



# Jesa Consulting Ltd.

## NEWSLETTER

July 2007

### In this issue:

- What is Jesa?
- Newly Enacted Chinese Bankruptcy Law
- Updated Chinese Franchising Regulations
- Highlights from Around China

## What is Jesa?

Jesa is a service company headquartered in Shanghai specializing in facilitating start-up of new industrial productions while providing reliable management and control solutions. We operate 4 main branches in China and a foreign office in Ulaan Baatar (Mongolia). Since 1998, Jesa has built a team of 70 specialized employees in addition to 25 engineers following "in loco" projects. Commercial relationships are exclusive and strictly confidential, ensuring the highest expertise on each single commercial and technical issue. Jesa is a leader in managing manufacturing processes and eliminating any industrial and regulatory problems while helping our clients save financial resources. Jesa is currently expanding its services to provide support to those companies seeking to develop environmental projects in china, such as alternative energies and environmental management.

---

## Newly Enacted Chinese Bankruptcy Law

In line with the numerous legislative changes which have been taking place in China over the past few months, came the implementation on June 1<sup>st</sup> of the new bankruptcy law, which introduces significant changes from its predecessor.

The Law of the People's Republic of China on Enterprise Bankruptcy (no. 54) was first enacted on December 2, 1986 as trial implementation and then formally came into operation in 1988. Since China was in the very initial stages of switching from a centrally-planned

economy to a market-based one, the law was plagued with tribulation from the start. The two primary problems with this law were that: 1) it only applied to State-Owned Enterprises - private companies were not even mentioned; and 2) employees' interests were placed before those of creditors. The now 20 year-old law placed the government in charge of every stage of the bankruptcy process. As a result, politics became more important than profits and for fear of social unrest, more importance was placed on laid-off employees. Need-less-to-say this created an unfriendly investment environment for potential creditors. Not many bankruptcy cases led to successful reorganizations and for this reason the PRC issued a review of the law in 1994; the current law is the result of a 12-year period of drafting and deliberation following this review.

The new law creates a formal corporate-bankruptcy procedure with judge appointed administrators and with creditors having payment priority over employees. Since creditors will be supervising the process, it means that professional, and even foreign lawyers and accountants will be leading the process (rather than Communist Party officials with secondary concerns). It will allow bankrupt companies to continue to run their assets, with a plan to reorganize them into viable businesses instead of going into liquidation (as is done in other parts of the world including the U.S.).

An important article in the law will allow both voluntary bankruptcy filings by the debtor and involuntary bankruptcy filings against the debtor by its creditors. The debtor that voluntarily files may choose reorganization (which restructures the enterprise's debts), liquidation (which ends the enterprise's operations and sells all assets for the benefit of the creditors), or conciliation (which allows for a quick compromise of unsecured claims without protracted bankruptcy proceedings). Another important provision states that a third-party administrator can oversee the bankruptcy or reorganization process. But the law also adds that either the debtor or the

administrator can take control of a debtor company and oversee its affairs (the creditors get to decide which path they believe is best).

Many experts agree that this law will strengthen protection for foreign investors in the country. This is because it provides a stable legal environment for dealing with problematic investments through insolvency or restructuring proceedings. *Prior to the law many foreigners were afraid to invest into China due to the lack of legal framework that can protect their interests if debtors default.* The new law will cure this since it is set to apply to all types of enterprises, including private firms, SOE's, financial institutions, and foreign-invested companies. It will bring China's bankruptcy system more in line with international standards by giving creditors more protection. But despite the good news, not all concerns will vanish as of yet. This is primarily because many experts are still sceptical about whether there are adequately trained judges and professionals in China to implement this complex piece of commercial legislation.

A positive result of the law is that while China's banks currently recover only about 20% to 30% of the face value of delinquent loans, the new law will allow the recovery rate to be closer to 70 cents on the dollar (i.e. much closer to the global average).

Most companies have been waiting for the new rules to be applied before filing for bankruptcy, therefore there is an expect surge of claims which will occur when the law will officially come into force on June 1<sup>st</sup>. The legislation will most likely not apply to SOE's until 2008 (although many say it will not apply to them even then). In either case, the new law comprises of 12 chapters with a total of 136 articles. Overall this is very simple when comparing it to other countries with mature bankruptcy legislation. For this reason we should expect to see improvements made to the law as companies file for bankruptcy; thus bringing China a step closer to matching international standards.

---

## Updated Chinese Franchising Regulations

The term franchising in China is often misunderstood and followed by puzzled looks which seek an explanation to the topic. But with the recent regulations implemented with the regards to franchising in China, the issue has recently come to the forefront of discussion among foreign companies wanting to enter China but wanting avoiding the infamous "Joint Venture."

By definition, franchising is a business system that allows a business-person, called a "franchisor" to put up for sale a proven business model, which can be bought and operated by an investor called a "franchisee." The business is called a "unit" and is run between the two parties as a legitimate business partnership. In this model the franchisee benefits from the proven track record of the franchisor and its training programs. Overall this type of venture requires substantial start-up costs and entrance fees to get involved and royalties must be paid annually to brand holders.

In the beginning of the franchise craze in China, most locals didn't understand why they had to pay for brand rights for what seemed to them like a regular join venture. Common examples of franchises in China include Subway, TNT, 3M, Cambridge English, and numerous others. Interestingly enough, two of the most famous franchise systems in China and around the world; Kentucky Fried Chicken (KFC) and McDonald's began operating in China in 1987 and 1990's respectively, but both waited until 2000 to start franchising - both can now been seen

regularly in many street corners in every major Chinese metropolis.

The first franchise law in China came as simple interim measures set forth in 1997. These were later amended in 2004 and implemented stronger provisions (called the "Measures") which included certain unusual regulations such as: the franchisor (or its subsidiary) must have opened at least two company-owned franchises in China for more than twelve months (also known as the 2-plus-1 rule), foreign franchisors must register and obtain approval by the Chinese governmental regulator as a pre-requisite to franchising, full disclosure about the franchised business must be made twenty days before execution of an agreement, franchisor must disclose any information requested by the franchisee, franchisor will be liable for certain actions of its suppliers, the franchisor has annual reporting requirements, and a few others.

Currently, a new "Franchise Regulation" has recently been issued by China's State Council and became effective May 1<sup>st</sup>, 2007. This Regulation is thought by many to be a vast improvement from the aforementioned Measures (which should be repealed altogether in the near future) and it will override any parts of the Measures that contradict the Regulations. The two major clarifications which were made are with regards to the "Filing Rules" and the "Disclosure Rules." Both these legal documents outline the procedures for which a franchisor must follow to satisfy the specific requirements set forth. This is done in order to have a uniform interpretation of the Regulations so as to avoid confusion; which was common during the previous Measures.

The Filing Rules primarily address the requirements and processes for franchisors to make a franchise filing with the relevant regulatory agency in order to be registered as a franchisor. Philip Zeidman from DLA Piper states that: "So long as the franchisor submits all required documents, including documentation

certifying that it has had two company-owned operations for one year (which now need not be in China) (the so-called "two plus one" requirement), the registration will be granted, and it remains permanently." In addition to these filings, the franchisor must report the status of its franchise agreements each year and update any and all filings within 30 days if there are any changes made.

The Disclosure Rules are put forth to outline the thorough disclosure requirements that the franchisor must follow in its disclosure document. The most significant changes are that the Rules *do* set a limit to the amount of information which under the Regulation a franchisor is forced to disclose.

Documents by DLA Piper have stated that despite the clarity which the new Regulation brings to the franchising laws in China, there are still some unresolved issues. For example: Will a franchisor be able to satisfy the "two plus one" requirement based on the operations owned by its affiliates? Will certain types of operations (e.g., hotels managed by a franchisor) be deemed sufficient to satisfy the "two plus one" requirement? Will foreign franchisors be able to make the filing with MOFCOM, rather than local agencies? How will a franchisor be able to make "evaluation of its franchisees' operations" when it does not have the relevant information from its franchisees? These are just some of the questions which remain in mind but it appears that government officers have hinted towards the fact that many of these processes will be able to be negotiated by the franchisors in the future; thus not requiring specific rules outlining the process.

In either case, the Regulation has allowed the Chinese franchising system to be clearer and overall fairer and we can only expect this to improve as further clarifications are put forth in the future.

-----

## Highlights from Around China

- **CHINA ENVIRONMENTAL SERVICE INDUSTRY ASSOCIATION (CESIA)**

80 companies have established the China Environmental Service Industry Association (CESIA). Approved by the All-China Federation of Industry and Commerce (ACFIC), this non profit organisation will provide environmental service and help the related industries. CESIA will also regulate the market competition, promote members' common development and assist government supervision of the sector.

- **HONG KONG RETURN ANNIVERSARY CELEBRATION**

To mark the 10<sup>th</sup> anniversary of Hong Kong's return to China, Chinese president Hu Jintao attended a gathering who also inaugurated the third-term government of the Hong Kong Special Administrative Region (HKSAR). Chief Executive Donald Tsang, who first went to the podium to take his oath, said that in the next few years HKSAR government will try to build a more democratic system, promote a new mode of economic development, and create a more open government that will also assure a better quality of life.

- **IMPORTS TO HIT \$ 1 TRILLION BY 2010**

Chinese Ministry of Commerce said that China is trying to enhance imports to more than \$ 1 Trillion by 2010 in order to balance trade surplus. The objective is to restrain exports and consequentially narrow the \$ 177.5 billion trade surplus of last year. The government has decided to eliminate export tax rebates for 538 categories such as fertilizer, non-ferrous metals and cement; also rebates for another 2268 products will be slashed to 5-11 percent from previous 8-17%.

- **CHINA HEADING FOR NUMBER ONE TOURIST DESTINATION**

According to experts, by 2014 China will replace France as the world's top tourist destination. In 2006 the number of foreign visitors to China reached 22 million (it was just 300,000 in 1978) and with the number of tourist arrivals doubling in the past five years, the Asian nation will pass Spain by 2010 and then overtake France by 2014. The explanation for China's appeal is the huge variety of destinations it offers; from the remote mountains of Tibet to the Terracotta Warriors in Xian, to Beijing Great Wall to the glamorous nightlife in Shanghai. This year China's tourism industry is expected to generate 2,5% of GDP or the equivalent of \$78 billion; an amount that could rise, according to the World Tourist Organisation, to \$ 277 billion by 2017.

- **CHINA PROMISES 50 BILLION YUAN FOR IMPOVERISHED STUDENTS**

The Ministry of Education will spend 50 billion yuan (\$6.5 billion) this year to help students from poor families. The money will come from the budgets of central and local governments. It will go toward the setting of national scholarships, stipends and student loans to ensure these students can continue their education. The funds will cover more than 20 percent of college students and 90 percent of vocational students. To guarantee fair distribution of the funds, high achieving students will each receive an annual scholarship of 8,000 yuan, students from poor families with high marks and good character will each receive an annual 5,000 yuan national supportive scholarship, and ordinary students will each receive a stipend of 2,000 yuan a year.



**Contributions:**

**Alessandro Bisagni**  
**Colin Wang**  
**Scott Sun (Supervisor)**

**SHANGHAI**

**(Headquarters)**

**Unit 3005, Jing'an Zhonghua  
Building  
1701, Beijing Road (W) - 200040**

**Shanghai - CHINA**

**Tel: +86 21 6288 0073 /  
6288 0075  
6288 0076**

**Fax: +86 21 6288 0072**

**Website: [www.jesa.com.cn](http://www.jesa.com.cn)**

**For inquires regarding this  
newsletter or for any other  
concerns; please contact us  
anytime at:**

**[info@jesa.com.cn](mailto:info@jesa.com.cn)**

Please consider the environment  
before printing this newsletter.

