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Competition Law and Distribution in East Asia

By William P. Johnson

While franchise lawyers, both domestically and in foreign jurisdictions, tend to focus their primary attention on matters of importance that are specific to franchise relationships, most are keenly aware that franchising is essentially just a form of distribution. Therefore, laws and regulations of broader impact can often be of critical importance. While distribution systems may often escape the applicability of franchise laws, franchise relationships nevertheless often have to deal with those affecting distribution generally.

When appointing distributors in foreign jurisdictions, U.S. suppliers and their counselors are well advised to be aware that assumptions based on U.S.-style distributorships can prove to be false. Indeed, in some jurisdictions, some assumptions can prove not only to be false but also to lead to significant adverse consequences. This is true in particular with respect to the competition law of some jurisdictions as such law is applied to distribution arrangements in those jurisdictions. Seemingly standard limitations placed on a distributor's activities that we may take for granted in the United States can give rise to potential civil, and even criminal, liability.

This article identifies common pitfalls that arise in three key East Asian jurisdictions: the Republic of Korea, Japan, and Taiwan. It does not present an exhaustive list of contractual provisions that can give rise to competition law issues, nor does it identify all jurisdictions where these issues arise. Rather, this article is intended to identify the most common pitfalls in specific jurisdictions with well-developed competition law where U.S. suppliers are actively establishing distribution networks, in order to bring to light the danger of assuming that what we know about U.S.-style distributorship agreements is applicable in those jurisdictions.

COMPETITION LAW IN THE U.S.: THE RULE OF REASON AND VERTICAL RESTRAINTS

Given the competition law backdrop in the United States, it is not surprising when U.S. suppliers are unprepared for the differences presented by foreign jurisdictions. In the United States, the Sherman Antitrust Act generally prohibits contracts,

continued on page 2

Too Little, Too Late

The Franchisee's Perspective on the Revised FTC Franchise Rule

By Susan P. Kezios

The Federal Trade Commission ("FTC") labored a dozen years to revise its Franchise Rule — only to give birth to a mouse.

The American Franchisee Association ("AFA") was actively involved in the Rule review process since its beginning in 1995. The AFA submitted written comments and participated in public workshops in both 1995 and 1996. In 1997, after the FTC published an Advanced Notice of Proposed Rulemaking ("ANPR"), the AFA submitted written comments again — along with 70 franchisees representing 20 independent associations of franchisees. The AFA suggested that regional workshops be held in order that franchisees might be better able to have their comments included on the record. The FTC responded to the AFA's request and held six public workshop conferences in which the second day was an open forum in which the public was invited to express its views. Franchisees from another 15 independent franchisee associations, all members of the AFA, participated in these public conferences. After the ANPR workshops, the FTC published a Notice of Proposed Rulemaking ("NPR") in 1999 to which the AFA again submitted written comments.

By 2002, the AFA had convinced the U.S. House to hold a hearing on the enforcement of

continued on page 4

In This Issue

East Asia

continued from page 1

combinations, and conspiracies that restrain trade or commerce. Sherman Antitrust Act, 15 U.S.C. §1.

However, over time the "judicial gloss" on this statutory prohibition has established the "rule of reason," which has become the prevailing standard for analysis of restrictive practices in most cases, to determine whether such practices ought to be prohibited under U.S. competition law. *See Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 49 (1977). Under the rule of reason, all of the circumstances of a case are weighed in deciding whether a restrictive practice imposes an unreasonable restraint on competition and should therefore be prohibited. *Id.* And when the agreement is between two parties in a vertical relationship (*e.g.*, between a supplier and its distributor), as opposed to a horizontal relationship (*e.g.*, between two competitors), courts, applying the rule-of-reason analysis, are unlikely to find that a restrictive practice contained in such an agreement, a "vertical restraint," constitutes an unlawful restraint on trade (in the absence of price-fixing). *See, e.g.*, *Id.* at 54-59.

Thus, it is common for a U.S. supplier to place limits on its U.S. distributor's right to resell the supplier's products. Also, suppliers frequently will have the right to terminate the distributorship agreement for cause if the distributor exceeds such limits.

Such limits are, in fact, restraints on trade in that a willing seller may be contractually prevented from consummating a sale to a willing buyer. However, in the United States, judicial and scholarly authority provide support for the position that such "vertical restraints" actually promote interbrand competition "by allowing the manufacturer to achieve certain efficiencies in the distribution of [its] products" and should therefore not be prohibited by competition law. *Continental T.V.*, 433 U.S. at 54.

In many foreign jurisdictions that have well-developed competition law, the U.S. rule of reason as applied to vertical restraints has no corollary. Consequently, many contractual terms that are customary in the United States may constitute unlawful restraints on trade in other jurisdictions. This issue arises not only in the Republic of Korea, Japan, and Taiwan, but also in other jurisdictions with well-developed competition law. However, the three East Asian jurisdictions provide examples that are particularly apropos, as the following sections show.

The Republic of Korea

The Korean Monopoly Regulation and Fair Trade Act ("KFTA") took effect in 1981. The KFTA forms the legal framework of the fair trade rules and regulations in Korea and is enforced by the Korea Fair Trade Commission ("KFTC"), the administrative organization in charge of competition laws and policies. An English translation of the KFTA can be found at the following link: *www.ftc.go.kr/eng/*.

The KFTA generally prohibits certain identified acts that are likely to impede fair trade. *See* Monopoly Regulation and Fair Trade Act, Ch. 5, Art. 23(1); *see also Id.* at Ch. 8, Art. 32 (making the prohibition of unfair business practices expressly applicable to international contracts). The definition of unfair business practices is broad and includes "[a]ny act that threatens to impair fair trade." *Id.* at Ch. 5, Art. 23(1)8. As a result, the KFTC has broad discretion to find that restrictive practices in distribution arrangements constitute

continued on page 3

William P. Johnson is an associate in the Business Law Department of Foley & Lardner LLP (*www.foley.com*) and a member of its International Business Team and its Commercial Transactions & Business Counseling and Distribution & Franchise Practice Groups. He can be reached at *WJohnson@foley.com* and at 414-297-5632.

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East Asia

continued from page 2

unfair business practices that violate the KFTA.

Thus, under the KFTA as it has been interpreted and enforced by the KFTC, a supplier may not restrict sales by the distributor to a particular area within Korea (although a restriction on sales outside of Korea is likely to withstand scrutiny under the KFTA). A supplier also may not prohibit a nonexclusive Korean distributor from handling a competitor's line of products and may be limited in its right to do so with respect to an exclusive distributor as well. As a consequence, domestic territorial restrictions and covenants not to compete can constitute unfair business practices in Korea. In addition, a supplier may not obligate its distributor to purchase minimum quantities of products from the supplier, although the parties to a distributorship agreement can designate a minimum sales "target" (as long as the supplier cannot terminate the distributor for failure to meet the target). *See generally Notification on the Types of and Criteria for Determining Unfair Business Practices in International Contracts*, Korea Fair Trade Comm'n Notification 1997-23 (April 21, 1997).

If a supplier engages in an unfair business practice in Korea, the KFTC can impose a range of possible penalties. The KFTC may order the supplier to suspend the offending act, to delete the pertinent provisions from the contract, to publicly announce that a violation occurred, or "take any other necessary corrective measures against that act." KFTA, Ch. 5, Art. 24. The KFTC also has authority to impose fines. *Id.* at Ch. 5, Art. 24-2; *see also Id.* at Ch. 14, Arts. 67 and 69-2. In addition, the KFTA provides for the possibility of imprisonment of up to two years for a person who has committed an unfair business practice. *Id.* at Ch. 14, Art. 67. Finally, the person harmed by the violation has the right to claim compensation for damages. *Id.* at Ch. 11, Art. 56. If, however, the supplier can show that its conduct was not intentional, it may be able to avoid liability for such damages. *Id.*

It is important to note that the KFTC has not frequently found unfair business practices in distribution arrangements. However, in a recent decision, the KFTC imposed a fine of 23 billion Won (approximately $24.3 million) on a company because the KFTC found multiple violations of the KFTA relating to the company's market dominance and its control over its network of sales intermediaries. *See KFTC decided to impose corrective measures and a surcharge of 23 billion Won on Hyundai-Motor Company*, Korea Fair Trade Comm'n (Jan. 19, 2007), *www.ftc.go.kr/eng/.* In that case, the sales intermediaries were sales agents. Notably, an agreement between a supplier and its sales agent in the United States will be subject to even less competition law scrutiny than a vertical restraint. In fact, even price restrictions are permissible in such agreements and other restrictions are rarely challenged on competition law grounds. The violations found by the KFTC included (among other violations) abuse of market dominance by forcing excessive sales quotas onto the sales agents in violation of Article 23(1)4 of the KFTA. While such a decision may not be common and appears to have been in large part a result of the market dominance found by the KFTC, the decision nevertheless shows the scope of the risk if the KFTC finds a violation.

Japan

The Japanese Act on Prohibition of Private Monopolization and Maintenance of Fair Trade (the "Antimonopoly Act") was enacted in 1947. An English translation of the Antimonopoly Act is available at *www.jftc.go.jp/e-page/legislation/ama/amended_ama.pdf.* The Japan Fair Trade Commission ("JFTC") enforces the Antimonopoly Act and its related laws. *See Role of the JFTC*, Japan Fair Trade Comm'n, *www.jftc.go.jp/e-page/aboutjftc/role_index.html.*

Like the KFTC, the JFTC has broad discretion to find that restrictive practices in distribution arrangements constitute unfair trade practices that violate the Antimonopoly Act. The definition of unfair trade practices is very broad. *See* The Antimonopoly Act, Ch. I, Article 2(9). For example, in Japan, carrying out trade on terms that restrict the business activities of trading partners may be found to be unlawful. *Id.* This provision has been relied on to find customer restrictions and sales area restrictions to be unlawful. Similarly broad, if the supplier is in a "dominant bargaining position" and uses it to commit certain acts, the acts may be unlawful. *Id.* This can apply to setting or changing transaction terms in a way that may be disadvantageous to the supplier. Thus, provisions in an agreement that give the supplier the unilateral ability to take action or impose changes may be unlawful. Notably, however, in its analysis of some vertical restraints, the JFTC focuses on the negative effect on competition that the restrictive practice is likely to have. *See generally* Japan Fair Trade Comm'n Guidelines Concerning Distribution Systems and Business Practices Under the Antimonopoly Act (July 11, 1991), *www.jftc.go.jp/e-page/legislation/ama/distribution.pdf.* Accordingly, a provision whereby a Japanese distributor is prohibited from dealing in the goods of the supplier's competitors is an unfair trade practice if it has the possibility of depriving competitors of trade opportunities and hindering new entry into the relevant market.

If a supplier engages in an unfair trade practice in Japan, the JFTC may impose a range of possible penalties. The JFTC may order the supplier to cease and desist from the offending act, to delete the clauses concerned from the contract, and to take any other measures necessary to eliminate the act. The Antimonopoly Act, Ch. V, Art. 20. A person whose interests are infringed or likely to be infringed by a violation has an express right to an injunction and damages. *Id.* at Ch. VII, Arts. 24-25. In addition, among other penal provisions, the Antimonopoly Act provides for "imprisonment with work" for up to one year, or payment of a fine, if any witness in a JFTC hearing makes

continued on page 4

East Asia

continued from page 3

a false statement or provides false expert testimony. *Id.* at Ch. XI, Art. 94.

Taiwan

The Taiwan Fair Trade Law (the "Fair Trade Law") became effective in 1992. Article 19 of the Fair Trade Law generally prohibits certain acts that are likely to impede fair com petition. Fair Trade Law, Ch. III, Art. 19. Accordingly, restrictions on a Taiwanese distributor's activities outside its defined territory could be deemed to be an improper restriction on competition. Prohibition of the Taiwanese distributor's handling competing goods could similarly be deemed to be an improper restriction on competition. However, in Taiwan, to determine whether such restrictions are unlawful, the Taiwan Fair Trade Commission will take into consideration all relevant factors, including the parties' intent and purpose, their market positions, the structure of the market to which they belong, the characteristics of the goods, and the impact on the competition created by the restrictions. The commission seems to pay particular attention to market share and, if the market share is immaterial enough, will tend to find no unlawful restraint.

Possible remedies available under the Fair Trade Law for violations include injunctive relief and payment of damages. The Fair Trade Law, Ch. V, Arts. 30-31. In addition, up to treble punitive damages are available in the event of intentional conduct. *Id.* at Ch. V, Art. 32. Finally, any person that continues a violation after having been ordered to cease and desist may be punished by imprisonment for up to two years, may be subject to a fine, or both. *Id.* at Ch. V, Art. 36.

Conclusion

These issues do not appear to be going away. In the KFTC's recent *2007 Action Plan for Strategic Objectives and Main Performance Targets*, dated March 9, 2007, one of the KFTC's major performance targets is that "a comprehensive measure will be devised to analyze and correct structural and behavioral problems of unfair trade practices of discount stores and large distribution companies." Similarly, the JFTC has identified "stronger enforcement against Antimonopoly Act infringements" as part of its current "Grand Design for Competition Policy."

Whenever a U.S. supplier expands its distribution network into foreign markets, the supplier should be prepared to encounter (in addition to the opportunities such markets may present) new issues, risks, and layers of complexity. Before appointing a distributor in a new market, it is important to assess local competition law.

It is also important not to assume that a standard domestic distributorship agreement is suitable for the appointment. Indeed, the supplier should not even assume that a standard form of international distributorship agreement will be adequate in every foreign jurisdiction, especially in any foreign jurisdiction with a well-developed body of competition law.

Even if the U.S. supplier is willing to accept the risk that its customary practices might be found to be unfair trade practices, the supplier should only do so after it has carefully considered the general limitations imposed by the relevant competition law and the potential consequences for violating such law.

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Too Little

continued from page 1

the FTC's Franchise Rule, 23 years after its promulgation (American Franchisee Association, Statement of Susan P. Kezios, president, before the U.S. House of Representatives Subcommittee on Commerce, Trade and Consumer Protection, Committee on Energy and Commerce). In August 2004, the FTC issued its Staff Report on the Franchise Rule, to which the AFA again submitted written comments. All along the way, the AFA encouraged its Affiliate Members of the franchisee bar to participate in the Rule review process; a dozen franchisee law firms actually did so.

Susan P. Kezios is the president of the American Franchisee Association. She consults with both current and prospective franchisees, assists with the formation of independent franchisee associations, and organizes franchisees for legislative action. She can be contacted by phone at 312-431-0545 or by e-mail at *spkezios@franchisee.org*.

Got a Little

The approval and release of the revised FTC Franchise Rule on Jan. 22, 2007, was, in many respects, heavily influenced by the input of the AFA, its member franchisees, and Affiliate Member attorneys. Many more of the AFA's suggestions, however, were rejected.

The AFA has never been in favor of more disclosure merely for the sake of disclosure, but instead, has been interested in increasing the level of honesty and reducing the opportunity for deception during the disclosure process. Toward that end, we were pleased to see that FTC staff concluded on many occasions that confusion and misunderstanding about the franchise relationship are prevalent and that many individuals have, in fact, been deceived about the nature of the franchise relationship during the presale process.

The most important change in the revised Rule is a new item of required information. Item 20 of the revised Rule requires franchisors to identify any organized independent franchisee association within the system. The burden to inform the franchisor of the existence of the association lies with the association leadership and must be renewed on an annual basis. Providing a prospective purchaser with the ability to speak with an independent association of franchisees is likely the most valuable unfiltered source of information available to a prospect. Information on the nature of the relationship between the franchisor and its franchisees, never revealed in its disclosure document, is conveyed via the collective memory of an independent association. Prospective purchasers will most likely learn information from the association that could either persuade or dissuade them from buying the franchise. Upon

continued on page 6