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Arbitration Agreement Survives Franchise Law Challenge

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The Supreme Court recently issued a judgment upholding the validity of an arbitration agreement in an international franchise agreement,[(1)] notwithstanding the franchisee's objection that the arbitration agreement violated mandatory provisions of Korean law intended to protect franchisees.

Korea has a solid track record of upholding arbitration agreements in commercial contracts. However, one area of the law that remains unsettled is the extent to which statutory protections designed to protect the weaker party in certain contractual relationships might be invoked to resist arbitration. For example, the Fair Transactions in Business Franchise Act contains a provision which states that "[n]o franchisor shall engage in, or cause any other business entity to engage in, any [act] putting a franchisee at an unfair disadvantage by abusing its position in transactions".[(2)] Similarly, the Act on the Regulation of Terms and Conditions, a statute that governs a broader range of contracts with standardised terms, includes a provision declaring null and void "[a] clause unreasonably disadvantageous to customers which prohibits them from filing a lawsuit or requires customers to agree to jurisdiction".[(3)]

In this recent case, a franchisee attempted to invoke these provisions to invalidate an arbitration agreement, but the Supreme Court rejected these arguments and held that the franchisee was bound by the arbitration agreement.

Facts - The standardized agreement called for an "arbitration in New York" as the ultimate dispute settlement method

The defendant was a restaurant franchisor headquartered in the Netherlands. The plaintiff franchisee was a Korean individual. The plaintiff sued when the defendant allegedly breached a territorial restriction in the franchise agreement by allowing two

other competing franchise restaurants to open in the same geographical area as the plaintiff's restaurant. The plaintiff also alleged that the defendant had wrongfully delayed the opening of the plaintiff's business by supplying non-compliant and uncertified ovens.

The franchise agreement, which the parties stipulated should be governed by Dutch law, included an arbitration agreement that disputes should be resolved by arbitration in New York administered by the International Centre for Dispute Resolution.[4]

Rather than commence arbitration in New York, the plaintiff commenced a lawsuit in the Seoul Central District Court.[5] The Dutch franchisor objected that the Korean court had no jurisdiction since the parties had agreed that all disputes were to be resolved by arbitration in New York.

The Korean franchisee argued that mandatory provisions in Korean law made the arbitration agreement voidable. The franchisee invoked the protection of the Fair Transactions in Business Franchise Act and the Act on the Regulation of Terms and Conditions, as noted above. The franchisee argued that these statutes were mandatory provisions of Korean law that protected franchisees operating in Korea, notwithstanding that the franchise agreement was governed by Dutch law. The franchisee argued that it was unreasonably burdensome to require the franchisee, an individual, to be forced to arbitrate disputes in New York.

Decision - All courts dismissed the plaintiff's case

The Seoul Central District Court dismissed the plaintiff's case for lack of jurisdiction based on the arbitration agreement. The plaintiff appealed to a three-member panel of the same court, and the three-member panel dismissed the appeal, which was upheld on a further appeal to the Supreme Court. This article refers primarily to the reasoning from the judgment of the three-member panel, which was upheld in the Supreme Court's shorter judgment.

The three-member panel first considered the law governing the validity and enforceability of an arbitration agreement. Because the litigation was filed in Korea, the Court first turned to the Arbitration Act, which is based on the United Nations Commission on International Trade Law Model Law. The Arbitration Act requires a court to dismiss an action when the defendant raises as a defence the existence of an arbitration agreement,[6] even in cases where the place of arbitration is outside Korea.[7] However, this provision does not apply to cases where the arbitration agreement is null and void.[8] To determine whether an arbitration agreement is null and void, a court must first ascertain the governing law.

Where parties have agreed on a governing law clause in their contract, and the contract includes an arbitration agreement, Korean courts will apply the agreed choice of law to both the main contract and the arbitration agreement. In this case, the parties agreed that Dutch law would govern their franchise agreement, so the Court evaluated the arbitration agreement according to the requirements of Articles 1020 and 1021 of the Dutch Code of Civil Procedure.[9] According to these provisions, there was no ground to challenge the validity of the arbitration agreement.

The Korean franchisee's defence was not based on Dutch law, but Korean statutory provisions that the franchisee insisted were mandatory. The plaintiff made a two-pronged argument:

- Article 7 of the Act on Private International Law requires the mandatory provisions of Korean law - which, in light of the purpose of legislation, are to be applied irrespective of applicable laws - to govern legal relationships even if their applicable law is foreign law.[10] Therefore, Article 12(1) of the Fair Transactions in Business Franchise Act, article 14 of the Act on the Regulation of Terms and Conditions,[11] and Article 103 of the Civil Code[12] - which are mandatory provisions ensuring fairness in contractual relationships - all applied. The franchisee insisted that the arbitration clause put the franchisee at an unfair disadvantage by requiring that disputes be resolved by arbitration in a place that was unreasonably disadvantageous to the franchisee, and that enforcing such a provision would clash with good social order. As a result, the arbitration agreement should be deemed null and void.

- Article 10 of the Act on Private International Law stipulates that if applying a foreign law would evidently violate the social order of Korea, the foreign law shall not apply.[13] Recognising the arbitration agreement under Dutch law would violate the social order of Korea.

The Court rejected the plaintiff's first argument that any of these statutes should be construed as mandatory provisions within the meaning of Article 7 of the Act on Private International Law. There was no evidence of any legislative intent to intervene in foreign cases or contracts governed by foreign law. Rather, the evidence suggested that these statutes were only intended to regulate domestic matters and protect domestic consumers.

As to the second argument, the Court declined to rule that enforcing the arbitration agreement under Dutch law would result in a violation of the good customs and social order of Korea. There was insufficient evidence that enforcing the arbitration agreement would significantly disadvantage the franchisee. The Court noted that the arbitration agreement contemplated that disputes would be resolved on a documents-only basis unless one party requested a hearing. Even in the case that one party requested a hearing, the arbitration agreement provided that the hearing could be conducted by teleconference. Under these circumstances, the Court did not regard the arbitration agreement to be so unduly burdensome on the franchisee as to violate the social order.

Comment - A possible guideline to future franchise disputes in Korea

It is conceivable, but not very likely, that the outcome could have been different if the Court had evaluated the validity and enforceability of the arbitration agreement under Korean law. Although Korea is an arbitration-friendly jurisdiction, the extent to which arbitration agreements in standardised terms and conditions can be enforced against consumers remains a controversial issue not only in Korea, but in many other arbitration-friendly jurisdictions. The issue also remains unsettled for franchise agreements. Franchise brands, both domestic and international, are quite popular in Korea, particularly in the food and beverage sector. Many restaurant franchisees are individual entrepreneurs who may face a disadvantage when negotiating with large-scale franchisors. However, it remains uncertain the extent to which franchisees might successfully invoke these provisions to resist arbitration clauses. At least for now this remains a possibility, and the outcome will likely depend on the facts of a particular case.

Endnotes

(1) Supreme Court Decision 2020Da225442 dated 5 November 2020. The Supreme Court's judgment did not recite all of the facts, so this article also cites the lower court's judgment (Seoul Central District Court Decision 2018Na63343 dated 1 April 2020) when discussing the factual background.

(2) Article 12(1)(3) (Prohibition on Unfair Trade Practices).

(3) Article 14(1) (Prohibition of Filing Lawsuits).

(4) The arbitration agreement was a complex clause too lengthy to be quoted in the judgment in full.

(5) Seoul Central District Court Decision No. 2018Na63343 dated 1 April 2020.

(6) Article 9(1) of the Arbitration Act.

(7) Article 2(1) of the Arbitration Act.

(8) Article 9(1) of the Arbitration Act.

(9) Article 1020 of the Dutch Code of Civil Procedure (Arbitration agreements in general) states as follows:

1. *Parties may agree to submit to arbitration disputes which have arisen or may arise between them out of a defined legal relationship, whether contractual or not.*

2. *The arbitration agreement mentioned in paragraph (1) includes both a submission by which the parties bind themselves to submit to arbitration an existing dispute between them and an arbitration clause under which parties bind themselves to submit to arbitration disputes which may arise in the future between them.*

Article 1021 of the Dutch Code of Civil Procedure (Form of arbitration agreement) states as follows:

The arbitration agreement must be proven by an instrument in writing. For this purpose an instrument in writing which provides for arbitration or which refers to standard conditions providing for arbitration is sufficient, provided that this instrument is expressly or impliedly accepted by or on behalf of the other party. The arbitration agreement may be proven also by electronic means. Article 227a paragraph 1 of the Civil Code applies accordingly.

(10) Article 7 of the Act on Private International Law (Mandatory Application of Acts of Republic of Korea) states as follows:

In the light of the purpose of legislation, irrespective of the applicable laws, the mandatory provisions of the Republic of Korea shall govern the corresponding legal relations even if foreign laws are designated as applicable laws thereof under this Act.

(11) Article 14 of the Act on the Regulation of Terms and Conditions (Prohibition, etc of Filing Lawsuits) states as follows:

A clause in terms and conditions concerning filing, etc. of lawsuits which falls under any of the following subparagraphs shall be null and void:

1. A clause unreasonably disadvantageous to customers which prohibits them from filing a lawsuit or requires customers to agree to jurisdiction.

(12) Article 103 of the Civil Code (Juristic Acts Contrary to Social Order) states as follows: "A juristic act which has for its object such matters as are contrary to good morals and other social order shall be null and void."

(13) Article 10 of the Act on Private International Law (Provisions of Foreign Law Contrary to Social Order) states as follows: "In case a foreign law shall govern, if the application of provisions of the foreign law shall evidently violate good customs and other social order of the Republic of Korea, the law shall not apply."

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