

SOUTH KOREA

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¹ See Enforcement Decree, Article 13 and its attachment 2 for a list of specific activities that are recognized as unfair trade practices pursuant to Article 12 of the Franchise Act.

§1 Introduction

Franchising is now a form of licensing that is fast gaining in popularity in South Korea. Based on the year 2001 figures, franchising has been successful in fast-food/restaurant retailing, hotels and retail stores in Korea. As of June 2002, there were over 1,600 franchise companies and about 120,000 franchise outlets,² which employed over 570,000 people and generated more than KRW 41.7 trillion in sales.³

In recognition of the growing number of franchises and the impact the franchising industry has on the national economy as a whole, in 2002, Korea enacted the Act on Fairness in Franchise Transactions (the “Franchise Act”).

§2 Legal Treatment of International Franchise Agreements

[1] Franchise-Specific Laws

South Korea has recently amended the laws governing the franchise relationships by passing the Act on Fairness in Franchise Transactions (“Franchise Act”), which went into effect on November 1, 2002, with the accompanying Enforcement Decree (i.e. Presidential Decree) taking effect on November 6, 2002. Prior to the enactment of the Franchise Act, Korea Fair Trade Commission (“KFTC”) regulated franchise transactions mainly through two notification requirements that were promulgated in 1997 under Article 23 (Prohibition on Unfair Trade Practices) of the Monopoly Regulation and Fair Trade Act (“MRFTA”).

The first notification, the Notification on the Type of and Criteria for Determining Unfair Business Practices in International Contracts (“the Notification on International Contracts”), dealt with international transactions between a foreign franchisor and a local master franchisee, while the second notification addressed domestic transactions (“Notification on Franchise”), between a local master franchisee and local sub-franchisees or between a local franchisor and local franchisee. However, because the KFTC’s ability to enforce these notifications was limited and because the

² This figure represents roughly 4% of all the business enterprises in Korea.

³ The domestic franchise businesses accounted for 7.6% of the nominal GDP in 2001 (KRW 545 trillion). Of the KRW 41.7 trillion in franchise sales, the wholesale/retail sector accounted for KRW 26.1 trillion (62.6%), restaurant businesses were KRW 11.2 trillion (26%) and service sector generated KRW 4.4 trillion (10.6%). Currently, USD 1 is equivalent to roughly KRW 1,200.

subjects regulated by the notifications were not proper in scope, the government was unable to effectively deal with various disputes such as exaggerated advertisings, unfair termination of franchise agreements, the return of the franchise fee, which mainly arose between local franchisors and local franchisees. Accordingly, the Korean legislature passed the Franchise Act to supplement what was lacking in the Notification on International Contracts and to replace the Notification on Franchise altogether to offer better protection. Currently, the Franchise Act, the Enforcement Decree, and the Notification on International Contracts directly govern franchising in Korea.

[2] Government Approval Requirement

There is no requirement for government approval with respect to international franchise agreements in South Korea.

[3] Franchise Act and Notification on International Contracts

The Franchise Act is based on the principle of good faith and fair dealing and tries to provide a framework for building a fair and equal business relationship between the parties involved in franchising.⁴ The Franchise Act delegates the task of overseeing the franchise industry to the KFTC, and the KFTC in turn provides necessary guidance and order by monitoring the industry through corrective measures and penalties for violations of the Franchise Act. In addition, the Notification on International Contracts, specifically Article 6, provides a set of criteria for determining what may be deemed an unfair trade practice in various franchise activities.

[a] The Franchise Act. The Franchise Act is divided into six main chapters. Chapter I sets the stage by providing the purpose of the Act and the definitions of various terms used throughout the Act. Chapter II deals with the basic principles that govern the franchise transactions, and Chapter III has to do with fairness in franchise transactions, which, among other requirements, places a disclosure requirement on the franchisor. Chapter III also provides a list of basic provisions that needs to be included

⁴ Under the Franchise Act, a franchise is defined as “a continuous business relationship in which a franchisor provides a franchisee with the right to use his trademarks, service marks, trade name, signs and other business marks [] and provides a right to offer products [] and services under specified quality standards. . .educates and controls a franchisee in relation to the management and business operations in connection with the above rights and in which the franchisee pays franchise fees to the franchisor . . .” Article 2, THE FRANCHISE ACT.

in a franchise agreement. Chapter IV provides for a nine-member dispute mediation committee regulated by the KFTC and details the qualifications and the roles of the committee. Chapter IV also defines the roles and responsibilities of a “franchise consultant.” Chapter V deals with the disposition of cases under the KFTC and goes into details of the corrective measures that can be instituted, including a provision on a surcharge (fine) imposed on a franchisor who violates certain provisions of the Franchise Act. Chapter VI imposes civil and criminal liabilities on the person(s) who violates the Act.

The Franchise Act does not apply to certain situations where the total franchise fee paid by a franchisee and a franchisor’s annual sales are less than the specified amounts as determined by the Presidential Decree.⁵

[b] **Notification on International Contracts.** The Notification on International Contracts deals specifically with unfair trade practices in franchise inducement contracts, and provides the following categories as examples of what may constitute an unfair trade practice or a fair trade practice: restrictions on trading amounts; a coercion to purchase franchise store equipment; restrictions on merchandise and business activities; restrictions on the source of goods or on the business territory; a refusal to assist in the business operation; unilateral imposition of obligation; and non-competition restrictions after the termination of the business relationship.

§3 Methods of Establishing the Franchise

A foreign franchisor intending to expand his/her franchise in Korea may consider a variety of methods. While a single unit franchise or area development franchise is occasionally used, the more popular method is to use a master franchise arrangement.

In Korea, international franchising typically entails a foreign “master franchisor” working with a domestic “master franchisee.” Master franchisees can be

⁵ See THE FRANCHISE ACT, Article 3. “The phrase ‘[franchise fee] as determined by Presidential Decree . . . shall mean KRW 1,000,000 [USD 840].’ “The phrase ‘[specified amounts] as determined by Presidential Decree’ . . . shall mean KRW 50,000,000 [USD 43,000].” THE ENFORCEMENT DECREE, Article 5. However, the aforementioned exclusion does not apply to Articles 9 (Prohibition of Provision of false or Exaggerated Information) and Article 10 (Return of Franchise fees). See THE FRANCHISE ACT, Article 3. “The Act shall not apply . . . [p]rovided, however, that Article 9 and 10 shall apply” *Id.*

either a 100% owned subsidiary of the master franchisor or a joint venture company with a local partner; a pure Korean company may also become master franchisees. The master franchisee then relies on “sub-franchisees” for running the franchise outlets, which are either directly owned and operated by a master franchisee or owned and operated by an independent person or entity—a “pure sub-franchisee”.

[1] Sub-Franchise Agreement

Under a master franchise arrangement as described earlier, a South Korean master franchisor will enter into sub-franchise agreements with independent local parties for the operation of each franchise. In drafting the sub-franchise agreement, consideration must be given not only to the Franchise Act and the Notification on International Contracts, but also to the Standardized Contracts Act (the “SCA”), because a violation of the “SCA” would render the sub-franchise agreement null and void.

The “SCA” limits or negates the effect of certain contract terms that are not fully negotiated between the parties, that is, adhesion terms. Under the “SCA”, adhesion terms are defined as contract terms pre-determined and applied by one party to a certain contract to enable that party to enter into such contracts with a number of other parties. Therefore, if the terms of the sub-franchise agreement have been pre-determined and prepared by the franchisor to be applied to a number of sub-franchisees, and the sub-franchisees accept without actually negotiating all the terms and conditions of the sub-franchise agreement, such terms are subject to the application of the “SCA”.

§4 Details of the Franchise Act

[1] Disclosure Requirement

As with the previous notification system, under the current Franchise Act, it is understood that a franchisor has a duty to disclose upon a written request for disclosure by a prospective franchisee. Presently, in real practice, there has not been much of a problem related to this disclosure requirement. However, it is expected that the KFTC will, in the near future, change the written request requirement whereby the KFTC may do away with the requirement altogether.

Under the Franchise Act, a franchisor is obligated to provide prospective

franchisees with information that is material to making an informed decision regarding the purchase of a franchise. The information disclosure must be made prior to the execution of a franchise agreement, and such a document should include the following:⁶

- Explanation regarding the general status of franchisor⁷
- Explanation regarding any legal violation by an executive of the franchisor⁸
- Explanation regarding the obligations of the franchisee⁹
- Explanation regarding conditions of and restrictions on business operations¹⁰
- Explanation regarding the current status of franchise of the franchisor¹¹
- Explanation regarding detailed procedures and period required in respect of commencement of a franchise business
- Explanation regarding instruction and training programs (if any)¹²

The information contained in the disclosure has to be kept current, and the franchisor has to renew its information disclosure documents within ninety (90) days from the close of each fiscal year. And if there are changes to important items listed in the disclosure document such as the franchisee's obligations and conditions of the business operations, the franchisor has to amend the disclosure document within ninety (90) days of the date of such change.¹³

In the event a franchisor provides information related to its franchisees' financial status of the past or future projections of expected profits such as the sales amount, profit, total sales profit, and net profit for promotion of its franchise business, the franchisor must have, at its office, audit reports prepared by certified public accountants.¹⁴ A prospective or current franchisee is also entitled to request and

⁶ See the Franchise Act, Article 11.

⁷ For example, a balance sheet and profit/loss statement of the franchisor for the fiscal year immediately preceding the date of the disclosure of information.

⁸ For example, any corrective measures ordered by the KFTC.

⁹ Examples include, details of trademark license fee, rental fee, advertising fee, instruction and training fee, and signage rental fee.

¹⁰ In the case where products, services, transaction counter-parties or business territory are restricted or protected, details regarding the same.

¹¹ Facts such as total number of franchise shops in operation as of the most recent fiscal year end.

¹² Information such as the minimum period for instruction and training provided to the franchisee.

¹³ See the Franchise Act, Article 8, Para (2).

¹⁴ See The Franchise Act, Article 9, Para (2).

receive the aforementioned information from the franchisor.

[2] Return of Franchise Fee¹⁵

To effectively deal with the rise in the number of franchise-fee-related disputes in Korean domestic franchise businesses, under the Franchise Act, a franchisor has to return the franchise fee in the following cases:

1. The prospective franchisee requests the return of the franchise fee prior to the execution of the franchise agreement on the grounds that the franchisor provided false or exaggerated information, or when the franchisor omitted an important piece of information from the information disclosure document.
2. The franchisee requests a return of the franchise fee within two (2) months from the date of execution of the franchise agreement on the grounds that false or exaggerated information has been provided or that the important information which was omitted have significantly influenced the execution of the franchise agreement.
3. The franchisor unilaterally suspends the franchise without a justifiable reason and the franchisee requests the franchise fee to be returned within two (2) months from the date of such suspension. In this case, the fee to be returned shall not exceed the amount paid during the term of the terminated franchise agreement.¹⁶

[3] Prohibition on Activities Constituting Unfair Trade Practices¹⁷

¹⁵ See The Franchise Act, Article 10. Only the initial fee and/or contract performance guarantee payment (which are similar to “key money”) may be subject to return. On the other hand, regular payments similar to a “running royalty” are not subject to return. See the Franchise Act, Article 10, Para (1).

¹⁶ See The Franchise Act, Article 10, Para (1) 3. The “date” of suspension as used here means the date in which the franchisee receives a notification of suspension sent by the franchisor; and in cases where without any prior notification to the franchisee the franchisor suspends transactions that have significant influence on the operation of the franchise outlet for more than 20 days, the date of suspension in this case shall mean the date specified in franchisee’s written request to the franchisor for resumption of transaction. See The Enforcement Decree, Article 22.

¹⁷ See Enforcement Decree, Article 13 and its attachment 2 for a list of specific activities that are recognized as unfair trade practices pursuant to Article 12 of the Franchise Act.

A franchisor is prohibited, whether directly or through another enterpriser, from committing any act that falls under any of the following, which may obstruct fair trade in the franchise business:¹⁸

1. Refusing to transact
 - a. Refusing to provide business support¹⁹
 - b. Improper termination of contract

2. Transactions with restrictive terms
 - a. Restriction of prices²⁰
 - b. Restriction of transaction counterparty²¹
 - c. Restriction on sale of products or services²²
 - d. Coercion of observance of business territory
 - e. Activities similar to the cases described in a. through d. above, which improperly restrict the business activities of the franchisee

3. Abuse of bargaining power
 - a. Mandatory purchase²³
 - b. Make improper demands²⁴
 - c. Improper establishment or amendment of contract provisions²⁵
 - d. Interference with management²⁶

¹⁸ The restrictions, however, do not apply in cases where it is objectively difficult to protect the franchisor's trademarks or to maintain uniformity of product or services unless the activities list below are permitted and such aforesaid fact has been notified to the franchisee through the information disclosure document before execution of the franchise agreement.

¹⁹ For example, suspension or refusal of the provision of real estate, services, equipment, products, materials and components necessary for operation of the franchise business.

²⁰ For example, activities which improperly requires the franchisee to maintain prices of products sold by the franchisee determined by the franchisor.

²¹ For example, activities which improperly require the franchisee to transact with a particular transaction counterparty (including the franchisor) in relation to the acquisition or lease of real estate, services, equipment, products, materials and components required for the franchise business.

²² Such restrictions would include activities that improperly require the franchisee to sell only particular products or services.

²³ Activities that require the franchisee to purchase or lease facilities, equipment, products, services, materials, components, etc. in excess of the volume necessary to engage in the franchise business.

²⁴ Improperly demanding the franchisee to provide economic profits or to take the burden of expenses.

²⁵ Activities of establishing or amending contract provisions which make it difficult for the franchisee to perform or which is disadvantageous to the franchisee.

²⁶ Interference with management would include acts that require the operation of a franchise with a

4. Any activity other than those listed in (1) through (3) above such as unfairly inducing a franchisee of a competitor-franchisor to transact with itself, which has the effect of undermining the notions of fair trade.

[4] **Corrective measures by KFTC**

For those franchisors who have 1) violated their duties to provide, renew or amend the information disclosure document; 2) who provided false or exaggerated information; 3) who violated their duty to return the franchise fee; or 4) who committed any act constituting unfair trade practices, the KFTC may require the franchisor to i) provide or amend an information disclosure document, return franchise fees, cease the activities in violation, report on necessary plans or actions taken for correction of violations, or any other measures necessary for correction of the violations (“**Corrective Measures**”); or to (ii) arrange a plan for correction and recommend that a franchisor follow such a plan (“**Recommendation of Corrective Measure**”). With respect to aforesaid violations, the KFTC may assess a surcharge of an amount not exceeding 2% of the sales amount²⁷ of the franchisor (“**Surcharge**”). Furthermore, in the event a franchisor violates certain provisions of the Franchise Act (i.e. provisions relating to disclosure requirements), the KFTC may file a criminal complaint with the Attorney General. It is worth noting that a complaint from the KFTC is required to commence a public criminal action for offenses found under the Franchise Act.

[5] **Mediation**²⁸

To resolve disputes between the parties to a franchise, the Franchise Act provides that a Franchise Transaction Dispute Mediation Committee be established to mediate matters related to the disputes over franchise transactions that are requested by the KFTC or by parties in dispute.

particular person without proper cause.

²⁷ The sales amount shall mean the average sales amount for the past three fiscal years immediately preceding the violation by the relevant franchise; provided, however, that in the event three years have not passed since the relevant franchise has commenced operations as of the first date of the relevant fiscal year, the annual revenue amount shall be the revenue amount for the period from the commencement date of operations to the end of the fiscal year immediately preceding the violation, and in the event that operations were commenced during the relevant fiscal year, then the sales amount during the period from the commencement of operations to the date of violation shall be converted to the annual revenue amount. See Enforcement Decree, Article 34.

²⁸ See The Franchise Act, Articles 16-26.

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 being subject to corrective measures under the Franchise Act.²⁹

[6] **Penalty**³⁰

The Franchise Act provides that a person who supplies false or exaggerated information or omits important information shall be punishable by imprisonment of five (5) years or less or a fine not more than KRW 150,000,000 (roughly equivalent to USD 125,000). A person may receive a prison term and be fined for violation of the MRFTA as well as for not complying with orders given by the KFTC concerning corrective measures. Failure to make the necessary disclosures and/or update such disclosures can also result in prison sentence and fines.³¹ Furthermore, a form of vicarious liability (concurrent punishment) is also provided for in the Franchise Act, whereby a company or an individual can be held simultaneously liable for the acts committed by his or her agents or employees in violation of the Franchise Act.³²

A complaint from the KFTC is required to institute a public criminal proceeding against violators of the Act. The standard used for determining criminal liability is objective “seriousness” and “clarity”.³³ In addition, the Attorney General may, on its own initiative, request the KFTC to file a complaint, and in such a case, the KFTC must comply with the request. Once a public criminal indictment has commenced, the KFTC cannot withdraw the complaint.

²⁹ See *supra* p. 7. Para (2), Article 33 of the Act provides that the KFTC shall not, absent special circumstances, order corrective measures if resolution is achieved through mediation pursuant to the Act.

³⁰ See The Franchise Act, Articles 41-43.

³¹ Failure to disclose or amend information provided to the franchisee in accordance with the Franchise Act shall be subject to not more than 2 years of imprisonment or a fine of not more than KRW 50,000,000. See the Franchise Act, Article 41, Para (3).

³² See The Franchise Act, Article 42.

³³ See The Franchise Act, Article 44, Para (2). “In the case where the Fair Trade Commission recognizes that the extent of the . . . offense under Article 41 . . . is objectively serious and clear, the Fair Trade Commission shall file complaints with the Prosecutor General.”

§5 Trademarks and Service Marks

[1] Protection of Trademarks and Service Marks

Korea is a “first-to-file” jurisdiction. To obtain reliable protection of trademark or service mark (hereinafter collectively referred to as “trademark”) rights in Korea, the owner of the trademark should register the trademark with the Korean Industrial Property Office (the “KIPO”) pursuant to the Trademark Act. Currently, a trademark registration will be granted about 18 months after a trademark application. During the application period, no protection is provided. However, 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 by ordering the destruction of infringing goods.

In respect of well-known trademarks, the Trademark Act includes various provisions for their protection. According to one of those protective provisions, a trademark that is identical or similar to another person’s trademark which is well-known among domestic or foreign consumers and filed with unfair purpose, that is, with the intent to obtain unreasonable profit or to harm another person, may not be registered regardless of the similarity of the goods.

In respect of unregistered trademarks, there are no laws or regulations prohibiting the licensing or sub-licensing of a trademark which is not registered with the KIPO. However, as a general rule, a trademark or exclusive license that is not registered with the KIOP, even though the application may be pending, is not legally protected. Therefore, the owner of such a trademark or the holder of an exclusive license which is not registered with the KIPO cannot make an infringement claim against a third party infringement. However, a third party may not register a well-known trademark of a franchisor with the KIPO due to the above-mentioned provision of the Trademark Act.

[2] Trademark Licensing

Under the current Trademark Act, exclusive licenses must be registered with the KIPO to be valid and enforceable. Non-exclusive licenses, on the other hand, need not be registered with the KIPO to be valid and enforceable between the licensor

(franchisor) and the licensee (franchisee), although they must be registered to be effective against any third party.