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Overview

1. What forms of business entities are relevant to the typical franchisor?

The stock company and the limited liability company are the business forms in South Korea that would be relevant to a typical franchisor. About 90 per cent of Korean companies are stock companies, which are similar to US stock companies. Only this legal entity, plus occasionally the limited liability company, is recommended for foreign investors and businesses.

2. What laws and agencies govern the formation of business entities?

Primarily, the Korean Civil Act and Korean Commercial Code govern the formation of business entities. In addition, the Foreign Investment Promotion Act relates to the formation of business entities from foreign investment.

The Korean Court Commercial Registrar, National Tax Service, and Ministry of Trade, Industry and Energy are the main agencies that have authority related to the formation of business entities in South Korea.

3. Provide an overview of the requirements for forming and maintaining a business entity.

There is no minimum paid-up capital for a stock company or a limited liability company. Registration is with the Court Commercial Registrar and National Tax Service. In the case of investment by foreign business entities or foreigners, the investment must be reported to the Ministry of Trade, Industry and Energy (in practice, the function of receiving reports is delegated to designated foreign exchange banks or the Korea Trade-Investment Promotion Agency).

4. What restrictions apply to foreign business entities and foreign investment?

A foreigner may freely carry on foreign investment activities in Korea without being subject to any restrictions unless otherwise specifically restricted by the Foreign Investment Promotion Act or other laws or regulations.

Specifically, a foreigner does not face any restrictions in investing in South Korea other than in the following circumstances:

- where it interferes with national security or disrupts public order;
- where it causes harm to the health and safety of nationals or is markedly contrary to public morals and decency; or
- where it violates Korean laws and regulations.

5. Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

The principal taxes affecting business enterprises in South Korea include corporate tax, individual income tax, value added tax, customs duty and inhabitant tax levied on corporate tax, income tax and other taxes.

The franchisor has a duty to pay taxes (corporate tax or individual income tax) on royalty income. However, the tax rates are limited to the rates stipulated in the tax treaty between South Korea and the state in which the franchisor resides. Meanwhile, the franchisee has a duty to withhold taxes from royalties it pays to the franchisor.

6. Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Under the Korean Civil Code, an employer is liable for a tort committed against a third party by an employee who is under the employer’s actual direction or supervision, in relation to the performance of a work that is directed or supervised by the employer. Therefore, if a franchisee or its employee is deemed to be an employee of the franchisor, the franchisor may be held liable for damages to a third party caused by the franchisee or the franchisee’s employee during the performance of his or her work.

To reduce the risk of such liability, it is advisable for the franchisor not to be involved with the specifics of the franchisee’s management and to specify in the franchise agreement that the franchise will be operated by the franchisee as an entity independent from the franchisor. However, since a franchisor and a franchisee are generally independent entities, and therefore the franchisee is not subject to the direction or supervision of the franchisor, it is unlikely that the above liability would be imposed on the franchisor.

7. How are trademarks and know-how protected?

Korea is a ‘first-to-file’ jurisdiction. To obtain reliable protection of trademark rights in Korea, the owner of the trademark should register it with the Korean Intellectual Property Office pursuant to the Trademark Act. During the application period, no protection is provided. However, while the application is pending, the applicant may send a warning letter to any person who uses an identical or similar mark on goods that are identical or similar to the goods for which the application has been filed. If the trademark application subsequently becomes registered, the applicant (now the registrant) may bring a claim against such person for losses accrued from the date the written warning was received by such person up to the registration date of the trademark.

Once the registration is granted, the owner may seek to enforce the trademark rights against third-party infringements by seeking injunctive relief against further infringement, damages or an order for the destruction of the infringing goods.

In addition to the Trademark Act, the Unfair Competition Prevention and Trade Secret Protection Act is available to protect well-known but unregistered trademarks, trade secrets and know-how.

8. What are the relevant aspects of the real estate market and real estate law?

In the past, the ownership of Korean real estate by foreigners was regulated in two ways: restrictions on title to land under the Alien Land Acquisition Act, and restrictions against leasing real estate (land or building) under the Foreign Investment and Foreign Capital Inducement Act. However, the Alien Land Acquisition Act was substantially amended in 1998 to permit a foreigner to purchase real property located in Korea with a simple report of the acquisition of title to the relevant local government office (this act has been repealed and the reporting is now required under the Act on Report on Real Estate Transactions, etc). In addition, through amendments to the...
Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

Under the Fair Transactions in Franchise Business Act (the Franchise Act), a 'franchise' is defined as:

[...] a continuous business relationship in which the franchisor allows the franchisee to sell goods (including raw and auxiliary materials) or services under certain quality standards and business method using its trademarks, service marks, trade name, signs and other business marks (collectively, 'Business Marks'), and supports, educates and controls the franchisee with regard to relevant management and operating activities, and in which the franchisee pays franchise fees to the franchisor in return for the use of the Business Marks and the support and education concerning the management and operating activities.

10 Which laws and government agencies regulate the offer and sale of franchises?

The Franchise Act, which was enacted on 1 November 2002 and most recently amended on 20 December 2016 (effective date 21 March 2017), and its Presidential Decree are the primary statutes applicable to the franchisor-franchisee relationship. Additionally, the Monopoly Regulation and Fair Trade Act (MRFTA) and regulations promulgated by the Korea Fair Trade Commission (KFTC) are generally applicable.

The KFTC regulates franchises in Korea. The KFTC maintains a franchise-specific department, the Korea Fair Trade Mediation Agency, and has the authority to impose administrative measures against those franchisors that engage in unfair activities. In this regard, the KFTC has the discretion to determine the unfairness or reasonableness of the activities of the franchisor and to levy penalties and issue corrective orders against those violators depending on the nature and degree of the unfair activity. However, the violator may seek a district court's judicial review of the KFTC's findings.

11 Describe the relevant requirements of these laws and agencies.

The Franchise Act is based on the principle of good faith and fair dealing and seeks to provide a framework for building a fair and equal business relationship between the parties involved in franchising. The Franchise Act delegates the task of overseeing the Korean franchise industry to the KFTC, and the KFTC in turn provides necessary guidance and order by monitoring and calibrating the industry through corrective measures and penalties for those who violate the Franchise Act.

The Franchise Act is divided into six main chapters.

Chapter I sets the stage by providing the purpose of the Franchise Act and the definitions of various terms used throughout the Franchise Act. Chapter II deals with the basic principles that govern franchise transactions and Chapter III addresses fairness in franchise transactions, which, among other requirements, places registration and disclosure obligations on the franchisor. Chapter III provides a list of basic, mandatory provisions that need to be included in a franchise agreement. Chapter IV outlines the dispute mediation committee regulated by the KFTC and details the qualifications and the roles of the committee. Chapter IV defines the roles and responsibilities of 'franchise brokers'.

Chapter V deals with the disposition of cases under the KFTC and stipulates details of the corrective measures that can be instituted, including a provision on administrative fines imposed on a franchisor that violates certain provisions of the Franchise Act. Furthermore, because this chapter makes references to provisions of the MRFTA, a franchisor must also be concerned with the application of the MRFTA.

12 What are the exemptions and exclusions from any franchise laws and regulations?

The Franchise Act provides for two exemptions. The specific criteria for eligibility are as follows:

- the total amount of franchise fees that a franchisee pays to a franchisor for a six-month period from the date of the initial payment does not exceed 1 million won; or
- the annual sales of a franchisor, on a worldwide basis, are less than 50 million won; provided, however, that this exemption is not applicable if the franchisor has entered into franchise agreements with more than four franchisees around the world.

The exemptions are intended for small-scale franchisors, and therefore are generally not applicable to franchising involving foreign franchisors.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

Although the disclosure requirement under the Franchise Act requires a franchisor to disclose information if the franchisor operated or is operating a franchise, there is no law or regulation that mandates that the requirements must be satisfied before a franchisor may offer franchises.

14 Are there any laws, regulations or government policies that restrict the manner in which a franchise recruits franchisees or selects its franchisees and suppliers?

The Franchise Act requires a franchisor to expressly grant a franchisee an exclusive business territory in the franchise agreement. Specifically, the franchisor must define the business territory pursuant to an agreement upon criterion (eg, geographic scope) and stipulate the business territory in the franchise agreement. During the term of the franchise agreement, the franchisor cannot establish a company-owned, affiliate-owned or franchised unit of the 'same type of business', which is determined on a case-by-case basis, within the business territory of the franchisee.

The term 'same type of business' means a business that would be considered the same in light of various factors, including the target class, territorial boundary, population boundary, types of products and services sold, and business manner and method.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

Prior to the amendments to the Franchise Act that occurred in 2007, which came into force in 2008, a franchisor was excused from the obligation to disclose to the prospective franchisees unless the prospective franchisees specifically requested delivery of the disclosure document in writing. However, under the current Franchise Act, a franchisor must make pre-contractual disclosure to enter a franchise relationship. The disclosure procedure is as follows:

- a franchisor must provide a disclosure document even if the franchisee does not specifically request it in writing;
- in providing the disclosure document to a prospective franchisee, a franchisor must register the disclosure document with the KFTC, and thereafter, provide the registered disclosure document to the prospective franchisee; and
- acceptance of franchise fees or execution of a franchise agreement is prohibited unless the franchisor has provided the registered disclosure document and 14 days (seven days if the prospective franchisee has been advised by counsel or franchise broker) have elapsed from the date of providing the registered disclosure document.

The disclosure document may be delivered to a prospective franchisee by:
- providing the disclosure document (hard copy) directly or sending it by content-certified mail to the prospective franchisee;
- providing the disclosure document via access to the internet; or
- providing the disclosure document in an electronic file to the prospective franchisee by email.

Regarding the update of the disclosures, a franchisor must register (or report) any changes in the disclosure document with the KFTC.
Depending on the importance of the information that has been changed, deadlines for filing the report thereto range from 'within 30 days from the occurrence of the cause of the change' and 'within 30 days from the expiration of the quarter in which the cause of the change has occurred'. Further, the franchisor has a obligation to update the disclosure document on an annual basis 'within 120 days from the expiry of each fiscal year'.

16 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

In a sub-franchising structure, the sub-franchisor must make pre-sale disclosures to sub-franchisees. A franchise – the master franchisor – need not provide a disclosure document to a sub-franchisee if the franchisor is not in a contractual relationship with the sub-franchisee, which is usually the case. In other words, a franchisor has no obligation to provide a disclosure document if it is not a party to the franchise agreement or any other agreements with a sub-franchisee.

In a disclosure document, there must be a disclosure on the description of the general status of the franchisor (see question 17). Although neither the Franchise Act nor its Presidential Decree specifically requires that the information concerning the master franchisor, and further, the information on the contractual or other relationship between the master franchisor and the sub-franchisor to be included in the disclosure document, as the information relates to the 'description of general status of the franchisor', depending on the circumstances, it could be appropriate to include a brief summary of such information on the sub-franchising structure in the disclosure document.

17 What information must the disclosure document contain?

The following broad categories of information are required to be included in the disclosure document:

- information regarding the general status of the franchisor;
- information regarding the current status of the franchisor's franchise (eg, the total number of company-owned and franchised units in operation as of the most recent fiscal year end);
- information regarding any legal violation by the franchisor and its executives;
- information regarding the obligations of the franchisee;
- information regarding conditions of and restrictions on the business activities of the franchisee;
- information regarding detailed procedures and the period required in respect of the commencement of the franchised business; and
- information regarding support for business activities and education and training programmes (it must be specified if there is no plan for education and training).

18 Is there any obligation for continuing disclosure?

A franchisor is required to prepare and register (or report) with KFTC any changes or updates to the disclosure document that is registered with the KFTC within:

- 30 days from the date the changes occurred (eg, changes pertaining to the general status of the franchisor);
- 30 days from the end of the quarter in which the changes occurred (eg, changes pertaining to obligations of the franchisee, or conditions of and restrictions on business activities); or
- 120 days from the end of the fiscal year in which the changes occurred (eg, changes pertaining to the current status of the franchisor's franchise). As explained (question 15), franchisors have a continuous obligation to update the disclosure documents on an annual basis.

19 How do the relevant government agencies enforce the disclosure requirements?

Where a franchisor has violated its duty to provide its disclosure document or has provided false or exaggerated information to a prospective franchisee, the KFTC may require the franchisor to provide or amend the disclosure document; report on necessary plans or actions taken; or any other measures necessary to correct such violations ('corrective measures'); or may arrange a plan for correction and recommend that a franchisor follow such a plan ('recommendation of corrective measures'). With respect to such violations, the KFTC may impose an administrative fine of an amount not exceeding 2 per cent of the franchisor's total sales derived in Korea.

Furthermore, in the event that a franchisor violates certain provisions of the Franchise Act relating to the disclosure requirements (eg, where franchise fees have been accepted or a franchising agreement has been executed before providing the disclosure document, or where a franchisor has provided false or exaggerated information or omitted important information), the KFTC may file a criminal complaint with the prosecutors to initiate criminal proceedings. It is worth noting that a complaint from the KFTC is required for a criminal action to be instituted for violation of the Franchise Act.

20 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated?

If there is a violation of any disclosure requirements, the franchisee may report such violation to the KFTC. Furthermore, the franchisee may bring a lawsuit for damages and cancel or rescind the franchise agreement under general principles of tort or contract law in accordance with the Korean Civil Code. If there remain damages that are not recovered by cancelling or rescinding the franchise agreement, the franchisee may additionally be entitled to such remaining damages, apart from such cancellation or rescission.

Violations of the Franchise Act may be introduced in a lawsuit for damages as evidence of a party's pattern of conduct or culpability for conduct, but in general such violations do not have any bearing on the calculation of damages in a civil context. Damages are calculated by the general principles of tort and contract law (proximate causation theory), and there is no specific law or regulation applied to franchise transactions.

In connection with criminal penalties, the Franchise Act does not create any private right of action. The franchisee can only report the franchisor's violations to the KFTC. A complaint from the KFTC is required to initiate a public criminal proceeding against franchisors, who may have violated the Franchise Act. Upon receiving a report from the franchisee or investigating on its own initiative, the KFTC may decide to institute a public criminal proceeding depending on the 'seriousness' and 'clarity' of the violation of the franchisor. In addition, the prosecutors may, on their own initiative, request the KFTC to file a complaint, and in this case the KFTC must comply with the request. Once there is a public criminal indictment, the KFTC cannot withdraw the complaint.

In theory, criminal penalties under the Franchise Act for disclosure violations are among the most severe in the Korean business sphere. The most severe penalty is reserved for fraud; provision of false or exaggerated information or omission of important items in a disclosure document required under the Franchise Act carries a penalty of up to five years' imprisonment or a fine of not more than 300 million won. Failure to provide a disclosure document, or execution of a franchise agreement or acceptance of franchise fees within the 14 days (seven days if the prospective franchisee has been advised by counsel or franchise broker) after the delivery of the disclosure document, is subject to a possible term of imprisonment of up to two years or a fine of up to 50 million won.

Refusal to comply with the KFTC's orders to provide disclosure, if such orders are given, is also potentially subject to a serious penalty. Where disclosure is not provided, or where the disclosure is later reviewed by the KFTC upon the franchisee's request and found to be insufficient (but not fraudulent), the KFTC may demand that the franchisor provide proper disclosure materials. Failure to do so in the face of the KFTC's 'corrective order' may be subject to a fine of up to three years' imprisonment or a fine of up to 100 million won.

In addition, in certain cases of disclosure failures, the KFTC may order the return of the franchise fees received. The KFTC generally prefers to apply pressure to a party – usually the franchisor, given the purpose of the statute – to correct its behaviour in order to avoid criminal sanctions from being imposed.
21 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

A master franchisor owes no duty to provide a disclosure document if it is not a party to the franchise agreement or any other agreements with a sub-franchisee. In this case, the liability for violations of any disclosure requirements is solely attributable to the sub-franchisor.

If individual officers, directors and employees of the franchisor engage in a disclosure violation, they would be exposed to liabilities similar to those of the franchisor. Such individuals may be subject to claims for damages filed by the franchisee, or in egregious circumstances may face criminal penalties.

22 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The general fair-trade principles under the MRFTA may affect the offer and sale of franchises (see question 10). No other rules or regulations and government agency or industry codes other than those of the KFTC may affect the offer and sale of franchises in South Korea.

23 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

No.

24 What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under franchise sales disclosure laws?

Fraudulent or deceptive practices by a franchisor may constitute fraud as stipulated under the Korean Criminal Code. In the case of a disclosure violation, the franchisor may only report such violation to the KFTC. Thereafter, the KFTC will determine whether to initiate criminal proceedings. In the case of fraudulent or deceptive practices constituting criminal fraud, the franchisee may directly file a criminal complaint with the prosecutors. In addition, the franchisee may file a lawsuit for damages against the franchisor with or without cancelling or rescinding the franchise agreement itself.

Legal restrictions on the terms of franchise contracts and the relationship between parties in a franchise relationship

25 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The Franchise Act regulates the ongoing relationship between a franchisor and its franchisee after the franchise agreement comes into effect.

26 Do other laws affect the franchise relationship?

General fair-trade principles under the MRFTA may affect the offer and sale of franchises (see question 10).

27 Do other government or trade association policies affect the franchise relationship?

The guidelines provided by the KFTC may affect the franchise relationship.

28 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor’s ability to terminate a franchise relationship?

The Franchise Act does not specify grounds for terminating a franchise agreement; it merely provides the procedure that must be observed to terminate a franchise relationship.

To terminate a franchise agreement in accordance with the Franchise Act, a franchisor is required to provide a first notice of breach (which describes the grounds for the breach, requests for a remedy of such breach, and states that failure to remedy will result in termination) to the franchisee. Once the first notice is given, a two-month remedy period begins to run (and the franchisee’s obligation to remedy arises). During the remedy period, the franchisor must send a second notice of the same breach to the franchisee. If the franchisee fails to remedy the breach, the franchisor may terminate the franchise agreement at the end of the two-month remedy period.

Meanwhile, the Presidential Decree provides for 10 exceptions to the above termination procedure, and thereby allows for immediate termination of the franchise agreement by the franchisor. No other grounds for immediate termination are permitted under the Franchise Act. The 10 exceptions are:

- a petition for bankruptcy is filed with respect to the franchisee (either by the franchisee or by a third party), the franchisee is adjudicated bankrupt, or rehabilitation or foreclosure proceedings commence against the franchisee;
- a suspension of payment of notes and cheques issued by the franchisee owing to insolvency, etc;
- the franchisee cannot continue with the operation of any franchised unit in the territory owing to an event of force majeure or for significant personal reasons, etc;
- the franchisee:
  - publicly disseminates false information, without cause, that clearly damages the reputation or credit of the franchisor;
  - leaks trade secrets or important information of the franchisor causing damage to the franchised business; or
  - receives an administrative disposition for violating applicable laws, including:
    - an administrative order requiring the franchisee to remedy the violation;
    - an administrative order imposing a penalty surcharge or fine on the franchisee for the violation; or
    - an administrative order mandating suspension of operation of the franchised business;
- the franchisee:
  - violates laws or regulations relating to the operation of any franchised unit and receives an administrative order, including an order imposing a fine or penalty for non-compliance, etc, which requires the franchisee to correct such violations; and
  - fails to correct such violations within 10 days from the date of receiving the administrative order or within such other period as set forth in the administrative order;
- the franchisee violates laws or regulations relating to the operation of any franchised unit and receives a cancellation order of qualifications, licences, or approvals or a business suspension order exceeding 15 days or other administrative order which in nature cannot be corrected, provided that this shall not apply where an administrative fine, etc has been imposed on a franchisee in lieu of such administrative order pursuant to any laws or regulations;
- if after having remedied the breach of the franchisee agreement pursuant to the request from the franchisor, the franchisee subsequently repeats the same breach within a period of one year although the franchisor have notified the franchisee in the notice of request to remedy the first breach that the franchise agreement could be terminated without providing the opportunity to remedy in case of same breach after the remedy;
- if the franchisee has been subjected to a criminal punishment for an act related to the operation of a franchised unit;
- the acts, errors or omissions of the franchisee imminently threaten public safety or health while operating any franchised unit; or
- the franchisee suspends business operations of any franchised unit for seven or more consecutive days without justifiable cause (as determined by the franchisor acting in good faith).

29 In what circumstances may a franchisee terminate a franchise relationship?

Under the Franchise Act, no restriction or prior notice is required for the franchisees to terminate their franchise relationships. As a general principle of law, however, the franchisee may terminate the franchise agreements in the case of default by the franchisor. In addition, where
the franchise agreement is seen as a ‘continuing contract’, the franchisee may terminate the franchise agreement based on the grounds that the purpose of the franchise agreement has been frustrated as a result of unforeseeable circumstances.

30 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

The Franchise Act stipulates that if the franchisee requests a renewal between 180 days and 90 days prior to the expiry of the franchise agreement, the franchisor may not refuse to renew the franchise agreement without just cause. As exceptions, the franchisor is permitted to refuse renewal of the franchise agreement in the following circumstances:

- the franchisee has failed to perform its payment obligations of franchise fees under the franchise agreement;
- the franchisee has not accepted the terms and conditions of the franchise agreement or business policy that are generally accepted by other franchisees of the franchise network; or
- the franchisee has failed to observe the following important business policies of the franchisor that are deemed necessary for maintaining the franchised business:
  - matters pertaining to the procurement of a store or facility that are necessary for the operation of the franchised business, or acquisition of licence, permit or approval as required by applicable laws;
  - matters pertaining to observance of production methods or service methods that are necessary for maintenance of quality of the goods or services for sale; and
  - matters other than those above that are deemed necessary for normal operations of the franchised business as determined by Presidential Decree.

If the franchisee requests a renewal, the notice of refusal stating the reasons for non-renewal must be provided within 15 days of receipt of the renewal request. If the notice of refusal (to the franchisee’s request for a renewal) is not provided to the franchisee, or a written notice of non-renewal or change in terms and conditions (for the renewal) is not provided to the franchisee between 90 and 180 days prior to the expiration of the franchise agreement, the franchise agreement will be deemed to have been renewed under the same terms and conditions.

As a cautionary note, even if a franchisee does not request a renewal, a franchisor must provide a written notice of non-renewal of the franchise agreement (between 90 and 180 days prior to the expiration of the franchise agreement) if the franchisor has no intent or does not wish to renew the franchise agreement. If the franchisor first provided a notice of non-renewal (prior to the franchisee’s request for renewal) within the above period, then the franchisee subsequently requests a renewal within the same period (despite the franchisor’s notice of non-renewal), the franchisor may not refuse to renew the franchise agreement without just cause. In other words, the franchisor’s notice of non-renewal (before the franchisee has made a request for renewal) would realistically work only as a reminder to the franchisee to decide whether to renew the franchise agreement.

The franchisee’s right to request a renewal may only be exercised for a total duration of 10 years (including the term of the initial franchise agreement and any renewal terms thereafter), and if 10 years have elapsed, the franchisor may refuse to renew the franchise agreement regardless of its reasons (as long as a written notice of non-renewal has been provided).

31 May a franchisor restrict a franchisee’s ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Because it can be said that the franchisor-franchisee relationship is reciprocal, where both parties are creditors as well as debtors to each other (supply obligation on the one hand and payment obligation on the other hand), the franchisee should receive consent of the franchisor prior to transferring the franchised business (transfer of its obligation) to a third party. In this regard, the Franchise Act provides that the franchisor must first obtain prior written consent of the franchisor to assign the franchised business. Thus, a franchisor may restrict a franchisee’s ability to transfer its franchised business.

However, unless the parties have specifically agreed not to allow for the transfer of ownership interests in a franchisee, there are no restrictions on the franchisee’s right to transfer ownership interests.

32 Are there laws or regulations affecting the nature, amount or payment of fees?

The payment and receipt of certain types of fees are strictly regulated under the Franchise Act. Specifically, the Franchise Act proscribes a franchisor from receiving ‘direct’ payment of the following fees from the franchisee:

- consideration that the franchisee pays to the franchisor for management rights, such as the permission to use the business marks or the support and education for its operating activities. Such consideration may include application fees, membership fees, franchise fees, education and training fees or down payment; and
- consideration that the franchisee pays to the franchisor to secure payment for goods supplied by the franchisor or compensation for damages.

The Franchise Act stipulates that the franchisor must require the franchisee to deposit – in escrow – the two types of fees described above to a Korean financial institution prescribed by the Presidential Decree. Thereafter, the franchisor may request payment from the financial institution at the earlier of when the franchisee has commenced operations (eg, opened its franchised unit) or two months from the date of execution of the franchise agreement.

Notwithstanding the above, the franchisee may receive both types of fees ‘directly’ from the franchisee without depositing the fees with a Korean financial institution if:

- the franchisor subscribes to an insurance policy (with the franchisor as the beneficiary) to cover the franchisee’s risks; or
- the franchisor and the franchisee agree that the franchisor will receive both types of fees after two months from the date of executing the franchise agreement or after the franchisee commences operation (eg, opened its franchised unit), whichever is earlier.

In practice, it is difficult, if not impossible, to find a Korean financial institution that will open an escrow account for the benefit of a foreign franchisor. Further, with regard to taking out insurance, there is only one insurance provider in Korea – Seoul Guarantee Insurance Company – that will issue an insurance policy. To subscribe, a foreign franchisor must have a guarantor located in Korea (individual or a business entity) that will guarantee the amount of the insurance policy being purchased.

Given the difficulties in finding a willing Korean financial institution and a suitable guarantor in Korea, foreign franchisors seeking to receive the two types of fees described above ‘directly’ from the franchisee often choose to defer the payment of those fees until the elapse of two months from the date of executing the franchise agreement or the franchisee commences operation of its franchised unit, whichever occurs earlier.

33 Are there restrictions on the amount of interest that can be charged on overdue payments?

There are no specific restrictions on the amount of interest that can be charged on overdue payments. However, if the interest is deemed excessive, it can be void for violating public policy.

34 Are there laws or regulations restricting a franchisee’s ability to make payments to a foreign franchisor in the franchisor’s domestic currency?

There are no laws or regulations restricting the ability of a franchisee to make payments to a foreign franchisor in the franchisor’s domestic currency.

35 Are confidentiality covenants in franchise agreements enforceable?

In principle, confidentiality covenants in franchise agreements are enforceable.
Update and trends

The purpose behind the Franchise Act is to ‘contribute to the promotion of the welfare of consumers and the sound growth of the national economy by establishing fair and competitive franchise business practices and by ensuring the complementary and balanced growth of franchisors and franchisees on an equal footing’. To achieve this stated purpose, the Franchise Act requires franchisors to register and disclose their disclosure documents on the one hand and restricts franchisors from engaging in certain business practices on the other. These mechanisms serve to provide a level playing field to franchisees at all stages of the franchise–franchisor relationship. Recent data, however, seem to show that these mechanisms may not be having their intended effect.

Between 2006 and 2016 there was a near threefold increase in the number of petitions filed by disgruntled franchisees to the KFTC for mediation. Furthermore, incidences of franchisors’ opportunism and abuse have made headlines and are becoming a growing social concern. Among others, coercing franchisees into purchasing ingredients and supplies from franchisors, and thereby forcing franchisees to become captive buyers, has been especially problematic. Given that a significant number of domestic franchisors receive franchise fees in the form of mark-ups on the sale of ‘must-have’ items, and moreover, there is no ceiling to the mark-ups, it is easy to see how incentivised certain franchisors – domestic franchisors, in particular – are in imposing high mark-ups.

To curb abusive practices in franchising, the National Assembly – the highest legislative body in Korea – recently passed a bill to amend the Franchise Act to allow for punitive damages (up to three times the amount of actual damages incurred) against franchisors. Franchisors that provide false or exaggerated information in their disclosure documents to franchisees or engage in unfair trade practices (e.g., unfairly refusing to provide support to franchisees and unfairly requiring franchisees to purchase products or other goods in excess of what is required to operate the franchised business) will be liable for punitive damages unless franchisors can show there was no wilfulness or negligence. The amendments to the Franchise Act will take effect on 19 October 2017.

It is expected that the incoming administration under President Moon Jae-in will aggressively seek to address the issues surrounding abusive practices in franchising that have come to light in recent years in the Korean franchise industry.

The KFTC has adopted a policy of reviewing the applications for registration of disclosure documents more strictly than previously. Until recently, the KFTC did not raise any issues with the substance of the information included in disclosure documents. Rather, the KFTC merely verified whether the information in the disclosure documents was adequately supported by ancillary documents that were required as part of the registration process. However, if sections of the disclosure documents are not in accordance with the provisions of the Franchise Act that are generally interpreted as mandatory provisions, such as to receipt of certain types of franchise fees (see question 32), duration and renewal (see question 36), exclusive territories (see question 14) and termination procedures (see question 28), the KFTC now liberally refuses to register the disclosure documents. Therefore, it is important that franchisors work with local counsel closely to ensure that all information included in the disclosure documents conforms to the requirements of the Franchise Act, and also that it is adequately corroborated.

In addition, the KFTC has recently begun imposing administrative fines on franchisors who fail to update their registered disclosure documents in a timely manner. This practice is exceptional because the KFTC has in the past reserved administrative fines for egregious violations of the Franchise Act. As noted, these trends at the KFTC signal a heightened enforcement policy against non-compliant franchisors, and it is imperative for franchisors to be vigilant in ensuring full compliance with the Franchise Act.

36 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Apart from the specific rules and regulations applicable to the conduct of a franchisor, the Franchise Act also promulgates a code of best practice. Under the Franchise Act, both parties to a franchise relationship must exercise good faith in the performance of their respective duties in connection with the management and operation of the franchised business.

Specifically, the franchisor’s duties defined under the Franchise Act are as follows:

- business planning for the success of the franchised business;
- continuing efforts toward quality control of goods or services and development of sales techniques;
- installation of unit facilities and supply of goods or services to the franchisee at reasonable prices;
- education and training of the franchisee and its employees;
- continuing advice and support for the management and operation activities of the franchisee;
- prohibition against establishing a franchisor’s company-owned units or establishing a franchised unit of the same type of business that of the franchisee’s franchised unit within its business territory during the period of the franchise agreement; and
- making efforts to resolve disputes through dialogue and negotiations with the franchisee.

Meanwhile, the franchisee’s duties are defined under article 6 of the Franchise Act as follows:

- making efforts to maintain the uniformity of the franchised brand and the good reputation of the franchisor;
- maintenance of inventory and display of goods in an appropriate manner in accordance with the franchisor’s supply plan and consumer demand;
- compliance with appropriate quality standards as presented by the franchisor with regard to goods or services;
- use of goods and services as provided by the franchisor in the event of failure to stock goods or services that meet the quality standards provided in the preceding point;
- compliance with appropriate standards as presented by the franchisor with regard to the facilities and exterior of the place of business, as well as the means of transport;
- consultation with the franchisor prior to effecting any changes in the goods or services in which it deals or in its operating activities;
- maintenance and provision of the data necessary for unified business management and sales strategy formulation by the franchisor, including, but not limited to, accounting books on the purchase and sale of goods and services;
- provision to the officers, employees or agents of the franchisor of access to its place of business for the checking and recording of its business status and the data as set out in the preceding point;
- prohibition of any change in the location of its place of business or any transfer of franchise management rights without the consent of the franchisor;
- prohibition of any act engaging in the same line of business as that of franchisor during the period of the franchise agreement;
- prohibition of disclosure of sales techniques or trade secrets belonging to the franchisor; and
- notification of any infringement of business marks by a third party to the franchisor if it becomes aware of such infringement, and appropriate cooperation with the franchisor to take necessary measures to prohibit such infringement.

The Franchise Act provides neither criminal penalties nor sanctions for failing to adhere to the above duties applicable to the franchisor and franchisee. Therefore we interpret most of these provisions as normative or suggested best practice rather than as mandatory standards.

37 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

In principle, franchisees are deemed to be independent commercial entities, and therefore there are no laws that specifically treat franchisees as consumers for the purposes of consumer protection.
38 Must disclosure documents and franchise agreements be in the language of your country?

Under the Franchise Act, there are no requirements that the disclosure documents be prepared in Korean. However, because the Franchise Act prescribes that the disclosure documents (that will be provided to the prospective franchisee) be registered with the KFTC (see question 15), in practice the KFTC requires the disclosure documents to be prepared in Korean.

The Franchise Act does not require that the franchise agreement be written in Korean. However, it is advisable for foreign franchisors to critically evaluate the English language capabilities of any prospective franchisees and be prepared to offer a Korean translation of franchise agreement if the franchisee does not comprehend English or is not using consultants, who are competent to assist with any language deficiency. In addition, when filing an application for registration of the disclosure document with KFTC, a copy of the template franchise agreement must be submitted, and if the template franchise agreement is in another language, a Korean translation must also be submitted. Therefore, it is necessary to prepare a Korean translation of the template franchise agreement for purposes of registering the disclosure document.

39 What restrictions are there on provisions in franchise contracts?

The main restrictions on provisions in franchise agreements under the Franchise Act relate to the receipt of certain types of franchise fees (see question 12), duration and renewal of the franchise agreement (see question 30), exclusive business territories of each franchised unit (see question 32), duration and renewal of the franchise agreement (see question 30), and procedures for terminating the franchise agreement (see question 28).

40 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

The Franchise Act was originally drafted to adapt the provisions of the MRFTA into the franchise context. Therefore the Franchise Act is the primary law that is applicable to franchised businesses (the MRFTA would not generally apply to franchised business since the Franchise Act is more specific to the franchise context).

41 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The Korean legal system is a civil law system, originally adopting the European civil law system and Japanese legal system. The Korean judiciary system is three-tiered and consists of the Supreme Court (the highest court), the high courts (the intermediate appellate courts) and the regional district courts (the courts of first instance). There are five high courts and 18 district courts, divided into geographical districts.

Alternatively, the parties in dispute may resolve disputes relating to the franchise agreement through mediation or arbitration. In particular, the Franchise Act provides that a franchise transaction dispute mediation committee may mediate matters related to disputes over franchise transactions if requested by the KFTC or by the parties in dispute. The franchisor is free to reject a mediation request. However, if mediation is requested due to an alleged violation of the MRFTA or the Franchise Act, it is advisable for the franchisor to comply with the request, because upon refusal, the franchisor may find itself subject to corrective measures under the Franchise Act.

The Korean Commercial Arbitration Board (KCAB) is the main institution of arbitration in Korea. The KCAB is dedicated to the settlement of commercial disputes as a neutral, unbiased and independent institution for administering and conducting arbitration, conciliation and mediation. Arbitration before the KCAB is an alternative way of producing impartial and fair resolutions to commercial disputes.

42 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Unlike litigation before the Korean courts, arbitration awards are not appealable, and therefore may resolve a dispute through a single proceeding. In addition, because arbitration procedures are not public, important information regarding the franchise transaction may be kept confidential.

However, arbitral proceedings may take longer than adjudication before the court of first instance (in many cases, the dispute practically comes to an end when the judgment of the court of first instance has been given), and therefore the dispute could be unnecessarily prolonged.

43 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Aside from minor differences in connection with the obligation to report real estate acquisitions (see question 8) and the restrictions imposed by the Foreign Investment Promotion Act (see question 4), foreign franchisors are not treated any differently from domestic franchisors.