted the right to deny an application in various situations, such as the franchisor's failure to comply with state law.<sup>153</sup> This includes a situation where a person identified in the franchisor's application or disclosure documents is convicted of a felony or found subject to liability in a civil action related to the franchise's sale.<sup>154</sup> The reason behind allowing the registrar to deny the application in the latter situation is that it may pose a risk to the prospective franchisee.<sup>155</sup> Registration usually expires at the end of the registration period, often one year, unless it is renewed with the addition of any changes that took place during the year.<sup>156</sup>

An amendment application must be filed to amend or change any of the information on the registration application.<sup>157</sup> Most states require franchisors to provide documents showing financial ability, proving he will be able to meet the agreed upon obligations for services, thus preventing "undercapitalized franchisor[s] from using a franchisee's initial fee payments for the franchisor's own working capital."<sup>158</sup> Alternatively, franchisors can show financial ability by obtaining a personal guarantor who audits the financial statement filed with the registration application.<sup>159</sup>

The Chinese New Regulations and the Chinese Measures for the Administration of Information Disclosure require the franchisor to submit specific documents to the Ministry of Commerce within fifteen days of concluding the franchise agreement.<sup>160</sup> The Chinese Archiving Measures list the documents that the franchisor must submit to register the franchise agreement.<sup>161</sup> Required documents under the Chinese Archiving Measures include the basic information related to the franchise, information on all stores within China, the market plan, the operation license, the registration certificates of the associated trademarks and patents, copy of the first commercial franchise contract concluded between the franchisor and his franchisee within China, the table of contents of the brochure for franchised operations, approvals by the relevant administrative entity, and any other data that the archival filing authority requires.<sup>162</sup> Similarly, a foreign enterprise shall submit

150. *Id.* at 153, 174–75.

151. 16 C.F.R. § 436.3.

152. *See, e.g.*, CAL. CORP. CODE § 31116(b) (giving a standard thirty business-day waiting period).

153. Spandorf & Forseth, *supra* note 24, at 144–45.

154. *Id.*

155. *Id.*

156. *Id.* at 147.

157. *Id.* at 149.

158. Spandorf & Forseth, *supra* note 24, at 157.

159. *Id.* at 159–60.

160. Chinese New Regulations, *supra* note 32, art. 8; SPENCER, *supra* note 10, at 182.

161. Shāngyè tèxǔ jīngyíng bèi'àn guǎnlǐ bànfǎ (商业特许经营备案管理办法) [Administrative Measures for Archival Filing of Commercial Franchises] (promulgated by the Ministry of Commerce, Dec. 12, 2011, effective Feb. 1, 2012), art. 6, P.R.C. Laws (China) (hereinafter Chinese Archiving Measures).

162. *Id.* art. 7.

the relevant approval certificates.<sup>163</sup> Article 8 of the Chinese Archiving Measures provides that if any of the information supplied by the franchisor changes, the franchisor must, within 30 days from the date of the change, apply to the archival filing authority for modification.<sup>164</sup> Moreover, Article 9 requires the franchisor to report any changes to the franchise agreement by March 31 of each year.<sup>165</sup> Furthermore, Article 9 requires the franchisor to confirm the clarity, completeness, and validity of all submitted documents.<sup>166</sup> Once the franchisor submits the required documents, the competent authority “shall archive [the documents] within [ten] days” of submission unless the documents are incomplete.<sup>167</sup> After archiving is complete, the competent authority must notify the Ministry of Commerce of the registration within ten days.<sup>168</sup> Article 14 requires the competent authority to keep any documents or information submitted by the franchisor confidential; however, Article 15 allows specific identifying information to be available online to the public.<sup>169</sup>

### VIII. CONCLUSION

In total, comparing franchise disclosure rules in both the U.S. and China reveals that the U.S. law seems to be more comprehensive than the Chinese law.<sup>170</sup> This is no wonder, since the U.S. law strongly resembles disclosure law whereas Chinese law could be considered a relationship law.<sup>171</sup> For example, U.S. disclosure law regulates all organizational aspects related to disclosure, including the use of a cover page, the language, and specific structure of disclosure.<sup>172</sup> In the same context, U.S. disclosure law provides a more comprehensive list of information required to be disclosed.<sup>173</sup>

It is clear that disclosure rules are necessary to give franchisees the comprehensive information necessary to make informed decisions about franchise opportunities.<sup>174</sup> Disclosure rules also guarantee a minimum level of transparency, particularly in a country like Egypt with a large number of small investors as franchisees.<sup>175</sup> However, it is hard to decide whether the American or Chinese approach on disclosure should be followed. In the first place, both the U.S. and China have created baseline regulations on disclosure to help promote the franchising industry.<sup>176</sup> Moreover, the fact that the U.S. has more comprehensive rules on disclosure does not mean that the Chinese law is insufficient, just

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163. *Id.*

164. *Id.* art. 8.

165. *Id.* art. 9.

166. Chinese Archiving Measures, *supra* note 161, art. 10.

167. *Id.* art. 11.

168. *Id.*

169. *Id.* arts. 14–15.

170. *See generally* Marks, *supra* note 2; Jones & Wulff, *supra* note 16.

171. *See* sources cited *supra* note 170.

172. *See* FED. TRADE COMM’N, *supra* note 41, at 24–119.

173. *See id.*

174. William L. Killion, *The Modern Myth of the Vulnerable Franchisee: The Case for a More Balanced View of the Franchisor-Franchisee Relationship*, 28 FRANCHISE L.J. 23, 29 (2008).

175. Radwa S. Elsaman, *Franchising in the Middle East: The Example of Egypt*, 35 UCLA PAC. BASIN L.J. 39, 53 (2017).

176. *See* sources cited *supra* note 170.



that it has a different focus.<sup>177</sup> For instance, Chinese law focuses more on the relationship between the franchising parties, such as fulfillment of obligations arising out of franchise agreements, protection of intellectual property and confidential know-how, and termination of agreements that will help protect both franchising parties.<sup>178</sup> For civil-law systems like China's, improved regulations will reduce the number of disputes arising out of franchising agreements and create a more desirable franchise market.

Finally, some legal systems, mainly common-law countries like the U.S., are less concerned with the parties' substantive relationship in their statutes, and that is why they focus on issues that second good faith such as pre-contractual disclosure.<sup>179</sup> In contrast, civil-law countries like China usually have statutes that fully regulate substantive relationship issues, particularly where their contracts are shorter and require statutes to supplement their terms.<sup>180</sup> That said, the U.S. disclosure rules could work as a good model for common-law countries, while the Chinese law would be a good model for civil-law systems.<sup>181</sup>

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177. *Id.*

178. See Jones & Wulff, *supra* note 16, at 58–60; Dominic Hui & Danny Tsui, *A Primer on Franchising in China*, 40 FRANCHISE L.J. 293, 302–03 (2020).

179. See Marks, *supra* note 2, at 620–22.

180. INT'L INST. UNIFICATION PRIV. L., GUIDE TO INTERNATIONAL MASTER FRANCHISE ARRANGEMENTS, at 30 (2d ed. 2007), <https://www.unidroit.org/english/guides/2007franchising/franchising2007-guide-2nd-e.pdf>.

181. See sources cited *supra* note 170.