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Understanding Agency, Distributorship and Franchise Regulation in Korea

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COMMERCIAL AGENCY REGULATION

Under Korean law, a **commercial agent** is a non-employee party who acts as a finder-broker for a certain principal, usually earning commissions on sales made by the principal as a result of activities of the agent -- generally finding and introducing customers.

Commercial agency is subject to provisions of the Korean Commercial Code at Arts. 87 to 92-3, and also often comes under the purview of the Korea Fair Trade Commission under the Monopoly Regulation and Fair Trade Act (MRFTA), a statute governing trading practices and abuse of market power.

A commercial agent has an affirmative obligation to notify the principal in respect of any transactions in which the agent has played a role (Commercial Code, Art. 88).

Principals are protected under Korean law against competition from their commercial agents. Under Art. 89 of the Commercial Code, a commercial agent must seek permission of the principal to directly engage in, or become a partner in, or director of, any business which "falls within the class of business" to which the principal's business belongs. Where the commercial agent so usurps the opportunities of the principal in contravention of Art. 89, the principal shall be entitled to claim any profit thereby earned by the commercial agent (Commercial Code, Art. 17).

A commercial agent is deemed as the agent of the principal for delivery of notices related to the performance of the contract for sale (Commercial Code, Art. 90). This includes the delivery of service of judicial process in litigation matters. Principals should take care to require that Korean-resident commercial agents be required by contract to

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notify the principal of receipt of any such notices, less the agent's inattention to litigation involving the principal result in default judgment against the principal.

Provided that the contract between the parties does not establish such limitations, termination of a commercial agent is not subject to any mandatory law or regulation which prevents the free exercise of the principal's termination right. As a baseline rule, a principal may terminate an agent at any time, for any reason, subject to two months' notice (Commercial Code, Art. 92).

However, termination of a commercial agent may require compensation be paid to the agent in cases where the agent has "remarkably contributed" to the current business prospects of the principal in Korea, and the termination of the agent is not a result or misconduct or other fault of the agent (Commercial Code, Art. 92-2). In actual practice, the courts are fairly generous to commercial agents' claims that the agent's activity had built up a business, so principals should always budget for compensation upon termination.

Compensation under Art. 92-2 is limited to one (1) year's commissions or other compensation which would have been earned, based on the average commissions over the five (5) years prior to termination or the average yearly compensation over the term of appointment in cases where the agent has been appointed less than five years. However, one year's commissions is not the base entitlement due the agent, but rather a statement of the maximum entitlement.

The time bar under Art. 92-2 for commencing a claim for compensation is six (6) months from the date of termination of the agency relationship. Pursuant to the Code of Civil Procedure, expiration of the time bar may be suspended once, for a period of six (6) additional months, by the delivery of a demand letter through content-certified postal mail; in such cases, if a claimant does not commence litigation within the extended six-month period, the claim shall be extinguished.

Even after termination of contractual relations between the parties, a commercial agent shall have the duty to preserve the trade secrets of the principal (Commercial Code, Art. 92-3).

DISTRIBUTORSHIP REGULATION

A **distributor** is a party who buys tangible or intangible goods from a party selling those goods (for purposes of clarity, this party will simply be described as "manufacturer") on the distributor's own account and transfers such goods to customers of the distributor, subject to a markup if the distributor's business operates normally. But because the distributor buys and sells on its own account, unless there is a separate agreement between the manufacturer and the distributor concerning price protection, the distributor is generally completely liable for profits and losses.

Distributorships are largely unregulated, because each party takes on its own business risk on an arm's-length basis. However, the MRFTA colors the rights and responsibilities of the parties in circumstances where one (usually the manufacturer) enjoys market power. In particular, where the distributor is deemed to be dependent on the manufacturer, termination rights may be circumscribed in ways which are unexpected.

In 2008, the Korean Supreme Court upheld the termination of the distributorship agreements of certain gasoline filling stations (Sup. Ct. 2004 *da* 39238; judgment of

February 14, 2008) undertaken in connection with the reorganization of a distressed oil company. The terminated stations appealed to the KFTC and to the courts to enforce their agreements.

The KFTC decision was in favor of the oil company: The agency held that reorganization of distributorship arrangements in the context of saving a failing business was not an abuse of market power under the MRFTA. The trial court, appeals court, and Supreme Court all found in favor of the oil company, for reasons similar to those cited by the KFTC. However, the terminated distributors filed a parallel appeal to the Constitutional Court, which found that the failure of the KFTC to sanction the oil company amounted to an infringement of the Constitutional rights of the terminated distributors.

Accordingly, the Constitutional Court remanded the fair-trade matter to the KFTC for re-adjudication with an instruction to the agency to sanction the oil company. Thus this matter is somewhat unusual in that the termination has been upheld, but the Constitutional Court has claimed jurisdiction over the operation of the fair-trade agency.

A relatively recent Korean Supreme Court case (Sup. Ct. 2001 *du* 1604; judgment of Jan. 10, 2003) voided a provision of a standardized distributorship agreement which provided that either party could terminate with two (2) months' written notice, because the actual facts of the relationship were that the distributor was dependent on the manufacturer, such that the clause could not be exercised by each party but rather only by the manufacturer. In such cases of dependency, the Supreme Court ruled that the distributorship agreement should contain notice of the causes for termination, such as breakdown of the trust relationship, breach of contract, or other "inevitable circumstances".

Later that same year, the KFTC sanctioned a manufacturer for termination of a long-standing distributorship agreement due to the distributor's failure to comply with a newly-adopted business policy of the manufacturer requiring that products be sold only in department stores and not in discount outlets. Based on the "continuous business relationship" of the parties and the history of successive renewals of the distributorship agreement, the KFTC found that termination of the agreement was an abuse of rights and sanctioned the manufacturer with a "administrative warning", a relatively mild sanction.

FRANCHISE REGULATION

Another class of commercial relationship is a **franchise**, which is subject to specific regulation under Korea's Fairness in Franchise Transactions Act ("Franchise Act"), an act first adopted in 2002 and substantially amended in 2007 in response to the country's specific experience with the growing franchise sector.

The Franchise Act defines a franchise relationship as involving all of three elements: (i) the license of "Business Marks", which includes trademarks, service marks, and elements of trade dress; (ii) the transfer of and participation in a uniform and reproducible "System" of operating methods (i.e., things like a standardized menu of food items, with ingredients and preparation methods dictated by the franchisor, or a selection of official licensed merchandise, but also including participation in common advertising); and (iii) a "Franchise Fee", which is defined as any fee paid to acquire or maintain the rights to participate in the franchise relationship (see Franchise Act, Art. 2, item 1).

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A Franchise Fee could include an initial payment, a royalty-based scheme, percentage of sales, training fees, rent paid to lease property owned by the franchisor, and other monies. The law is not particular about the form of the Franchise Fee but rather the fact that payment by the Franchisee is essential to the acquisition or maintenance of rights to participate in the relationship.

Without the presence of all three elements of the franchise relationship, the relationship shall be classified as a simple license agreement, an authorized distributorship, or other relationship -- but not as a franchise. In such cases, the Franchise Act shall not be applicable. Therefore, if a party wishes to ensure that the Franchise Act shall not apply to a business relationship in Korea, care should be taken to ensure that at least one of the three elements of the franchise relationship defined in Franchise Act is absent.

The Franchise Act was amended in August 2007 (with the amendment taking effect February 4, 2008) to impose additional burdens on the franchisor than did the previous version of the statute. In brief, the amendment requires franchisors (i) to **register** their disclosure statements with the KFTC; (ii) to **deliver a written disclosure statement** to all prospective franchisees in all cases, not just the cases where disclosure is requested; (iii) to **observe a "cooling off" period** after disclosure is given to the prospective franchisee; (iv) to **escrow franchise fees** at the commencement of the relationship and to establish some means to protect the franchisee's right to refund in certain cases; (v) to **refrain from direct competition** with the franchisee; and (vi) to **be much more meticulous** in respect of communications and acts concerning the renewal, non-renewal, and termination of the franchise relationship.

Disclosure statements under Korean law are much simpler than a US Uniform Franchise Offering Circular (UFOC) -- the model form suggested by KFTC results in a document of about 20-30 pages rather than the hundreds of pages that comprise a US UFOC. However, due to the amendment, the Franchise Act now implicitly requires that the disclosure statement be prepared in the Korean language, and the registration requirement effectively gives the KFTC the power to direct changes to the terms and conditions of the franchise agreement by deeming that provisions of the disclosure statement are unfair or unclear.

Franchise-fee escrow has been mandated to protect the franchisee's right to refund in the case that disclosure is false or misleading. The franchisor shall be required to escrow the fees with an institution approved by the KFTC for a period of 60 days from receipt of the fees or until the franchisee's business gets underway, whichever is shorter.

Art. 13 of the Franchise Act restricts terminations. In cases of a franchisor's election not to renew after franchisee has made a request for renewal, the franchisor shall be required to respond in writing within 15 days of receipt of franchisee's request, stating the reasons for franchisor's non-renewal decision.

Art. 13 additionally requires that where the franchisee requests renewal of the relationship within 180 and 90 days prior to the scheduled expiration of the franchise agreement, the franchisor shall not have the right to decline renewal except in cases where there is "just cause" for non-renewal. Earlier non-renewal decisions, however, are not subject to any special restriction if notified prior to the franchisee's request.

“Just cause” language in other contexts of Korean law — in particular, employment law — is generally very restrictively interpreted, with the burden of proof falling completely on the party deemed to have greater power in the relationship. Art. 13 therefore requires franchisors to be conscious of the possibility of non-renewal, and to make certain to preserve their rights by delivery of notice, before it is too late.

Art. 13, para. 1 of the Franchise Act enumerates specific cases deemed to constitute “just cause” for non-renewal. They are: (i) default in payments of contractually-agreed amounts including franchise fees; (ii) default in adherence to standards and practices applied to the rest of the franchise system; (iii) default in adherence to “material standards” of the franchise system, including elements of trade dress and technical specifications meant to ensure uniform levels of quality.

In the case that a franchisor sends default notices to the franchisee, the Franchise Act requires a clear, “concrete” statement of exactly which provision of the Franchise Agreement is in default. It is inferred that the franchisor must describe the method by which the franchisor has become aware of the breach.

The amended Franchise Act requires two (2) written default notices be delivered to a defaulting franchisee over a 60-day period before the agreement may be terminated for default; However, default notices are required to affirmatively warn the franchisee that termination of the franchise agreement will result in the case of failure to cure.

ABOUT THE AUTHORS

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