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Look Before You License-Recent Amendments to Korean Franchise Laws Increase Burdens on Cross-Border Franchisors

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With a population of 50 million people (12 million in the greater Seoul area alone) and a Gross Domestic Product per capita of US$19,400, Korea is one of the largest economies in the industrialized world and represents a market that cannot be ignored by US companies. Not only has the spending power of Korean consumers been increasing steadily since the 1988 Olympic Games, Korean consumers generally perceive western brands quite favorably - Starbucks and Coffee Bean & Tea Leaf are omnipresent in bustling Seoul along with other prominent US consumer brands (including a considerable number of chain restaurants like California Pizza Kitchen and Cold Stone Creamery). It is important to note, however, that many Korean franchisees are large, sophisticated companies with bargaining power equal to their US franchisors. Last year's amendment to the Korean Franchise Act introduced a number of requirements that provide significant protections for the franchisee's interests. This article provides a brief summary of the regulatory framework for franchising in Korea and a summary of the amendments, as well as a few cautionary pitfalls and tips for cross-border franchisors interested in franchising in Korea.

Regulatory Framework for Franchising in Korea

South Korea first adopted a franchise disclosure and relationship law in 2002, under Korea's Act on Fairness in Franchise Transactions (the "Franchise Act"). The Franchise Act was subsequently amended in 2007, with an effective date of February 4, 2008, as the country's franchise sector experienced significant growth. Many of the specific mechanics of the statute's implementation are included in the "Presidential Decree to Implement the Act on Fairness in Franchise Transactions" (the "Presidential Decree"). The current Presidential Decree, which also took effect on February 4, 2008, details requirements regarding fees, termination, specific disclosure requirements and other items included in the Franchise Act. (Business Franchise Guide (CCH) ¶ 7170).

Most of the revised provisions of the Franchise Act apply to any franchise agreement entered into on or after February 4, 2008, and to any earlier franchise agreement that is renewed after February 4, 2008. The amended provisions are significant from the perspective of the cross-border franchisor.

Summary of Amendments and Effective Dates

• Disclosure Statement Registration Requirement

Perhaps the most significant amendment to the Franchise Act is the requirement that franchisors register a disclosure document with the Korea Fair Trade Commission ("KFTC"). Under this registration requirement, which took effect on August 4, 2008, a franchisor must provide each prospective franchisee with a copy of the registered disclosure document at least 14 days prior to the signing of the franchise agreement or receipt of the franchise fee. (*See* Chapter III, Article 7 of Act on Fairness in Franchise Transactions). A franchisor must set aside adequate time for the registration process (i.e., a first-time registration could take approximately two months) in order to prevent any unexpected delay in its business plan.

The information that must be included in the disclosure document is similar to that required for the Franchise Disclosure Document (“FDD”) in the United States. As a practical matter, most of the information required can be pulled from a franchisor’s FDD, with the exception of information regarding criminal sanctions by the KFTC against the franchisor. Prior to this amendment, although the Franchise Act did require franchisors to provide information to prospective franchisees, there was no registration requirement.

On June 17, 2008, the KFTC issued the Model Disclosure Document (“MDD”), which provides a format that franchisors may use for purposes of registration. The information required to be disclosed about a franchisor (as set forth in the MDD) include: (1) general corporate information; (2) a description of the franchised business; (3) past records of violations of law committed by the franchisor and its high-level employees; (4) the franchisees’ obligations; (5) terms and conditions applicable to franchisees; (6) a detailed procedural description on how a franchisee may start its business and the time required for such procedure; and (7) a description of the franchisee training program. Franchisors may amend the MDD after registration, provided that the amended MDD includes all mandatory disclosure. (KFTC Regulation on MDD, Section 4).

• Mandatory Delivery of Disclosure Statement to Franchisee

Prior to the Amendment, franchisors were required only to provide a disclosure document to parties making a written request to the franchisor. The amended Franchise Act removes the requirement for a written request and requires the franchisor to provide a disclosure document to any party that negotiates or discusses execution of a franchise agreement with the franchisor. (*See* Act on Fairness in Franchise Transactions, Chapter I, Article 4). Perhaps even more significant than the new delivery requirement is the franchisee’s ability to rescind the franchise agreement and demand a refund of the franchise fee if the disclosure statement contains false or misleading information or omits material information. (*See* Chapter III, Article 10 of Act on Fairness in Franchise Transactions).

• “Cooling Off” Period After Delivery of Disclosure Statement

Article 7 of the amended Franchise Act now contains a “cooling off” period similar to that of the FTC Rule. (*See* 16 C.F.R. § 436.2(a)). The franchisor may not accept any franchise fee or execute the franchise agreement until 14 days after delivery of the disclosure document. (*See* Chapter III, Article 7 of Act on Fairness in Franchise Transactions). The period may be shortened to seven days – the “sophisticated franchisee” exception – when the prospective franchisee is represented by a certified franchise transactions consultant registered with the KFTC or a lawyer. (*See* Chapter III, Article 7 of Act on Fairness in Franchise Transactions). In the event a franchisor does not follow the 14 day cooling off requirement, the franchisee can demand the refund of any franchise fees paid within two months of the execution of the franchise agreement. (*See* Chapter IV, Article 10 of Act on Fairness in Franchise Transactions).

• Expanded Definition of Franchise Fees

The amended Franchise Act broadens the definition of “Franchise Fee” to include (1) costs of fixtures and trade dress elements, (2) rent paid to the Franchisor, as well as (3) any other amounts to be paid to the franchisor for the franchisee to acquire or maintain franchise rights. (*See* Chapter I, Article 2, Item 6 of Act on Fairness in Franchise Transactions). Prior to the amendments, “Franchise Fees” only included any guaranty deposit, any royalty payments for the use of the trademarks and charges assessed by the franchisor for support and training.

• Partial Escrow of Franchise Fees

Under the amended Franchise Act, the franchisor must set aside and deposit a portion of the initial franchise fees in an escrow account maintained with a qualified custodian. The portion of the franchise fees that has to be escrowed consists of membership fees, training fees, franchise contract deposit, trademark license fees, and other fees for support and assistance.

The qualified custodians include: (1) financial institutions within the meaning of the Banking Act, (2) postal offices engaging in the deposit insurance business, (3) insurance companies within the meaning of the Insurance Business Act, and (4) trust companies within the meaning of the Trust Business Act. (*See* Article 5-6 of Presidential Decree).

• *Prohibition on Competition with Franchisee*

The amended Franchise Act includes language prohibiting a franchisor from establishing competitive businesses or entering into franchise relationships with other parties that may compete with an existing franchisee. (*See* Chapter III, Article 12 of Act on Fairness in Franchise Transactions).

• *Revised Provisions Regarding Renewal and Termination of Franchise Agreements*

The amended Franchise Act forces franchisors to renew franchise arrangements with existing franchisees who request a renewal within three to six months before the scheduled expiration of the franchise agreement unless there is "just cause" for nonrenewal. The amended Franchise Act gives several examples of "just cause," including (1) the franchisee's breach of its confidentiality obligation (e.g., unauthorized disclosure of intellectual property of the franchisor, including its trade secrets), (2) the franchisee's failure to participate in the franchisee training program, (3) the franchisee's payment default, and (4) the franchisee's failure to follow the franchise system standards. (*See* Chapter III, Article 13 of Act on Fairness in Franchise Transactions). In cases where a franchisor sends a default notice, the amended Franchise Act requires a clear statement of exactly which provisions have been breached. Prior to the amendments, the franchisor was required to give three written default notices before any termination; however, under the amendments, only two notices are required. The default notices must affirmatively warn the franchisee that the franchisor will terminate the franchise agreement if the franchisee fails to cure the default. (*See* Chapter III, Article 14 of Act on Fairness in Franchise Transactions).

The Franchise Act and its Presidential Decree also list certain other grounds upon which renewal of a franchise agreement may be refused without prior notice. These grounds include: (1) a bankruptcy filed by or against either the franchisee or the franchisor, or a compulsory execution proceeding or reorganization proceeding filed by or against the franchisee or the franchisor, (2) dishonor of notes or checks issued by either the franchisee or the franchisor due to bankruptcy or otherwise, and (3) the franchisor's inability to continue its franchising business due to a significant reason. (*See* Article 15 of the Presidential Decree)

• *International Franchise Agreements*

Although there are numerous cross-border franchising arrangements in Korea, the amendments do not include any specific language addressing a non-Korean resident franchisor. Furthermore, the Act does not specify an official language requirement for the franchise agreement.

Pitfalls for United States Franchisors in Korea

The problems facing a foreign franchisor are not specific to the United States; any non-Korean franchisor will face the same issues. Although the regulatory framework is fairly extensive, especially in light of the recent amendments, franchise law is still fairly new in Korea. As a result, there is very little court or KFTC precedent upon which franchisors or franchisees may rely. This underscores the tremendous importance of a detailed and complete disclosure statement. Additionally, all cross-border franchisors should remember the following when franchising in Korea:

- Register the MDD with the KFTC prior to the receipt of any franchise fee or the signing of a franchise agreement;
- Remember there is a two month review period required for a first-time registration;
- Remember that a portion of the franchise fees must be escrowed with a qualified custodian;
- Franchisors have no termination right during the initial 10 years with their franchisees unless they can demonstrate "just cause;"
- Franchisors must give a clear written notice of default and opportunity to cure to the franchisee at least twice prior to any termination.

Franchisors that do not comply with the KFTC may face strict penalties. On October 1 the KFTC launched a major investigation into 200 franchise operators in 15 types of businesses for illegal trading practices. The KFTC noted that of the 200 franchise operators, 20 have advertised through the internet and franchise exhibitions without registering the necessary documents. Additionally, the KFTC will be investigating signs of irregular trading practices such as unfair termination of contract and refusal to provide operational support to franchisees. The KFTC's investigation will include internet and telephone surveys as well as onsite investigations of various franchise operators. (See Choi He-suk, Watchdog Probes Franchise Operators, The Korea Herald, October 1, 2008, available at http://www.koreaherald.co.kr/NEWKHSITE/data/html_dir/2008/10/01/200810010049.html) A franchisor that discloses false or misleading information or omits to disclose material information will be subject to imprisonment not to exceed 5 years or a fine not to exceed 150 million Korean Won (approximately US$135,000). A franchisor who fails to comply with a correctional order from the KFTC will be subject to imprisonment not to exceed 3 years or a fine not to exceed 100 million Korean Won (approximately US$90,000). Also, a franchisor that fails to deposit the required portion of franchise fees in escrow or receives franchise fees or executes a franchise contract in violation of the "cooling-off" requirement will be subject to imprisonment not to exceed 2 years or a fine not to exceed 50 million Korean Won (approximately US$45,000). The franchisor, even though a legal entity such as a corporation, may be deemed criminally

liable for failure to comply with the KFTC. The individuals (directors or officers of the corporation, or other employees) who actually committed the breach of the regulations may also be held criminally liable. If identifying a specific individual is not possible, a "representative director" (i.e., the president) may be deemed responsible. Notwithstanding the foregoing, violations of this type of administrative regulation (especially when liability is attributed to a "representative director" rather than a specific individual for actual wrongdoing), have historically resulted in a fine rather than a prison term.

Tips for Franchisors Entering Korean Market

While there is no standard for "plain Korean," consider drafting the franchise agreement in a manner that is easy to understand for non-lawyers. Although many US franchisors will deal with sophisticated Korean franchisees, in the event the franchisee is a "small" or unsophisticated party or someone with little international experience, a franchisor may want to consider providing an unofficial Korean translation of the MDD and franchise agreement. This not only creates goodwill with the franchisee, but could also help avoid confusion later on during the franchise relationship. Additionally, since there is no official language requirement under the KFTC, the franchise agreement should include a provision regarding the official language and construction and interpretation of the franchise agreement (whether or not the parties agree to have translations made for their convenience). The franchise agreement should also address which party will bear the burden of paying for any unofficial translations of the franchise agreement and other documents. Training raises another issue with respect to language – which may be an issue for both sophisticated and small franchisees alike. While the franchisee may speak English or the franchisor may speak Korean, the operators or employees of the parties may not. Franchisors may need to provide training in both Korean and English. The franchise agreement should address who bears the cost of providing interpreters for training. Finally, as in any international transaction, it is crucial for a prospective foreign franchisor in Korea to consult with competent local counsel experienced in antitrust law.

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