

*Franchising in South Korea* is the 18th article in Wiley Rein's International Franchise Development Series. The International Franchise Development Series offers a broad overview of franchise regulation and the legal issues confronting franchisors seeking to expand into certain countries from the combined legal perspective of U.S. and local counsel.

## Franchising in South Korea

By Robert A. Smith, Sun Chang, and Maureen A. O'Brien

Franchising is an efficient, effective, and powerful business model. Over the past decade, franchising has expanded dramatically in Korea across various industry sectors, including hospitality, restaurant, fast-food, apparel, and others. In fact, in certain industries such as pizza delivery, fried chicken delivery, and convenience stores, franchising has become the predominant business model.

Statistics published in early 2015 by the Korean Fair Trade Commission (KFTC), the government agency with regulatory oversight of the franchise industry, demonstrates the growing pervasiveness of franchising in Korea. According to the KFTC, as of the end of 2014, there were over 3,500 registered franchisors in Korea accounting for nearly 4,300 franchise brands. Collectively, these franchisors operated over 13,000 units and franchised another 200,000 units. These figures would only have increased in 2015.

To regulate the exponentially growing number of franchised businesses, the Korean legislature enacted franchise-specific legislation in 2002. Since its enactment, the Korean franchise-specific legislation has become the most sophisticated legislation of its kind in Asia.

### Legal Framework of the Korean Franchise Law

The Fair Transactions in Franchise Business Act (Franchise Act), and its Enforcement Decree, are the primary statutes that govern the franchisor-franchisee relationship. The Franchise Act came into effect in 2002, and thereafter, was substantially amended in 2008, 2010, and, most recently, in 2014. Additionally, the Monopoly Regulation and Fair Trade Act (MRFTA), Korean Commercial Act, and various regulations promulgated by the KFTC are also generally applicable. Finally, general principles of tort and contract law that exist within the Korean Civil Code are also applicable.

### Pre-Contractual Disclosure

The Franchise Act requires a franchisor to register and provide a registered disclosure document to prospective franchisees. All franchisees, including master franchisees and area developers who are granted the right to operate franchised units, must receive the registered disclosure document. The following broad categories of information must be disclosed:

- Description of the franchisor's general status;
- Description of the current status of the franchisor's franchise – e.g., the total number of company-owned and franchised units in operation as of the most recent fiscal year's end;
- Description of any legal violations of the franchisor and/or its executives;
- Description of the franchisee's obligations;
- Description of the conditions of, and restrictions on, the franchised business operations;
- Detailed description of the procedure and period required to commence the franchised business; and
- Description of the franchisor's support, education, and training with respect to management and operation of the franchised business.

The Franchise Act prohibits the franchisor from accepting any franchise fees or executing the franchise agreement unless and until the franchisor has provided the registered disclosure document and allowed 14 days (seven days if the prospective franchisee is advised by a franchise counsel or broker) for the prospective franchisee to review the contents of the disclosure document. The franchisor must also obtain proof of delivery.

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## Registration of the Disclosure Document

To register the disclosure document, the franchisor must prepare an application, which includes the disclosure document itself and various ancillary documents, and file it with the KFTC. Once filed, the KFTC will conduct its review before issuing a certificate of registration and recording the registration. Given the KFTC's heavy docket load, this review process takes approximately two months from the application date to complete.

If the KFTC finds any deficiencies in the application (e.g., false/omitted information) or with respect to the ancillary documents, the KFTC will issue an office action requesting correction of the deficiencies. If, for whatever reason, the KFTC rejects the application, the franchisor will need to reapply.

The following steps must be taken in order to prepare the disclosure document application for filing with the KFTC:

### 1. Reviewing the Franchise Agreement

As detailed below, the Franchise Act imposes certain mandatory requirements with respect to the franchise agreement. Therefore, it will be necessary to review, and to the extent necessary, modify the franchise agreement to comport with the Korean franchise law.

### 2. Preparing the Disclosure Document

The KFTC has issued a standardized template for the disclosure document and requires the franchisor to submit a disclosure document consistent with this prescribed format. Therefore, even if a franchisor has a disclosure document that is registered in the U.S., the franchisor cannot simply modify the U.S. disclosure document in order to meet the KFTC's registration requirements. In addition, while there is no express provision in the Franchise Act that requires the disclosure document to be in a certain language, the KFTC requires the disclosure document to be in Korean. Consequently, the KFTC will register and publicize the Korean version of the disclosure document.

### 3. Translating the Franchise Agreement and Other Ancillary Documents

The KFTC likewise requires documents that are submitted to the KFTC for registration purposes to be accompanied by Korean translations. As the franchise agreement and various ancillary documents (e.g., excerpts of financial statements, etc.) must be submitted along with the disclosure document, they also must be translated into Korean.

## Receiving the Initial Franchise Fee

The Franchise Act restricts when a franchisor may receive "direct" payment of the following franchisee fees – defined in the Franchise Act as initial franchise fees:

- (1) Consideration that the franchisee pays to the franchisor for the management rights, such as the permission to use the business marks or the support and education for its operating activities, such as an application fee, membership fee, franchise fee, education and training fee or down payment; and
- (2) Consideration that the franchisee pays to the franchisor to secure payment for goods supplied by the franchisor or compensation for damages.

Rather than receiving the initial franchise fees from the franchisee directly, the Franchise Act requires the franchisee to deposit, in escrow, the initial franchise fees in a financial institution prescribed by the Enforcement Decree. Thereafter, the franchisor may request payment from the financial institution at the earlier of: (1) the date on which the franchisee commences business; or (2) two months after the execution date of the franchise agreement.

Alternatively, the franchisor may receive the initial franchise fees directly if the franchisor either: (1) subscribes to a compensatory insurance policy to cover any losses by the franchisee; or (2) defers payment of the fees until the earlier of the date on which the franchisee commences business or two months after the execution date of the franchise agreement. Because it is very difficult for foreign franchisors to subscribe to a compensatory insurance policy due to the domestic guarantor requirement, foreign franchisors typically opt to defer receipt of the initial franchise fees until the franchisee commences business or two months after the execution date of the franchise agreement, whichever is earlier.

## Term of the Franchise Agreement

The Franchise Act does not impose either a minimum or a maximum term for the franchise agreement. However, the Franchise Act does provide that, if a franchisee makes a request for a renewal between 180 days and 90 days prior to the expiration of the franchise agreement, the franchisor may not refuse the request without some justifiable reason (e.g., the franchisee defaults on payment of the franchise fees or other payments) if the term of the franchise agreement, including the initial term, is less than 10 years.

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## Termination of the Franchise Agreement

The Franchise Act strictly governs termination of a franchise agreement. Specifically, the Franchise Act requires “just cause” for termination and imposes a mandatory notice and cure period.

### • Notice of Termination

To terminate a franchise agreement in accordance with the Franchise Act, a franchisor is required to provide a first notice of breach to the franchisee. The contents of this notice must include: (1) the grounds for the breach; (2) a request to cure the breach; and (3) a statement that the failure to cure would result in termination of the franchise agreement.

Once this first notice is delivered, the franchisor must provide a two-month cure period for the franchisee to cure. At any time during this cure period, the franchisor must send a second notice with the same content as the first notice to the franchisee. If the franchisee fails to cure within the cure period, the franchisor may then terminate the franchise agreement.

### • Immediate Termination

Despite the strict notice termination requirement, in drafting the Franchise Act, the Korean legislature recognized that the ability to terminate is an important means for a franchisor to monitor and incentivize franchisees, prevent free-riding on the efforts of the franchisor to maintain the franchise brand and, most importantly, to protect against franchisee misconduct that can threaten the franchise system as a whole. Therefore, the Franchise Act provides 10 incurable defaults that allow the franchisor to terminate the franchise agreement immediately.

The franchisor must follow the termination procedures stipulated in the Franchise Act. Any termination that is not in accordance with the statutorily-mandated procedures is invalid.

## Intellectual Property Rights – Trademarks

Intellectual property rights, in particular trademarks, are one of the most important assets of the franchisor. South Korea is a “first-to-file” jurisdiction. Because trademark rights are territorial, to obtain the strongest protection of trademarks, a franchisor is advised to register the trademarks before licensing them for use

by the franchisees. In Korea, there are no particular requirements or formalities for granting a valid trademark license. Although registration of the trademark is not technically required prior to licensing, a trademark should be registered with the Korean Intellectual Property Office to be afforded the maximum legal protection.

## Fair Trade Issues

The Franchise Act incorporates certain provisions of the MRFTA regarding general fair trade principles and prohibits certain conduct by a franchisor. In particular, a franchisor may not, whether directly or through another enterprise, commit any act which may obstruct fair trade in the franchised business, including: (1) an unreasonable refusal to transact; (2) a transaction with restrictive terms; or (3) an abuse of bargaining power. ■

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## Upcoming Event:

Chris Connelly, partner in the Wiley Rein Franchise Group, will be moderating a session at the 49th Annual IFA Legal Symposium entitled "Basics Track: Franchise Default and Termination - Best Practices to Enforce the Contract and Protect the System" on Monday, May 16, 2016 from 1:45pm to 3:00pm at the JW Marriott in Washington, DC.

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