Contracts Issues, Liability Issues and Dispute Resolution in Australia and New Zealand affecting Hospitality Law

Seventh Annual Hospitality Law Conference
February 9 – 11, 2009
Houston, Texas

Barrie Goldsmith
AUSTRALIAN TRAVEL AND TOURISM LAWYERS
Level 8, Bligh Chambers
25 Bligh Street
Sydney NSW 2000
Tel: (61) (2) 9233 4766
Fax: (61) (2) 9233 4966
E-mail: goldlaw@bigpond.com

AUSTRALIAN TRAVEL & TOURISM

L A W Y E R S

Barrie Goldsmith
Australian Travel & Tourism Lawyers
Level 8, Bligh Chambers
25 Bligh Street
Sydney, NSW 2000
Tel: (61) (2) 9233 4766
Fax: (61) (2) 9233 4966
E-mail: goldlaw@bigpond.com

Barrie Goldsmith was admitted as a solicitor in England in 1975. Prior to his migrating to Australia in 1982, he was a partner in a successful law firm.

Having migrated to Australia, Barrie worked for 2 years for Blake Dawson Waldron, one of Australia's largest law firms.

In 1984, Barrie established his own law firm, Goldsmiths Lawyers. Since that time, Barrie has acted for a diverse range of clients primarily in commercial, corporate and property matters, intellectual property, all types of commercial litigation and in international law.

He has, virtually from the outset, acted for clients in the travel, tourism and hospitality industries and continues to be heavily involved in those industries.

Barrie is a Past President of the Australia-Singapore Chamber of Commerce and Industry, a Past Vice-President of the Australia-Korea Chamber of Commerce and Industry, has been actively involved in the Australia-China Chamber of Commerce and Industry and the Australia-British Chamber of Commerce and Industry and has been involved in a number of other activities of a bilateral nature.

Barrie has been the author of a regular legal column in the *TravelTrade* magazine, a prominent magazine written for the travel industry, and has spoken at international conferences on Australian travel, tourism and hospitality law.

TABLE OF CONTENTS

I. BACKGROUND INFORMATION – AUSTRALIA AND NEW ZEALAND…….....4

II. DOING BUSINESS GENERALLY IN AUSTRALIA AND NEW ZEALAND….....5

III. CONTRACTS ISSUES.....…….6 - 8

IV. LIABILITY ISSUES……..9 - 12

V. DISPUTE RESOLUTION……...13

VI. CONCLUSION.....14

I. BACKGROUND INFORMATION – AUSTRALIA AND NEW ZEALAND

Australia, or Terra Australis as it was then known, was formally discovered by Captain Cook (who also discovered Hawaii in 1788 and other now renowned destinations) in 1770, although he was not the first European to have sailed by and visited the Australian continent.

The continent was formally claimed as British land in 1788 by Captain Arthur Philip on behalf of the King of England. One of the principal objectives of the settlement of the continent was to establish a penal colony (because, by that time, Americans had, understandably so, decided that they did not wish to use their continent as a penal colony and had objected vociferously to the payment of excessive taxes to the British Crown).

Australia became a federated nation in 1901. It comprises six States and two Territories, with the national capital being Canberra (in the Australian Capital Territory). Canberra became the national capital because the powerbrokers at the time could not agree on whether the capital should be in Sydney or in Melbourne, the two major cities, so they developed an entirely new city approximately half way between each (and which was designed by an American architect, Walter Burley Griffin).

Each State and Territory has its own Government. Commonwealth or Federal laws also apply throughout the country.

The country's defining legal authority is the Constitution, embodied in the *Commonwealth of Australia Constitution Act* 1900. The Constitution provides that the Federal Government shall have specific responsibility for matters such as:

- Immigration
- Family matters
- Interstate trade and commerce
- Corporations
- Taxation
- External affairs
- Military defence
- Currency

New Zealand was discovered by the Dutch explorer Abel Tasman in 1642. Captain Cook explored the New Zealand islands (of which there are 3 but only 2, the North Island and the South Island, are renowned) in 1769 and claimed them on behalf of the British Crown. They originally formed part of the Australian State of New South Wales but subsequently became a separate British Colony. In due course, New Zealand obviously became an independent country with an elected legislature.

Allegiances between Australia and New Zealand and Britain remains strong.

II. DOING BUSINESS GENERALLY IN AUSTRALIA AND NEW ZEALAND

Generally, there are very few limitations on doing business in Australia and New Zealand. Both countries have a legal system founded on the Westminster system and apply both common law and statute. For example, there are no limitations upon the repatriation of profits.

So far as Australia is concerned, the 2 principal limitations affecting overseas businesses or individuals doing business in Australia are:

A. On the acquisition of some real estate; and

B. On the acquisition of commercial interests which may be regarded as being contrary to the national interest.

The Australian Government does impose some limitations on the acquisition of real estate by non-citizens and non-residents, and corporations controlled by them. However, there are numerous exemptions to those limitations, such that real estate can frequently be acquired, often as a result of an application to the Government for approval for the acquisition.

Historically (during recent times), there was a limitation on overseas corporations acquiring a commercial interest in Australia valued at more than $50 million without obtaining Government approval. However, in the case of American corporations, that has now been changed by the Australia-United States Free Trade Agreement, and which is provided for in the *US Free Trade Agreement Implementation Act 2004*.

That Act now permits acquisitions by American corporations where the acquisition cost does not exceed $800 million (in excess of that amount, Government approval still needs to be sought). However, the threshold of $50 million still applies in the case of “sensitive sectors”, including media and telecommunications, military activities, the extraction of uranium or plutonium and others.

Apart from those matters, overseas corporations are actively encouraged to invest and do business in Australia. Many large American corporations, including all of the well-known hotel chains, have conducted business in Australia for many years.

The American Chamber of Commerce is long-established in Australia, is very active and has a committed and large membership.

III. CONTRACTS ISSUES

Contracts issues that arise in Australia are inevitably similar to contracts issues that arise in the United States.

One issue of importance and which frequently arises and which is relatively contentious, is the enforceability or otherwise of a clause in a contract that seeks either to exclude or alternatively to limit liability. This is of particular significance within the hospitality industry.

As a general proposition, such a clause, like other contractual terms and conditions, is binding and enforceable. However, Section 68(1) of the *Trade Practices Act 1974* (Cth) ("the Act") provides as follows:

> *"(1) Any term of a contract…that purports to exclude, restrict or modify or has the effect of excluding, restricting or modifying:*
> *(a) the application of all or any of the provisions of this Division;*
> *(b) the exercise of a right conferred by such a provision*
> *(c) any liability of the corporation for breach of a condition or warranty implied by such a provision; or*
> *(d) the application of section 75A;*
> *is void".*

A relevant provision within the Division is Section 74(2) which provides as follows:

> *"Where a corporation supplies services… to a consumer in the course of a business and the consumer, expressly or by implication, makes known to the corporation any particular purpose for which the services are required or the result that he or she desires the services to achieve, there is an implied warranty that the services supplied under the contract for the supply of the services and any materials supplied in connection with those services will be reasonably fit for that purpose or are of such a nature and quality that they might reasonably be expected to achieve that result, except where the circumstances show that the consumer does not rely, or that it is unreasonable for him or her to rely, on the corporation's skill or judgment"*

Accordingly, any term of a contract seeking to exclude liability for any of the matters referred to in Section 74(2) is void.

The area of law that is undoubtedly more contentious is in respect of any term or condition that seeks to limit any damages payable.

Section 68A of the Act provides as follows:

> *"(1) Subject to this section, a term of a contract for the supply by a corporation of goods or services other than goods or services of a kind ordinarily acquired for personal, domestic or household use or consumption is not void under section 68 by reason only that the term limits the liability of the corporation for a breach of a condition or warranty (other than a condition or warranty implied by section 69) to:*
>
> > *(a) in the case of goods, any one or more of the following:*
> >
> > > *(i) the replacement of the goods or the supply of equivalent goods;*
> > > *(ii) the repair of the goods;*
> > > *(iii) the payment of the cost of replacing the goods or of acquiring equivalent goods*
> > >
> > > *(iv) the payment of the cost of having the goods repaired; or*
> >
> > *(b) in the case of services:*
> >
> > > *(i) the supplying of the services again; or*
> > >
> > > (ii) the payment of the cost of having the services supplied again.

However, there is also an exception to the operation of Section 68A(1).

Section 68A(2) provides as follows:

> *"(2) Subsection (1) does not apply in relation to a term of a contract if the person to whom the goods or services were supplied establishes that it is not fair or reasonable for the corporation to rely on that term of the contract.*

The section of the Act is helpful in that it also provides indices as to whether or not reliance by a corporation on a term of a contract is fair and reasonable. Section 68A(3) provides as follows:

> *"(3) In determining for the purposes of subsection (2) whether or not reliance on a term of a contract is fair or reasonable, a court shall have regard to all the circumstances of the case and in particular to the following matters:*
>
> > *(a) the strength of the bargaining positions of the corporation and the person to whom the goods or services were supplied (in this subsection referred to as the buyer) relative to each other, taking into account, among other things, the availability of equivalent goods or services and suitable alternative sources of supply;*
> >
> > *(b) whether the buyer received an inducement to agree to the term or, in agreeing to the term, had an opportunity of acquiring the goods or services*

> *or equivalent goods or services from any source of supply under a contract that did not include that term;*
>
> *(c) whether the buyer knew or ought reasonably to have known of the existence and extent of the term (having regard, among other things, to any custom of the trade and any previous course of dealing between the parties); and*
>
> *(d) in the case of the supply of goods, whether the goods were manufactured, processed or adapted to the special order of the buyer.*

As with all provisions, any clause seeking to limit liability by a service provider needs to be carefully drafted.

IV. LIABILITY ISSUES

Again, liability issues that arise in Australia are inevitably similar to liability issues that arise in the United States.

One particular issue that has surfaced during recent years and which has been the subject of much debate, both politically and legally, relates to the question of personal responsibility.

Whilst the principle of contributory negligence has existed in the common law since the beginning of the 19th century, since 2002, there has also been a similar (but not identical) statutory consideration for the Courts. That consideration arises from the *Civil Liability Act* (2002).

In 2001/ 2002, there was considerable movement in Australia towards tort law reform, specifically upon the question of personal responsibility. This proceeded on the basis that the judiciary had become too plaintiff-oriented.

The movement was also prompted by, or at least gained momentum from, the collapse in Australia of HIH Insurance Group, which had about 22% of the public liability insurance market, the collapse of a major medical insurer, the impact of the 11 September 2001 attacks on the global reinsurance market and increasing awards of damages by the Courts.

The increasing awards of damages by the Courts was of even greater concern when coupled with an extremely litigious society composed of many individuals who were not prepared to take responsibility for their own actions. Many saw the balance of responsibility between society and the individual, reflected by tort law and insurance, shifting in an uneasy way.

The debate in Australia, leading to the statutory changes, focused on particular cases and a range of circumstances in which persons recovered damages, sometimes substantial damages, when there could be little doubt that they were the author of their own misfortune.

As a consequence, the Federal Government established a Committee to review the law of negligence. The report that was prepared by the Committee became known as the “Ipp Report”, named after the Honourable David Ipp, a Judge of the New South Wales Court of Appeal, and who chaired the Panel. The principal thrust of the changes was the limitation of circumstances in which damages could be recovered for personal injury and the restriction of the heads and quantum of damage that could be recovered.

The Ipp Report made a number of recommendations. It restated the four distinct components of negligence, namely the probability that harm would occur if care was not taken; the likely seriousness of the harm; the burden of taking precautions to avoid the harm and, lastly, the social utility of the risk creating activity. Amongst other things, it also included the following proposals:

1. The not “far fetched or fanciful” test for foreseeability be replaced by a test that a risk be “not insignificant” which, despite the double negative, is of a higher order of possibility.

2. Changes be made to the law about voluntary assumption of risk and contributory negligence. An intoxicated person is deemed to have contributed (at the least) twenty-five percent to the injury.

3. An injured person is deemed to have been aware of any obvious risk, about which there is no duty to warn save in the case of a request or in the case of a professional service.

Traditionally, an individual was assessed by reference to the reasonable person, the ancient common law principle. However, the new law introduced a statutory consideration for the Courts. Under the new law, a defendant can now only be liable to the extent of its responsibility for the harm.

Fallas v Mourlas [2006] NSWCA 32 provided the first opportunity, in the context of the New South Wales legislation, for an appellate court to consider the meaning of the provisions outlined by the Ipp Panel. Fallas and Mourlas were members of a group of four men from Sydney who went to the country to engage in the sport of shooting kangaroos. After meeting at a local hotel, they had a meal and consumed some alcohol. It was then decided, around 10.00pm, to do some kangaroo shooting. In the course of hunting kangaroos by spotlight, the plaintiff was accidentally shot in the leg by the defendant. The defendant denied liability under Section 5L of the *Civil Liability Act 2002* (NSW):

> *"(1) A person ("the defendant") is not liable in negligence for harm suffered by another person ("the plaintiff") as a result of the materialisation of an obvious risk of a dangerous recreational activity engaged in by the plaintiff.*
>
> *(2) This section applies whether or not the plaintiff was aware of the risk"*

The risk that materialised was not deemed "obvious" by Justices Ipp and Tobias, but they held that spotlighting was a 'dangerous recreational activity' within the meaning of Section 5K 'Definitions' of the *Civil Liability Act 2002* (NSW). 'Spotlighting' as a recreational activity involved a significant risk of physical harm that one of the shooters might handle a loaded gun in a negligent manner and cause someone to get shot.

People who tripped on footpaths were no longer always able to successfully sue local councils (*Ghantous v Hawkesbury City Council* (2001) 206 CLR 512). The owner of a shopping mall was no longer responsible for criminal conduct in the mall's car park (*Modbury Triangle Shopping Centre Pty Ltd v Anzil* (2000) 205 CLR 254). The authors of the rules for rugby were not liable to injured players (*Agar v Hyde* (2000) 201 CLR 552), or was the person who conducted an indoor cricket arena (*Woods v Multi Sport Holdings Pty Ltd* (2002) 208 CLR 460). A cinema was not liable when a client tried to sit down in a darkened cinema but the seat was, as is common, retractable (*University of Wollongong v Mitchell* [2003] Aust Torts Rep 81-708).

Lastly, a hotelier was not liable for injuries suffered after departure by an intoxicated patron (*Cole v South Tweed Heads Rugby League Football Club Ltd* [2004] HCA 29) and a club with gambling machines was not liable to refund the losses of a compulsive gambler whose cheques it had cashed (*Reynolds v Katoomba RSL All Services Club Ltd* (2001) 53 NSWLR 43).

The *Civil Liability Act* was of particular interest to the tourism and hospitality industries, and members of which had previously been held liable in a number of well publicised cases concerning intoxicated patrons and injuries suffered after departing the venue. While the operators of hotels and restaurants are now required to have harm minimisation strategies and procedures in place, including Responsible Service of Alcohol and Responsible Certificate of Gaming training for all staff, the Courts now seem to appreciate the importance of individual responsibility and autonomy.

The Australian legal system now imposes a greater obligation upon people to appreciate and accept risk.

Liability issues in New Zealand's tourism and hospitality industries, have been managed by the implementation of voluntary safety codes of practice. In a country such as New Zealand, where tourism and hospitality are the country's biggest "export" earner with two million tourists visiting per year, these safety codes typically address key legal, environmental, safety and customer services principles. This approach has been undertaken in extreme sports and adventure tourism where accidents are recognised to be part of the experience. Based on operator reports of injuries, a study into New Zealand's adventure tourism industry identified that clients' "failure to attend to and follow instructions" was a prime cause of injury.

Overall, Australia and New Zealand are very safe destinations by world standards, having high standards in public health, clean drinking water, a low level of infectious disease, and a well-equipped and coordinated medical system. However, there are situations where operators in the tourism and hospitality industries have a heightened duty of care to customers especially those vulnerable and unfamiliar to the language and many cultural nuances in existence in Australia.

In *Preti v Conservation Land Corporation and Ors* [2007] Justice Southwood of the Northern Territory Supreme Court considered the fact that the deceased did not speak or understand much English. The Swiss tourist died on 18 January 1999 from drowning when his head hit a submerged obstacle after he lost his balance and fell into the water. The father of the deceased brought an action against the Conservation Land Corporation, Sahara Tours Pty Ltd and the Parks and Wildlife Commission.

The findings of the trial judge and those of the Court of Appeal highlighted the fact that 'obvious risk' (Section 5H of the NSW *Civil Liability Act* 2002) may be culturally specific and informed by local knowledge. Australians have grown up with a concept of "beach safety" and are familiar with behaviours that minimised or mitigate risks and hazards associated with beach and bush environment such as rips, sharks, stingers and crocodiles. Similarly, a coronial inquest into the death of a German backpacker in the Northern Territory, highlighted the vulnerability of tourists who were unable to read or understand the several signs warning about crocodiles in the area next to the Billabong where the attack took place.

Since the introduction of the *Civil Liability Act*, the High Court of Australia (the most superior Court in the country) has continued to emphasise the importance of individual responsibility, autonomy and choice with the extension of the *Civil Liability Amendment (Personal Responsibility) Act 2003* ("the Amending Act"). The new laws having been introduced, it is unlikely that there will be a reversion to the "old days". The community still appears to expect a greater element of

personal responsibility and whilst that expectation exists, legislators are unlikely to reform existing law.

During recent years, Australian insurers have enjoyed some of the best levels of profitability that they have had for many years. Return on capital for the insurance industry has exceeded 23% whereas in the decade preceding the introduction of the Act, return on capital averaged only about 11%. The insurance industry no doubt would also discourage any reversion to the “old days”.

V. DISPUTE RESOLUTION

Australia has a long-standing tradition of engaging in alternative dispute resolution. All Australian States and Territories, and all legal profession associations, have or can arrange mediation, arbitration, independent expert appraisal, negotiation and early neutral evaluation.

There are many diverse alternative dispute resolution providers. They range from government provided and publicly funded dispute resolution organisations to private professional organisations. Each State and Territory within Australia has uniform Commercial Arbitration Acts dealing with domestic arbitration. Arbitration in New Zealand is covered by the *Arbitration Act 1996*.

The Australian Commercial Dispute Centre ("ACDC") was established in 1986 by the then NSW Attorney General, the Honourable Justice Terry Sheahan AO, and the Honourable Sir Laurence Street, Chief Justice of the NSW Supreme Court from 1974 to 1988. It is one of the premier organisations for ADR.

In 2005, the Australian Centre for International Commercial Arbitration ("ACICA") received a substantial boost in its promotion, assisted greatly by the introduction of new arbitration rules. In general, international arbitrations in Australia are governed by federal legislation, namely the *International Arbitration Act* 1974 (Cth). The Act incorporates an internationally accepted law on arbitration known as the UNCITRAL Model Law on International Commercial Arbitration. However, parties are permitted to exclude this law. Where they do so, the arbitration will be governed by the Commercial Arbitration Act of the State or Territory where the arbitration is held.

In addition to giving force of law in Australia to the UNCITRAL Model Law, the *International Arbitration Act* implements two international conventions. The first is the New York Convention, which provides for the international enforcement of arbitration agreements and awards, the second is the Washington Convention which provides for a special system of arbitration for disputes between States (countries) and foreign investors.

The availability of arbitration in Australia and clear cut rules governing such arbitrations appear to be well received in the region. Indeed, many corporations based in Asia invoke a provision for arbitration or mediation in Australia, even when contracting with another corporation based in Asia.

As a general rule, Australian Courts will stay any Court proceedings that may be issued where there is an effective arbitration clause in existence.

In addition, Free Trade Agreements ("FTAs") also tend to bring with them dispute resolution provisions. Australia has a number of FTAs including with the United States and other FTAs are being negotiated with China, Japan, Malaysia and other member nations of ASEAN (Association of South East Asian Nations).

Mediation and arbitration are actively encouraged and implemented and no doubt, given the increasing complexity and cost of litigation, will continue to do so.

VI. CONCLUSION

Legal and commercial issues and considerations in Australia are substantially the same as those in the United States. It is not surprising that Australia is often referred to as the 51st State of the United States of America.

Survey of International Issues

How to Climb the Great Wall – Doing Hotel Transactions in China: Procedural Issues, Contract Issues, Liability Issues & Dispute Resolution

The Hospitality Law Conference
February 9-11, 2009
Houston, Texas

Tao Xu, Esq.
DLA Piper LLP (US)
500 Eighth Street, NW
Washington, DC 20004
+1.703.773.4181
tao.xu@dlapiper.com

Tao Xu

Attorney

500 Eighth Street, NW
Washington, DC 20004
(703) 773-4181 T (703) 773-5086 F
tao.xu@dlapiper.com

PRACTICES

Franchise and Distribution
Hospitality and Leisure

EDUCATION

- Tulane University, J.D. *cum laude*
- Beijing Foreign Studies University, B.A.

EXPERIENCE

Tao Xu devotes his practice to franchising and distribution matters, especially international franchising, licensing, and distribution transactions. He counsels a broad range of clients in their international expansions, in countries and regions that include Australia, Austria, Brazil, Canada, China, Cyprus, the Czech Republic, France, Germany, Hong Kong, Hungary, India, Indonesia, Italy, Japan, Korea, Malaysia, Mexico, the Netherlands, New Zealand, Poland, Portugal, Qatar, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Taiwan, Turkey, the UAE, Ukraine, and the UK.

Mr. Xu has an active hospitality and leisure practice, counseling hotel clients in deals in the Asian-Pacific region, particularly in China and India.

As a native Chinese, Mr. Xu has been deeply involved in franchising activities in China. He is a member of DLA Piper's US and China joint team, which represents the International Franchise Association in lobbying the Chinese government to adopt a new franchise regulatory regime. He has also represented many US and European clients in entering into the Chinese market, covering such industries as quick-service restaurants, premium dining, lodging, service, retail, real estate service, education, and others.

Prior to attending law school, Mr. Xu worked at Bank of China's headquarters in Beijing, China, specializing in international trade financing. He is a native speaker of Mandarin.

PUBLICATIONS

Mr. Xu has authored articles appearing in the *Franchise Law Journal*, *Franchise Lawyer*, *Franchise Times*, LJN's *Franchising Business & Law Alert*, ILO's franchise newsletter, and other publications.

PRESENTATIONS AND SEMINARS

Mr. Xu has spoken international franchising issues, particularly those in China, in a variety of venues, including the International Franchise Association/International Bar Association Joint Conference (May 2007) and the International Franchise Expo (March 2007 and April 2008).

TABLE OF CONTENTS

Section Page

I. PROCEDURAL ISSUES 1

A. Local Presence: To Have or Not To Have 1
B. Approval of Foreign Investment in China 3
C. Types of Local Entities 5
D. The Special Case of Franchising 6
E. Real Estate in China 8

II. CONTRACT ISSUES 9

A. Domestic vs. Foreign-related Contracts 9
B. FOREX Issues 10
C. Good Faith and Fair Dealing 11
D. Special Requirements Applicable to Hotel Franchise/License Agreements 11

III. LIABILITY ISSUES 12

A. Disclaimer/Exclusion of Liability/Exemption Clauses 12
B. Franchisor/Licensor Liability 13
C. Personal Liability 14

IV. DISPUTE RESOLUTION 14

A. China's Court System 14
B. Arbitration 15
C. Mediation 17

V. THE SPECIAL ROLE OF OFF-SHORE STRUCTURING 17

VI. CONCLUSION 17

How to Climb the Great Wall –
Doing Hotel Transactions in China:
Procedural Issues, Contract Issues, Liability Issues & Dispute Resolution

For companies big and small, doing business in China can be one of the riskiest yet most rewarding undertakings.[1] Its economy has been growing (up until recent months) at an exponential and, as some would argue, breakneck, speed; it is a market economy with a heavy dose of government intervention; its evolution to a society of rule of law is ongoing but far from complete. Opportunities, as well as challenges, abound.

For hotel owners, operators and licensors, the key to success is a keen understanding of the constantly changing commercial, political, legal and regulatory landscape in China – what is possible and what constraints exist. This paper will introduce some of the legal and regulatory issues that arise when foreign companies enter the hospitality and leisure industry in China.

I. PROCEDURAL ISSUES

A. Local Presence: To Have or Not To Have

For foreign companies venturing into China, one of the first questions that they face is whether or not to establish a local presence there. While local presence will bring credibility in the market place, and often is required under Chinese law to carry out the intended business, it at the same time brings a myriad of tax, corporate, profit repatriation, employment and other local law issues.

1. Hotel Owners

For a hotel owner, the current law requires a local entity. As part of its effort to cool down the real estate market, in July 2006 China started requiring that for a foreign investor to acquire real estate property in China, it must incorporate a Foreign-invested Enterprise ("FIE") and own the property through the FIE.[2] China has not issued any regulations or listing rules for

[1] In this paper, references to "China" and "the People's Republic of China (PRC)", unless otherwise explicitly noted, are to "mainland China" – that is, excluding Hong Kong SAR, Macao SAR and Taiwan. Hong Kong and Macao, after their return to the Chinese sovereignty, remain separate in terms of economic laws and regulations, and are treated similarly to "foreign countries" by the mainland Chinese economic regulations. However, both jurisdictions (Hong Kong in particular) have entered into special arrangements with the central Government that grant them certain preferential treatments. For example, the Closer Economic Partnership Arrangement (CEPA, 内地与香港关于建立更紧密经贸关系的安排) accelerates or, in some instances, increases Hong Kong's access to the Chinese market compared to other WTO members. Such preferential treatment is one of the reasons why many foreign companies use Hong Kong as a jumping board to enter the mainland Chinese market.

[2] *See*, Measures to Regulate Foreign Investment in the Real Estate Market (关于规范房地产市场外资准入和管理的意见), by the Ministry of Construction, the Ministry of Commerce and the People's Bank of China, July 11, 2006.

Real Estate Investment Trusts ("REIT"), and the current legal and taxation regime does not present any benefit for foreign investors to use REIT as an investment vehicle in China.[3] Chinese officials have suggested that a REIT pilot program is in the works, as the government views REITs as a way to stimulate China's troubled real estate market.

In addition to requiring that a local entity (i.e., FIE) be incorporated, China's foreign exchange regulatory authority, the State Administration of Foreign Exchange ("SAFE"), has ceased registration of any debt owed to foreign lenders by domestic real estate projects.[4] Without such registration, repayments of the foreign debt will not be allowed to be remitted outside China. As such, foreign real estate investors and their advisors will need to structure the real estate transactions creatively to achieve their business objectives without running afoul of the Chinese laws and regulations.

2. Hotel Operators

For foreign hotel operators (whether brand operators or independent operators), if the managed hotel is a hotel owned by an FIE, then there is no legal requirement to incorporate a local entity to provide management services to that FIE-owned hotel. Instead, the hotel operator is required to obtain a business license from the appropriate State Administration of Industry and Commerce ("SAIC") office before it starts managing a hotel.[5]

If the hotel is not owned by an FIE but rather by a domestic Chinese owner, then the foreign hotel operator must incorporate an FIE in China, and the FIE must obtain a business license with the appropriate business scope before providing management services to the hotel.[6]

---

[3] Hong Kong, on the other hand, has amended the code of its Securities and Futures Commission to allow REITs authorized by the SFC to invest in properties outside Hong Kong. This and other reasons make Hong Kong an attractive jurisdiction from where the foreign investor can incorporate an FIE in China to invest in real estate properties there.

[4] *See*, Notice Regarding Further Strengthen the Regulation of Foreign Investment in the Real Estate Industry (商务部、国家外汇管理局关于进一步加强、规范外商直接投资房地产业审批和监管的通知), the Ministry of Commerce and the State Administration of Foreign Exchange, June 11, 2007.

[5] *See*, Measures for Registering Foreign Countries (Regions) Enterprises Engaged In Business Operations in China (外国(地区)企业在中国境内从事生产经营活动登记管理办法), the State Administration of Industry and Commerce, August 15, 1992; *See also*, Notice regarding Approval and Registration of Foreign Enterprises being Entrusted to Manage Foreign Invested Enterprises (国家工商行政管理局、经贸部关于受托经营管理合营企业的外国(地区)企业审批登记问题的通知), the State Administration of Industry and Commerce and the Ministry of Foreign Trade and Commerce, June 11, 1988.

[6] "Business License" and "Business Scope" (which is contained in a business license) are key concepts in Chinese law. Every company in China must act within its business scope, which is written into its business license.

3. Hotel Franchisors

There is no requirement under Chinese law that a franchisor must be a company incorporated in China. Therefore, a foreign hotel franchisor can choose to franchise into China directly, without incorporating any local entity, or, alternatively, incorporate a local entity in China and franchise through that local entity. Both foreign and domestic franchisors are required to comply with China's Franchise Regulation.[7]

B. Approval of Foreign Investment in China

1. The Investment Catalogue

If a foreign company determines that it wishes, or is required, to establish a local presence in China, then it needs to examine whether the Chinese law allows the foreign company to do so and, if affirmative, to what extent (e.g., is 100% ownership by the foreign company allowed, or only a minority stake)? The Ministry of Commerce ("MOFCOM") and National Development and Reform Commission ("NDRC") have issued an *Industry Catalogue Guiding Foreign Investment* ("Investment Catalogue," the last version of which took effect on December 1, 2007),[8] which contains four categories: "encouraged," "permitted," "restricted" and "prohibited." Generally, "encouraged" projects enjoy certain preferential treatment, while "restricted" projects require approval by agencies at the higher level and are subject to other more stringent restrictions.

The current Investment Catalogue lists "establishing and operating luxury hotels" and "franchising" in the "restricted" category.

2. Various Government Approvals

Establishing an FIE in China is subject to approvals by various government agencies, which, generally speaking, include the following:

- the approval of the NDRC or its local counterparts may be required;
- the approval of MOFCOM or its local counterparts is necessary;
- issuance of the Business License by the SAIC or its local counterparts is necessary;

[7] Regulation on Administration of Commercial Franchise (商业特许经营管理条例), Decree of the State Council, No. 485 (effective from May 1, 2007).

[8] Available at http://www.ndrc.gov.cn/zcfb/zcfbl/2007ling/W020071107537750156652.pdf.

- for foreign exchange issues, the approval of SAFE or of its local counterpart may be required;

- if land use is involved, approval or registration by the State Land Administration Bureau or its local counterparts is necessary;

- if the FIE is a joint venture with a Chinese partner that possesses State-owned assets which the Chinese partner intends to contribute as its capital contribution to the joint venture, the State-Owned Assets Supervision and Administrative Commission or its local counterparts will be involved in approving the assets appraisal of such contribution; and

- specific tax treatment is decided by State Administration of Taxation along with the Ministry of Finance and, in some cases, the State Council.

3. "Registered Capital" and "Total Investment"

When the Chinese authorities review and decide whether to approve an FIE project, they will consider, among other things, two numbers: the "registered capital（注册资本）" and the "total investment（投资总额）" of the FIE. In essence, the "registered capital" is the monetary value of the total amount of share capital to be subscribed by all of the investors to an FIE, while the "total investment" is the sum of the registered capital and the amount of subsequent financing that the FIE can obtain (loans, etc). The scale of the total investment of an FIE will decide which level of governmental approval (central or local) is necessary.

The Chinese government attempts to control the "debt/equity ratio" of an FIE through controlling the ratio between the registered capital and the total investment. By the operation of Chinese law,[9]

- Where the total investment is USD3 million or less, its registered capital shall be at least 7/10 of its total investment;

- Where the total investment is between USD3 million and USD10 million (up to and including USD10 million), its registered capital shall be no less than 1/2 of its total investment (if the total investment of a FIE is less than USD4.2 million, its registered capital may not be less than USD2.1 million);

- Where the total investment is between USD10 million and USD30 million (up to and including 30 million), its registered capital shall be no less than 2/5 of its total

[9] *See, e.g.,* Interim Measures Regarding the Ratio Between Registered Capital and Total Investment for Sino-Foreign Equity Joint Venture Enterprises (国家工商行政管理局关于中外合资经营企业注册资本与投资总额比例的暂行规定), February 17, 1987.

investment (where the total investment is less than USD12.5 million, its registered capital may not be less than USD5 million); and

- Where the total investment is over USD30 million, its registered capital shall be no less than 1/3 of its total investment; and where the total investment is less than USD36 million, the registered capital shall be no less than USD 12 million.

Currently, if the total investment of an FIE engaging in encouraged or permitted business is USD100 million or more, or if the registered capital of an FIE engaging in restricted business is USD50 million or more, the central government's approval is required.[10]

C. Types of Local Entities

1. Representative Office and Branch

Like the FIEs, the establishment of a representative office in China requires the approval of the relevant governmental authority. Upon approval, the representative office must register with such authorities as the SAIC or its local office, the public security bureau and the tax administration. Unlike the FIEs, a representative office is not an independent legal entity, and may not engage in direct business (profit-making) operations. The representative office can conduct business liaison, product introduction, market research and some technology exchange on behalf of a foreign company.

Branches may be established under specified circumstances. However, it is usually difficult to obtain the requisite government approvals. It appears likely that in future, after the State Council adopts the necessary regulations, foreign companies will be permitted to, upon application and approval, establish branch offices which will be able to engage in a wider range of activities when compared to representative offices.

2. Various Types of FIEs

There are generally three types of FIEs: Wholly Foreign Owned Enterprise ("WFOE"), Equity Joint Venture (EJV), and Cooperative Joint Venture (CJV).

WFOEs, being 100% owned by the foreign companies, benefit from the avoidance of conflicting partner interests, differences in corporate culture and other issues relating to control and management. On the other hand, JVs (both EJVs and CJVs) are typically set up either because the applicable Chinese law requires local ownership (e.g., for some of the industries that are "restricted" to foreign investment), or because the foreign company wants to leverage local expertise and capital. In the past, the foreign company is required to own at least 25% of the equity of a JV, which is no longer the case. However, for the JV to enjoy certain preferential

[10] *See*, Notice Regarding Further Strengthening the Regulation of Foreign Investment Projects (国家发展改革委关于进一步加强和规范外商投资项目管理的通知), the NDRC, July 8, 2008.

treatment (e.g., reduced customs duty and tax rates) generally available to FIEs, 25% foreign ownership is still required.[11]

The CJV structure offers more flexibility to investors than the EJV structure. The parties can establish a CJV without incorporating an independent legal entity, although in practice it is often difficult to obtain government approval for such a set-up, as tax and other related regulations have not been issued. Much more importantly, under the CJV structure, the parties are afforded certain flexibility in allocating their equity ownership and profit/loss sharing percentages, and in deciding the CJV's management and operation structures in accordance with the parties' contractual arrangement, whereas under the EJV structure, the ownership and profit/loss sharing allocation must be in accordance with the parties' equity contribution to the EJV.[12]

D. The Special Case of Franchising

In addition to general laws and regulations that apply to foreign investors and hotel operations, hotel franchisors and franchisees are also subject to the special regulatory regime prescribed by China's Franchise Regulation adopted by the State Council, and the two implementation guidelines issued by the MOFCOM – one for the franchisor registration filing (the "Filing Rules"), and the other for the preparation and delivery of the franchise disclosure documents (the "Disclosure Rules").

1. Qualifications to be a "Franchisor"– the "Two Plus One" Rule

The Franchise Regulation requires that every franchisor must have two company-owned units and operate them for more than one year before it can offer franchises in China. This is the so-called "two plus one" rule.[13] Unlike its predecessor regulation, the Franchise Regulation does not require these company-owned units to be located within China. Instead, they can be located anywhere in the world.

---

[11] *See*, Notice Regarding the Strengthening of the Administration of Approval, Registration, FOREX and Taxation of Foreign-invested Enterprises (关于加强外商投资企业审批、登记、外汇及税收管理有关问题的通知), by the Ministry of Foreign Trade and Economic Cooperation, the State Administration of Taxation, SAIC and SAFE, effective from January 1, 2003; *See also*, Notice of National on Tax Issues concerning Foreign Invested Enterprise with Foreign Investor's Contribution Lower than 25% of the Capital (国家税务总局关于外国投资者出资比例低于 25%的外商投资企业税务处理问题的通知), by the State Administration of Taxation, April 18, 2003, and Notice of State Administration of Foreign Exchange on Improvements of Administration of Foreign Loans (国家外汇管理局关于完善外债管理有关问题的通知), the State Administration of Foreign Exchange, October 21, 2005.

[12] *See*, the PRC Sino-Foreign Cooperative Joint Venture Law (中外合作经营企业法), Article 2, and the PRC Sino-Foreign Equity Joint Venture Law (中外合资经营企业法), Article 4.

[13] Franchise Regulation, Article 7.

However, there are still many other questions associated with the "two plus one" rule that are not addressed in the Franchise Regulation nor in the Filing Rules. For example, will the company-owned operations owned by an affiliate of this franchisor count? Does a franchisor's management of a unit owned by a third party suffice? Must this requirement only be met when the franchisor files for registration, or must it be met continuously after registration?

Conversations with the Chinese regulators over the past two years indicate that they are inclined to take a more liberal approach in interpreting the "two plus one" rule, especially with regard to the affiliate issue. In addition, MOFCOM, which directly oversees the enforcement of the Franchise Regulation, is also seeking formal guidance from the State Council on the interpretation of the "two plus one" rule and other issues of concern to many foreign franchisors.

2. Franchisor Registration Requirement

Instead of requiring each franchisor to be "approved" and obtain a "franchise license" before starting to franchise in China (an approach that appeared in drafts dated as late as May 2006), the Franchise Regulation provides that franchisors need only "register" with the provincial government or (for those who will engage in "cross-province" franchising) MOFCOM.[14] Such registration is required within 15 days after the franchisor sells its first franchise. Franchisors who have already been franchising in China are required to be registered by May 1, 2008.[15]

The government agency is required to register a franchisor within 10 days following its receipt of all the required documents, which includes copies of certificate of incorporation or business license, form franchise agreement, operations manual, market plan, and evidence of franchisor's satisfaction of the "two plus one" rule. Notably, franchisor's disclosure document and audited financial statements are not required for registration (although they are still required to be provided to prospective franchisees).

For U.S. franchisors who are accustomed to meeting registration requirements in certain U.S. states, the use of the term "registration" under the Franchise Regulation may be confusing. "Notice filing" is probably closer to what the Franchise Regulation actually contemplates. Nonetheless, we must sound a note of caution. The author's recent experience with MOFCOM in connection with the registration filing on behalf of clients indicates that MOFCOM staff is actually commenting on the substantive issues raised by the submitted documents. That is a disappointing departure from the intent of the Franchise Regulation, but a reality that will have to be dealt with by foreign franchisors.

3. Franchise Disclosure Document

[14] Franchise Regulation, Article 8. *See also*, the Filing Rules.

[15] Franchise Regulation, Article 33.

The Franchise Regulation and the Disclosure Rules lay out the information that a franchisor is required to disclose to a prospective franchisee.[16] Please see Exhibit A for a list of information that is required to be delivered. The disclosure document must be delivered at least 30 days prior to signing the franchise agreement, and the disclosure obligation is not triggered by any preliminary discussion or accepting any money. Although the disclosure obligations are quite comprehensive, most of the required information can be gathered from the U.S. franchise disclosure document. There is no requirement that the franchise disclosure document be in a particular format, so long as the information required to be disclosed is contained in the document. There is also no specific requirement as to the financial statements to be attached to the franchise disclosure document, other than that they are to be audited. Our experience so far indicates that those financial statements, prepared in accordance with the U.S. GAAP, will be accepted and should fulfill the requirement.

E. Real Estate in China

1. Land Use Rights

In China, land is owned by the State and, in some rural areas, by collective farmers. In 1988, the Constitution (宪法) was amended to recognize the "land use right," as opposed to the "land ownership," which remains with the State.[17] The 2007 PRC Property Law affirms the private ownership of "land use rights."[18] Unlike the land, private parties can own buildings as properties.

Land use rights are not perpetual. Instead, depending on the intended use of the land, they range from 40 years (for commercial use), 50 years (for industrial use), to 70 years (for residential use, which will be automatically extended after 70 years).[19] The PRC Property Law requires the establishment of a uniform real estate registration system to replace the current patchwork of local registration systems administered by various local authorities.[20] Depending on who the seller is (e.g., the government, real estate developer, individual owner, etc.), different documents are needed to perfect the purchase of land use rights. Due diligence is necessary to ascertain whether the seller can transfer the relevant land use rights.

2. Lease

[16] Franchise Regulation, Article 22. *See also*, the Disclosure Rules.

[17] *See*, the PRC Constitution, Article 10.

[18] *See*, the PRC Property Law, Article 135.

[19] *See*, Article 12 of the Interim Regulations Concerning the Assignment and Transfer of the Right to the Use of the State-owned Land in the Urban Areas (城镇国有土地使用权出让和转让暂行条例), May 19, 1990.

[20] The PRC Property Law, Article 10.

For a lease to be valid against third parties (e.g., mortgage lenders), it must be registered with the appropriate local authority. Requirements for registration vary from locale to locale, although generally the following documents would be necessary: (i) the lease agreement; (ii) the business licenses of both the landlord and the tenant; and (iii) the landlord's real estate ownership certificate regarding the leased premise.

II. CONTRACT ISSUES

A. Domestic vs. Foreign-related Contracts

There are major differences between a purely domestic contract, and a "foreign-related" contract. A contract qualifies as a "foreign-related" contract if one of the following three factors is present:[21]

(a) at least one of the contracting parties is a foreign party;
(b) the object of the contract is located outside China; or
(c) the legal facts that establish and/or change and/or terminate the contract between the parties take place outside China.

Obviously, the most certain way to establish a "foreign-related" contract is to have the foreign company, not its subsidiary in China (i.e., the FIE), sign the contract.

The major differences between domestic and foreign-related contracts include the following:

[21] *See*, the Supreme People's Court Opinions Regarding Implementation of the General Principals of the Civil Law (Amended), December 5, 1990, Article 207.

	Chinese Domestic Contracts	Foreign-Related Contracts
Governing Law	Must be governed by Chinese law.	May provide for foreign law as governing law.
Dispute Resolution	Disputes must be resolved in China, either by litigation or arbitration.	May provide for dispute resolution outside China. (See Section IV below for further discussions.)
Payment	Must be in RMB (Ren Min Bi, 人民币).	Must be in foreign currency. (See Section II.B below for further discussions.)
Taxation	No withholding tax; but domestic corporate income tax, VAT and other taxes.	In many instances, the foreign party is subject to mandatory withholding tax and/or business tax.

B. FOREX Issues

1. General

The Chinese government's control over payments to overseas has been greatly relaxed over the years. However, restrictions on foreign exchange (FOREX) matters still exist. These restrictions vary depending on the payment types. Generally speaking, for payments under the current accounts (e.g., purchase & sale, license fees, service fees, etc.), as long as the domestic party that is making the payment can present certain documents as required under FOREX regulations, no prior approval from the government (i.e., SAFE and its local offices) is required.

That being said, foreign companies must still make sure that the agreements, based on which the payments will be made, are drafted appropriately to reflect the FOREX requirements. Banks and (if government approval is required) SAFE offices will review the agreements to determine the "authenticity" of the underlying transaction. One of the issues will be whether the payments fall under any of the "recognized" types of payments that SAFE authorizes. As such, foreign companies must ensure that the types of fees and payments in the contracts will be accepted by the banks and/or SAFE offices. For example, while trademark and technology license fees are acceptable, franchise fees will face considerable difficulties for lack of specific FOREX regulations allowing the payment of such fees.

2. Special Ramifications for Guarantees

Although guarantees are permitted under Chinese law, if the guarantor will make payments in FOREX to overseas, then such guarantee is subject to the FOREX regulations. Essentially, if the guarantor is an FIE, then the guarantee must be registered with SAFE after it is signed. If the guarantor is a non-FIE Chinese domestic company, then the guarantee must be

approved by SAFE before execution. Without such registration or approval, the guarantor will not be permitted to make the payout.[22]

C. Good Faith and Fair Dealing

Both the PRC General Principles of Civil Law (民法通则) and the PRC Contract Law (合同法) provide that the parties should act in accordance with the principle of good faith and fair dealing.[23] Furthermore, the PRC Contract Law imposes an obligation that is generally know in civil law as "pre-contractual good faith." Specifically, no party may (i) engage in consultation with malicious intent in the name of entering into a contract; (ii) intentionally conceal key facts related to the entrance into a contract or provide false information; or (iii) take any other act contrary to the principle of good faith.[24]

In addition to these laws of general applicability, many other narrower-focused laws and regulations in China reiterate the principle of good faith and fair dealing. For example, the Franchise Regulation provides that the franchisor and the franchisee shall act "in compliance with the principles of free will, fair dealing, honesty and good faith."[25]

D. Special Requirements Applicable to Hotel Franchise/License Agreements

Unlike hotel management agreements, hotel franchise/license agreements are subject to a specific regulation in China – Franchise Regulation, in addition to other laws and regulations that are generally applicable to foreign companies' operations in China. As discussed in Section I.D above, the Franchise Regulation provides for a regulatory regime that requires both registration of the franchisor and pre-contractual disclosure of certain information. In addition, with respect to the franchise agreements, the Franchise Regulation contains a list of issues that it requires every franchise agreement to address, as follows:[26]

(1) basic information of the franchisor and the franchisee;
(2) contents and duration of the franchise;
(3) types, amounts, and payment methods of the franchise fees;

---

[22] *See*, Administrative Measures Regarding Guarantees by Domestic Entities (境内机构对外担保管理办法), the People's Bank of China (October 1996), and the Implementing Rules of the Administrative Measures on Domestic Organizations' External Guarantees (境内机构对外担保管理办法实施细则), the State Administration of Foreign Exchange, December 11, 1997.

[23] *See*, the PRC General Principles of Civil Law, Article 4, and the PRC Contract Law, Articles 5 and 6.

[24] The PRC Contract Law, Article 42.

[25] Franchise Regulation, Article 4.

[26] Franchise Regulation, Article 11.

(4) specific contents and provision methods of the operational guidance, technical support, business training, and other services;

(5) quality and standards requirements, as well as guarantee measures, for the products or services offered by the franchised business;

(6) promotion and advertisement of the products or services offered by the franchised business;

(7) arrangements for protection of consumer rights/interests and undertaking of liability for compensation in the franchising activities;

(8) amendments, rescission, and termination of the franchise contract;

(9) liability for breach of contract;

(10) methods of dispute resolution; and

(11) other matters as agreed upon by the franchisor and the franchisee.

This approach (essentially a form of disclosure requirement, but contained in the franchise agreement itself) is one to which most foreign franchisors are unaccustomed, but these requirements are not particularly controversial. It should be noted that item (7) represents a welcome turnaround from the approach undertaken under the predecessor regulation, where joint liability is imposed on the franchisors. Here, it is only required that the franchise agreement specify who will be responsible for customer liability issues.

The Franchise Regulation imposes a mandatory cooling-off period under the franchise agreement – that is, a franchisee is allowed to rescind the franchise agreement within a period of time after the agreement is signed.[27] Unfortunately, neither the Franchise Regulation nor the implementation guidelines specify how long that cooling-off period should be. Unless MOFCOM comes forward with a definitive answer, franchisors and their advisors will have to use their judgment as to how long a period they want to specify under the franchise agreement. Presumably, a period of one or two weeks should suffice, as this requirement is clearly modeled after the 7-day cooling-off period found in the Australian Franchising Code of Conduct.

III. LIABILITY ISSUES

Hotel owners and operators face many liability issues when they own and operate hotels in China, including areas such as labor and employment, environment, taxation, safety, consumer privacy and advertising. Although each of these areas presents unique challenges to foreign companies, they are familiar with these subjects based on their experience in their home countries. As such, with assistance from competent advisors, foreign companies should be able to navigate these liability issues.

Below are a few liability-related issues that might be different from what foreign companies usually face in their home countries.

A. Disclaimer/Exclusion of Liability/Exemption Clauses

[27] *Id*, Article 12.

Like many civil law jurisdictions, China seeks to restrict clauses that would exclude a party's liability in case of a breach. In particular, the PRC Contract Law provides that a clause is invalid if it purports to exclude liability for bodily injuries or for property damages caused by willful misconduct or gross negligence.[28] Although the statutory language seems to suggest that the provision is to invalidate clauses that "exclude" such liabilities, as opposed to merely "limiting" such liabilities, the Legislative Affairs Commission of the Standing Committee of the National People's Congress interprets the clause to also invalidate contractual provisions intended to limit liabilities.[29] In addition, the Supreme People's Court and many legal scholars are also of the same view.[30]

B. Franchisor/Licensor Liability

Articles 24-30 of the Franchise Regulation set out a series of penalties for non-compliance, including publication by the regulatory agency of the violation, and imposition of fines. They cover failure to have the qualifications required of a franchisor, such as having operated two locations for not less than one year; failure to register; failure to comply with the provisions regarding advance fees and updating the franchisor's registration information; failure

---

[28] *See*, the PRC Contract Law, Article 53.

[29] *See*, Interpretation of the PRC Contract Law, the Legislative Affairs Commission of the Standing Committee of the National People's Congress (中华人民共和国合同法释义，全国人民代表大会常务委员会法制工作委员会编，法律出版社，1999 年 4 月第 1 版), page 53, "A 'disclaimer' in a contract refers to a clause that the parties of a contract have stipulated in a contract in order to exempt or limit one party or both parties future liabilities (合同中的免责条款就是指合同中的双方当事人在合同中约定，为免除或者限制一方或者双方当事人未来责任的条款)".

[30] *See*, Interpretation and Application of the PRC Contract Law, the Economic Branch of the Supreme People's Court (合同法释解与适用，最高人民法院经济审判庭编著，新华出版社，1999 年 4 月第一版), page 228, "the so-called 'disclaimer clause' means such a clause that the parties of a contract stipulate in the contract for the purpose to eliminate or restrict future liabilities of one party or both parties (所谓免责条款，是当事人双方在合同中约定的，旨在免除、限制一方或双方将来责任的条款)".

See also, Interpretations on the PRC Contract Law, Jiang Ping (中华人民共和国合同法精解，江平，中国政法大学出版社，1999 年 3 月第 1 版), page 43 to 44, "A disclaimer clause in a contract shall mean such a clause that the parties have stipulated to exempt or to limit future liabilities (合同的免责条款，是指当事人约定免除或限制其未来责任的合同条款)"; Remedies for Breach of Contract, Fang Shaokun and Yang Shaotao (损害赔偿理论与司法实践丛书，《违约损害赔偿》，人民法院出版社，1999 年 12 月第 1 版), page 45, "The disclaimer clause in a contract refers to the clause that the parties of a contract stipulate to limit or exempt the liabilities of one party or both parties (合同中的免责条款是指合同双方当事人在合同中约定的免除或者限制当事人一方或双方的民事责任的条款)."

to comply with the provisions regarding misleading advertising; and failure to disclose. There is also an Article stating that fraud will be dealt with under the provisions of the Criminal Code and that any multi-level marketing activities will be dealt with in accordance with the State Council Regulation on the Prohibition of Multi-level Marketing Regulations.[31]

Interestingly, there is also an article imposing liability on any official of MOFCOM or its local counterparts who abuses his/her power, is derelict in his/her duties or engages in malpractice for personal gain.[32] This may partly explain the agencies' exceeding caution in granting franchise registrations.

The fines could be as high as RMB500,000 (approximately USD73,000), but the more meaningful punishment is the publication of non-compliance, which could severely impede any franchise sales activities.

In addition, it is important to note that these penalties under the Franchise Regulation are only administrative penalties. Franchisors' liabilities will also stem from the Contract Law and other laws that might be applicable.

C. Personal Liability

Under the PRC Criminal Law, if a company conducts criminal activities (e.g., bribery or tax evasion), the person in charge of the company or the personnel that is directly responsible for the company's illegal activity will very possibly be personally liable for criminal liabilities.[33] While there is no clear definition of "person in charge" or "direct responsible personnel" under the PRC Criminal Law, in practice, these terms normally refer to senior officers in charge of relevant operations of the company, including, e.g., the company's CEO, general manger, CFO, legal representative, chairman of the board or executive director, etc.

The concept of a director's fiduciary duty under the PRC Company Law is similar to that exists under the U.S. law. Civil litigations against company directors in China remain rare. Nonetheless, directors should be very cautious about company activities that may lead to criminal liabilities such as tax evasion and bribery, especially when they are in the position of legal representative, CEO or other management responsibilities.

IV. DISPUTE RESOLUTION

A. China's Court System

According to the Constitution and the Organic Law of the People's Courts of 1979 as amended in 1983 and 2006 (人民法院组织法), China practices a system of courts characterized

[31] Franchise Regulation, Article 29.

[32] *Id*, Article 30.

[33] *See*, the PRC Criminal Law.

by "four levels and two instances of trials." There are four levels of "people's courts": the Basic People's Courts, the Intermediate People's Courts, the High People's Courts and the Supreme People's Court.[34] Court decisions may be appealed once, but the judgment of the second instance is final and binding upon the parties – hence the "two instances of trials."[35]

Most major cases involving a foreign party fall under the jurisdiction of the Intermediate People's Court, and are usually heard by a panel of three judges. The proceedings will be conducted in Chinese, and the parties must obtain any translation service at their own cost.[36] Only PRC licensed lawyers can appear in courts.[37]

Although the Chinese court system can dispose of cases very quickly – many are decided within weeks or months, there are currently too many deficiencies for it to be a recommended mechanism to resolve dispute in China for foreign companies. The courts in a few major cities, including Beijing, Shanghai and Shenzhen, have regularly dealt with cases involving foreign parties, and tend to have the judicial expertise and temperament to handle such cases competently and fairly. Outside these cities, judicial independence is at best tenuous in many places. Local protectionism and government intervention make it difficult to navigate these local courts without the assistance of experienced Chinese litigators.

B. Arbitration

Arbitration is the preferred mechanism to resolve disputes for foreign companies doing business in China. Arbitration in China is governed by the PRC Arbitration Law (仲裁法), the PRC Civil Procedural Law, the New York Convention on the Recognition and Enforcement of Foreign Arbitral Award (the "New York Convention," to which China is a party) and various judicial interpretations issued by the Supreme People's Court.

As discussed above in Section II.A, foreign companies can provide for arbitration outside China in their agreements with domestic Chinese companies. Awards rendered by foreign arbitration tribunals are called "foreign awards" under the Chinese arbitration regime, and are enforceable in China through the court system under the New York Convention.[38] It should be noted that after Hong Kong's return in 1997, the arbitral awards rendered by arbitration institutions in Hong Kong no longer enjoy the benefits of the New York Convention. To address this issue, the mainland and Hong Kong signed the "Arrangement Concerning the Mutual Enforcement of Arbitral Awards by the Mainland and Hong Kong SAR (关于内地与香港特别

[34] Organic Law of the People's Courts, Article 2.

[35] *Id*, Article 11.

[36] The PRC Civil Procedural Law (民事诉讼法), Article 238.

[37] *Id*, Article 239.

[38] The PRC Civil Procedural Law, Article 267.

行政区相互执行仲裁裁决的安排)" in June of 1999, which is based on the principles of the New York Convention.

The foreign companies could also choose to arbitrate in China. Domestic arbitrations between foreign companies and Chinese companies are treated as "foreign-related arbitrations (涉外仲裁)" under the Chinese arbitration regime.[39] Before June 1996, the China International Economic and Trade Arbitration Commission ("CIETAC"), along with the China Maritime Arbitration Commission, enjoys a monopoly over foreign-related arbitration in China.[40] Since then, other domestic arbitration institutions have also been allowed to handle foreign-related arbitrations, but CIETAC remains the dominant and preferred choice for foreign companies. It is a well-established arbitration institution, and handles 700-800 cases each year. Its reputation and expertise far exceeds those of other domestic Chinese arbitration institutions.

CIETAC's current arbitration rules took effect on May 1, 2005. The changes to the previous rules focus on giving parties more freedom in choosing arbitrators, improving the efficiency of the arbitration procedures, and expanding the discretion of the arbitral tribunal.

Arbitration between two domestic Chinese companies is called "domestic arbitration," and is primarily governed by the PRC Arbitration Law and Civil Procedural Law.[41] It should be noted that an arbitration between two FIEs, or between a domestic Chinese company and an FIE, will likely be deemed a "domestic arbitration," not "foreign-related arbitration," even though the FIE has foreign ownership. In 2001, the Beijing Second Intermediate Court rejected a WFOE's argument that the arbitration should be conducted under Beijing Arbitration Commission's international procedures as a foreign-related arbitration, not its domestic procedures.[42]

It remains unclear whether an arbitration agreement that provides for arbitration before a foreign arbitration institution with the seat in China will be recognized by the Chinese courts, and whether arbitration awards rendered by such arbitration tribunal will be enforceable. The PRC Arbitration Law does not consider foreign arbitration institutions as "arbitration commissions" that are qualified to handle domestic and foreign-related arbitrations in China.

---

[39] *See*, the PRC Arbitration Law, Chapter VII; the PRC Civil Procedural Law, Article 255.

[40] *See*, Notice Concerning Clarification of Several Issues Regarding the Implementation of the PRC Arbitration Law (国务院办公厅关于贯彻实施《中华人民共和国仲裁法》需要明确的几个问题的通知), the State Council, June 8, 1996.

[41] *See*, the PRC Arbitration Law, Chapters V and VI; the PRC Civil Procedural Law, Article 213.

[42] *See*, Amcro Flexibles (Beijing) Co. Ltd. (安姆科软包装(北京)有限公司) vs. (China No. 22 Metallurgical Construction Co. Ltd. (中国第二十二冶金建设公司), (2001)二中经仲字第 1640 号.

C. Mediation

Lastly, a word about mediation. In China, judges routinely attempt to get the parties to resolve their disputes through mediation. This process is called judicial mediation, and is done at various stages of the litigation process. Judicial mediation is essentially a settlement negotiation supervised by the judge. The settlement agreement reached by the parties will be enforceable as a judicial judgment.[43]

V. THE SPECIAL ROLE OF OFF-SHORE STRUCTURING

Although China has come a long way in terms of improving its regulatory environment for foreign investors, for tax planning and regulatory compliance purposes, foreign investors still frequently utilize various off-shore structures when they enter into the Chinese market. Such off-shore structures often involve the use of special purpose vehicles in jurisdictions like Cayman Islands, British Virgin Islands, etc., as well as Hong Kong. The purpose is to bring the key contractual relationship outside of China, so that it is not subject to Chinese law, which means that the structuring, management and exit decisions can be made without the constraints imposed by Chinese law and regulations. For an illustration of a few basic examples (off-shore joint venture, off-shore hotel ownership and off-shore franchising), please refer to Exhibit B.

VI. CONCLUSION

Long gone are the days when foreign companies could succeed in China by relying on good local connections, novel products or western brand names. To be successful in China, they need to make sure that all fundamental aspects of the business are sound, including a legal strategy that is committed to understanding and complying with the Chinese laws and regulations. Here is hoping that China will continue improving its legal and regulatory regime for foreign companies, including those in the hospitality and leisure industry, in the years to come.

[43] The PRC Civil Procedural Law, Article 212.

Exhibit A
Information Required to be Delivered by a Franchisor in China

1. Basic information of the franchisor and the franchise activities.

    1.1 The franchisor's name, mail address, means of contact, legal representative, general manager, amount of registered capital, business scope, and the quantity, addresses, and telephone numbers of existing directly operated outlets;

    1.2 Overview of the commercial franchise activities of the franchisor;

    1.3 Basic information in the franchisor's filings;

    1.4 Where an affiliate of the franchisor supplies products or services to the franchisee, the basic information of such affiliate;

    1.5 Any information regarding the bankruptcy or application for bankruptcy of the franchisor or its affiliates over the last five years.

2. Basic information of the franchisor's possession of operational resources.

    2.1 The franchisor shall elucidate to the franchisee in writing the available information on the registered trademark(s), enterprise logo, patent(s), know-how, operation mode, and other operation resources;

    2.2 Where the owner of the operational resources listed above is an affiliate of the franchisor, the basic information of such affiliate should be disclosed. The franchisor shall simultaneously specify how it will handle the franchise system in the case that the authorization contract with such affiliate is terminated;

    2.3 Information regarding any litigation or arbitration which has occurred in relation to the franchisor's (or its affiliates') registered trademark(s), enterprise logo, patent(s), know-how and other operation resources.

3. Basic information regarding franchise fees.

    3.1 The categories, amounts, standards, and payment methods of the fees collected by the franchisor for itself or on behalf of third parties. Where the information cannot be disclosed, the franchisor must give an explanation. Where different amounts of franchise fees apply among franchisees, the franchisor shall disclose the maximum and minimum amounts of such fees;

    3.2 The conditions for the collection and return of guarantee funds, and the time and method of return of guarantee funds;

3.3 Where the franchisee is required to pay any fees before the conclusion of the franchise contract, the franchisor shall specify in writing to the franchisee the purpose of use of such fees, as well as the conditions and method for the return of the same.

4. Prices and conditions of products, services and equipment to be supplied to the franchisee.

4.1 Whether the franchisee must purchase products, services or equipment from the franchisor (or its affiliates), and the relevant prices, terms, etc.;

4.2 Whether the franchisee must purchase products, services or equipment from suppliers designated (or approved) by the franchisor;

4.3 Whether the franchisee may choose other suppliers, and the qualification requirements on the suppliers.

5. Continuous services to be provided to the franchisee.

5.1 The specific contents, method of provision and implementation plan, including locations, methods and duration of the training;

5.2 The specific contents of technical support, and description of the table of contents and relevant page numbers of the franchise operation manual.

6. Specific method and contents of guidance and supervision on franchisee's operation.

6.1 The method and contents of the franchisor's guidance and supervision on the franchisee's operation, and the obligations that the franchisee must fulfill as well as the consequences resulting from the franchisee's failure to fulfill such obligations;

6.2 Whether the franchisor will bear joint and several liability for customer complaints. If so, how.

7. Investment estimate of franchise stores/outlets.

7.1 The investment estimate may include the following expenses: franchise fees; cost of training; real estate property and decoration expenses; expenses for equipment, office appliances, furniture, etc.; initial inventory; fees for water, electricity and gas; expenses for obtaining license(s) and other governmental approval(s); start-up working capital;

7.2 The source of data and the basis of estimation of the above expenses.

8. Relevant information of the franchisee(s) within China.

8.1 Number, geographic distribution and the authorized franchise scope of existing and anticipated franchisees, and whether they have any exclusive franchising rights (if any, specify the specific area expected to be covered);

8.2 Appraisal of the operation of franchisees. The franchisor shall disclose the franchisees' actual or estimated average sales volume, cost, gross profit, net profit, and simultaneously explain the source of the aforesaid information, time span, franchise stores/outlets concerned, etc. If such information is an estimate, the franchisor shall explain the basis of such estimate, and explicitly warn potential franchisees that the actual operating circumstances may be different from the estimate.

9. Abstract of financial accounting report and abstract of auditing report of the past two years that have been audited by an accounting firm or an auditing firm.

10. The franchisor's material litigation and arbitration in the past five years related to the franchise activities.

10.1 Material litigation and arbitration refer to litigation and arbitration involving 500,000 Renminbi or more; and

10.2 The franchisor shall disclose basic information, venue and result of such litigation.

11. Record(s) of material illegal operation of the franchisor or its legal representative. A record of material illegal operation refers to (1) the imposition of a fine by the relevant authority in charge of administrative enforcement of law in an amount no less than 300,000 Renminbi and no more than 500,000 Renminbi; and (2) the imposition of a criminal liability.

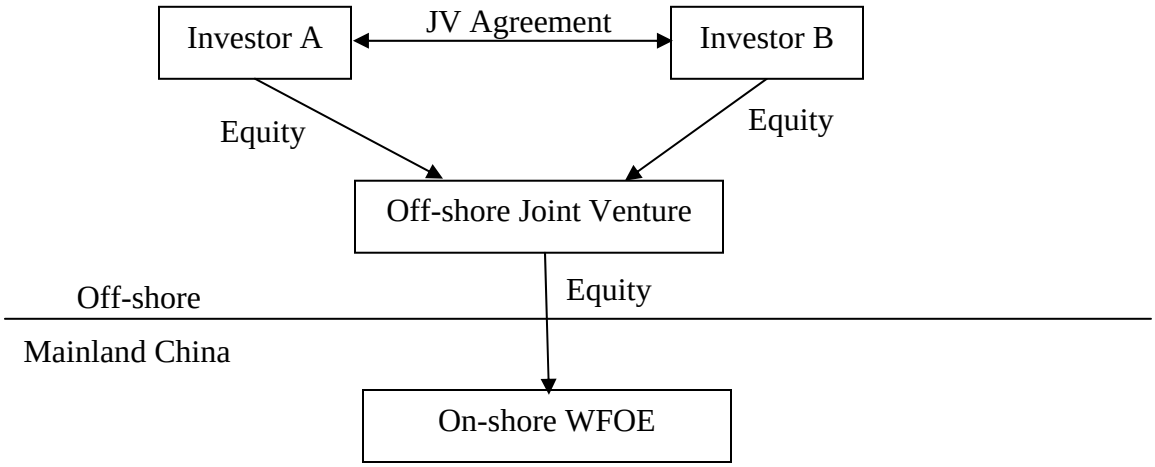
12. Franchise contract text

12.1 Sample of franchise contract;

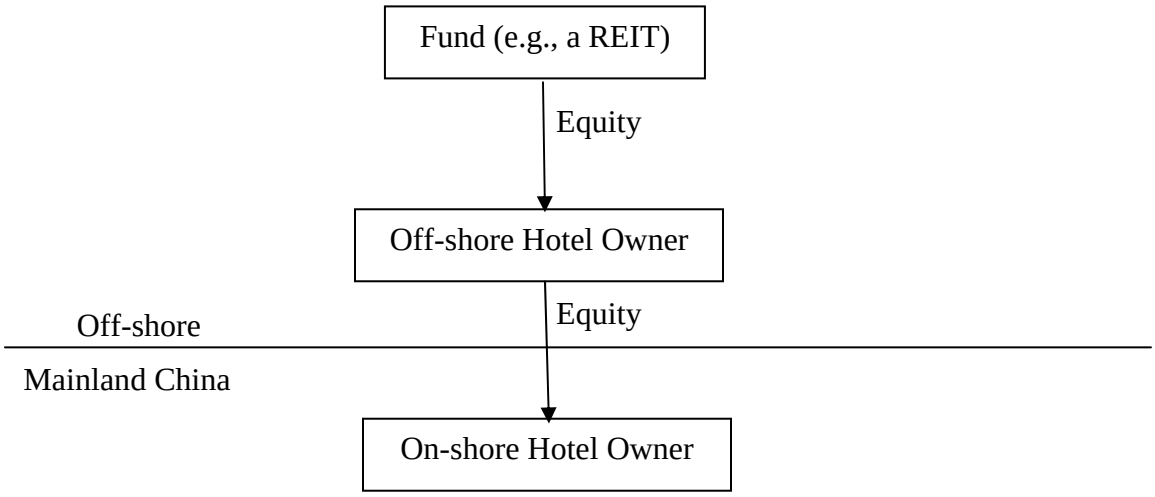
12.2 Where the franchisor requires the franchisee to enter into with the franchisor (or its affiliate) any other contract related to the franchise, a sample of such contract should be provided at the same time.

Exhibit B
Select Examples of Basic Off-shore Structures

A. Off-shore Joint Venture



B. Off-shore Hotel Ownership



C. Off-shore Franchising