



Guiding You Through the Legal Maze.SM

**AN AMERICAN EXPORT
TO THE PACIFIC RIM –
FRANCHISING**

**© 1990 Keith J. Kanouse
Kanouse & Walker, P.A.
One Boca Place, Suite 324 Atrium
2255 Glades Road
Boca Raton, Florida 33431
Telephone: (561) 451-8090
Fax: (561) 451-8089
E-mail: Keith@Kanouse.com**

This article contains the author's opinions. Some material in this article may be affected by changes in the law or regulations, or changes in interpretations of the law. Therefore, the accuracy and completeness of the information contained in this article and the opinions based on it cannot be guaranteed. If legal services are required, the reader should obtain them from a competent business attorney. The author specifically disclaims any liability for loss incurred as a consequence of following any advice or applying information presented in this article.

AN AMERICAN EXPORT TO THE PACIFIC RIM - FRANCHISING

While cars, electronics, computers and other goods are being imported from the Pacific Rim, contributing to our increasing trade deficit, there is an American export to the Pacific Rim, the marketing technique of FRANCHISING. Many U.S. franchising companies are looking to international expansion opportunities and, in addition to Canada and Europe, are focusing attention on the Pacific Rim, including Japan, Korea and Hong Kong. Japan will soon become the largest foreign market for U.S. franchisors, ahead of Canada.

This article will briefly highlight the current state of franchising in Japan, Korea and Hong Kong, based on the author's recent trip to these countries as part of the Franchise Delegation of the People to People Citizen Ambassador Program, including information gleaned from meetings with government officials and attorneys. While none of these countries has laws similar to our FTC Franchise Rule or our state registration and disclosure laws, there are laws which impact upon franchising in these countries. A detailed review of these laws (*e.g.*, trademark and competition laws) should be undertaken in conjunction with U.S. and host-country counsel prior to franchising in such countries. Such an analysis is beyond the scope of this article.

JAPAN

Japan has a bustling economy with a legal structure not as complex or all-encompassing as ours. There are far fewer attorneys and litigation is a "loss of face" for all litigants. There is a social aspect to doing business there. Negotiations are extensive and take a long time as the parties attempt to get to know each other as much as possible before entering into a business relationship. Japanese customs, not just their laws, have to be taken into account in doing business in Japan.

Master Franchising

Although foreign investment is not substantially restricted and a U.S. franchisor can open a branch or subsidiary, most U.S. franchisors enter into a master franchise agreement with a Japanese company which acts as the franchisor of the U.S. franchisor's concept in Japan and subfranchises to Japanese franchisees. The master franchise agreement is considered a "technical assistance agreement." A technical assistance agreement between a U.S. company and a resident of Japan is subject to the Foreign Exchange and Foreign Trade Control Law (the "FECL"). The FECL requires the filing of the master franchise agreement with the Japanese Fair Trade Commission, which reviews the agreement to ensure that its provisions do not violate various laws regarding monopolization, unreasonable restraints of trade and unfair business practices. The filing must be made within 30 days after execution of the agreement.

Retailers Law

In light of the striking difference between medium- and small-scale enterprises and large-scale enterprises, particularly durability and strength, Japan enacted the Law Concerning the Development of Middle- and Small-Scale Retailers of 1973 (the "Retailers Law") to protect and assist these weaker businesses. A medium- or small-scale enterprise is any business which has capital (*i.e.* net worth) of not more than ten million yen (\$10MM□) and employing not more than fifty (50) persons. The Retailers Law applies to businesses selling products to ultimate consumers, not to service businesses. At present there are approximately 1,600,000 businesses meeting this definition.

Some of the benefits afforded to medium- and small-scale enterprises under the Retailers Law include government loans at low interest rates for improvements such as beautification of entrances and store premises to make the retail establishment more attractive to customers. A Japanese franchisee may be subject to the Retailers' Law and qualify for its benefits.

The Retailers Law defines "Chain Business" and "Specific Chain Business" which definitions may impact upon U.S. franchising activities in Japan. A "Chain Business" is a business: (a) involving medium- and small-scale enterprises; (b) based on a standard form agreement; and (c) engaged in the continuous sale of goods and management assistance. "Specific Chain Business" is a Chain Business where the standard form of agreement provides for: (a) the granting of trademarks, trade names or other marks for the business operation; and (b) the payment by the applicant of a certain amount of money, such as a down payment or deposit.

Any person or corporation operating a Specific Chain Business as a franchisor must give an applicant for such business (a prospective franchisee) the following information in writing:

1. Initial payment of money to be deposited or transferred by the applicant;
2. Condition or method of sales of goods;
3. Management assistance to be rendered;
4. Trademarks or any other marks to be used by the applicant;
5. Term, renewal, termination, or cancellation of the agreement;
6. Name, address and representatives of the person or corporation operating the Specific Chain Business;
7. Date of commencement of the Specific Chain Business;
8. Money to be paid periodically by the applicant; and
9. Obligation of the applicant with regard to structure, design, or layout of the store.

This disclosure document does not have to be filed with the Japanese government. There are no formal sanctions for non-compliance except public notice of non-compliance. The threat of public notice of non-compliance is usually a sufficient "stick" to assure compliance as such disclosure would be considered a loss of face. However, as discussed below, the Japanese Franchise Association requires its members to comply as a condition of membership.

Japanese Franchise Association

The Japanese Franchise Association ("JFA") has been established in Japan. The JFA is composed of approximately 178 franchisors out of approximately 570 franchisors in Japan. These 178 franchisors represent a majority of the franchise units in Japan as the larger franchise companies are members of the JFA. Based on information reported to the Japanese Ministry of International Trade and Industry, the number of franchisors and the units represented are as follows:

<u>Year</u>	<u>Franchisors</u>	<u>Units</u>
1979	335	N/A
1980	365	46,371
1982	424	N/A
1983	438	N/A
1984	469	N/A
1985	462	N/A
1986	492	N/A

1987	496	N/A
1989	491	68,301
1990	527	71,967
1991	570	N/A

As mentioned above, Japan's requirement that a disclosure document be given by a franchisor to a prospective franchisee is a voluntary requirement, not a mandatory requirement. However, the JFA helps to comply with the requirements by requiring, as a condition to membership, that its members make the disclosures. Membership in the JFA is considered beneficial because membership connotes that the company can be trusted by others. In order to become a member of the JFA, a franchisor must comply with the following requirements:

A. The franchisor must be considered a person who will not violate public order and possesses good morals; and

B. The franchisor must have not less than one year of actual experience in the management of the business being franchised.

Currency Restrictions: Taxes: Import Duties and Quotas

There are no restrictions on repatriating profits, sales or liquidation proceeds from Japan to the United States. However, franchise fees and royalties are subject to a twenty percent (20%) withholding tax.

While few legal restrictions on foreign investments and repatriating profits exist, as demonstrated by the President's recent trip to Japan, trade barriers are the major impediment to doing business in Japan. Certain segments, like the food service industry, have little problem with this area, while other segments, like automotive and computers, have major obstacles. A lessening of these trade barriers such as impact duties and quotas are needed to make Japan more accessible for U.S. franchisors.

KOREA

Korea is trying to break away from the penumbra of its neighbor, Japan. Hosting of the 1988 Summer Olympics helped. Korea remains protectionist but is attempting primarily to foster its manufacturing segment. It is in the midst of an austerity program. The threat from North Korea remains a concern to South Koreans as Seoul is only 25 miles from the DMZ.

Master Franchising

As in Japan, the most common way a U.S. franchisor enters Korea is through a master franchise agreement with a Korean company which acts as the franchisor of the U.S. franchisor's concept in Korea and subfranchises to Korean franchisees. The master franchise agreement is considered a "technology inducement agreement." The Korean Foreign Capital Inducement Law ("FCIL") requires government approval of all technology inducement agreements. The agreement is approved by a relevant Ministry depending on the nature of the goods or services involved. For instance, food service franchisors are subject to the Ministry of Health and Social Services and consumer goods franchisors are subject to the Ministry of Trade and Industry. The agreement is reviewed to determine whether any of its provisions violate Korea's Fair Trade Act. Review must take place within 20 days or the agreement is deemed approved. It is the Korean company which must

submit the application. The appropriate Ministry may require changes to the agreement as a condition to approval and enforcement. In the last few years there has been a liberalization and greater flexibility by the government in allowing provisions customarily found in franchise agreements to remain in the agreement (*e.g.*, return of technology after expiration, sales area restrictions, development schedule) which were previously found objectionable.

Foreign Investment Restrictions (Negative List)

Under the FCIL, the Korean government has a Negative List of Industries which lists all activities for which foreign investment is not permitted. Any activity not on the Negative List is permitted. The Negative List is reviewed annually by the Ministry of Finance for deletion of certain market segments to encourage foreign investment in Korea as its economy matures. Many service-type businesses remain on the Negative List as manufacturing is being encouraged. In most cases, there is no restriction on the amount or percentage of investment by U.S. franchisors provided the business is not on the Negative List. However, certain industries and small- and medium-sized enterprises have a fifty percent (50%) maximum foreign equity investment limitation.

Currency Restrictions and Taxes

If the foreign investment is permitted, the FCIL guarantees the remittance of profits from a foreign-invested Korean company. Initial franchise fees, royalties and other payments can be repatriated. There is a fifteen percent (15%) withholding income tax on franchise fees and royalty payments. In addition, royalty payments made by franchisees to foreign franchisors are subject to a value-added tax ("VAT") at the rate of ten percent (10%) of the gross royalty amount. While previously there were restrictions on the amount of a royalty which could be charged and how it was computed, today there are no restrictions and royalties can be based on gross sales.

Financing Restrictions

There are little financing opportunities available at this time. Korea is in the midst of an austerity program discouraging luxurious or speculative activities such as hotels, restaurants and golf courses. The emphasis remains on manufacturing companies. Even eating at McDonald's is considered a luxury. Therefore, instead of seeking governmental financing assistance, a U.S. franchisor desiring financing in Korea should seek a Korean partner and franchisees with deep pockets.

HONG KONG

Hong Kong continues to exuberate the epitome of capitalism, with a mixture of East and West. Its active port and skyscrapers are the beacons of international commerce, but the shadow of 1997 is beginning to loom.

July 1, 1997

The most important question on everyone's mind is what is going to happen in 1997. On July 1, 1997 the New Territories (comprising 92% of all land area of Hong Kong) will revert to the Peoples Republic of China. Based on a Joint Declaration between the United Kingdom and China, Hong Kong will become a Special Administrative Region and capitalism is supposed to continue for another 50 years. However, the incident at Tiananmen Square has left people insecure. Many are hedging their bets by formulating exit strategies. Certainly Hong Kong (a city of 6 million residents) will continue to

be a vibrant and significant economic area regardless of whose sovereignty it is under.

Foreign Investment

The Hong Kong government actively encourages foreign investment. It has opened five overseas offices, including two in the United States (New York City and San Francisco), to assist overseas investors in investing in Hong Kong. There are no restrictions on foreign investment. There are no restrictions on repatriating profits to the U.S. Hong Kong deems that ten percent (10%) of the gross royalties paid to a U.S. franchisor are assessable profits subject to the profits tax. The standard corporate income tax rate is ten percent (10%). Therefore, the effective corporate profits tax rate for royalties paid to a U.S. franchisor is 1.7%.

Laws Affecting Franchising

Hong Kong is a businessperson's idea of Nirvana. There are no laws affecting franchising. It is purely a matter of contract. There are no franchise registration or disclosure laws. There are no special industry laws. As mentioned above, there are no foreign investment or currency restrictions. There is no requirement of local participation in ownership or management. There are no antitrust laws or regulations, and even restrictive covenants or covenants not to compete are enforceable if they are reasonable.

The Hong Kong Intellectual Property Office handles the registration of patents and trademarks. Service mark registrations will commence in March, 1992. Their procedures are similar to that found in the United Kingdom. A franchisee is advised to register as a registered user of the franchisor's trademarks. Trade secrets are protected under the law of confidence imposing a duty upon the disclosee not to use the confidential information for his or her own personal benefit or to disclose it to a third party without the consent of the owner.

CONCLUSION

I was surprised more by the similarities between the Far East and the United States than its mysteriousness and differences. It appears we are all heading towards a common vortex - a desire to have a certain way of life - peace, secure jobs and income, family, home, consumer conveniences, recreation and travel. Franchising assists in the fulfillment of these goals. As we move closer and closer to a global economy and trade barriers are broken down, franchising opportunities will become more available. The United States can, and should, insure that it continues to lead in this area.

Keith J. Kanouse, Esq.