



# Franchise

in 33 jurisdictions worldwide

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# 2010



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# Japan

Etsuko Hara

Anderson Mōri & Tomotsune

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## Overview

### 1 What forms of business entities are relevant to the typical franchisor?

The most typical franchisors are organised in the form of a joint-stock company.

### 2 What laws and agencies govern the formation of business entities?

The formation of joint-stock companies in Japan is governed by the Corporation Act (Act No. 86, 2005) and administered by the Ministry of Justice.

### 3 Provide an overview of the requirements for forming and maintaining a business entity.

One can form a joint-stock company by preparing articles of incorporation and other incorporation documents and registering them at a competent legal affairs bureau. After the formation, it is necessary to prepare financial statements, etc, and to hold a shareholders' meeting each year.

### 4 What restrictions apply to foreign business entities and foreign investment?

Foreign business entities must register their representatives in Japan to conduct business continuously in Japan. Once registered, they can carry out business in the same way as domestic entities. In addition, foreign investment is regulated by the Foreign Exchange and Foreign Trade Act (Act No. 228 of 1949 – FEL).

### 5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Franchisors in the form of joint-stock companies need to pay corporate tax, corporate enterprise tax, corporate inhabitant tax and consumption tax. In addition, depending on the kinds of assets held by a franchisor, property tax and automobile tax may also be payable. As to foreign businesses and individuals, their Japan-sourced income is generally subject to Japanese taxation.

### 6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Labour regulations are generally applicable to franchisors. Breach of labour regulations may result in penalties, including imprisonment. To avoid the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor, a franchisor needs to structure the franchise relationship so that the franchisee is an independent entity and needs to clearly explain the independent nature of the fran-

chise relationship with the franchisee. In addition, if a franchisor is involved in the hiring process of employees of the franchisee, it should explain its position well and make it clear to the prospective employees that the employer will be the franchisee, not the franchisor.

### 7 How are trademarks and know-how protected?

Franchisors can register trademarks to protect such marks from infringing use. However, there is no registration system per se for know-how. Know-how that falls within the scope of registerable types of intellectual property, such as patents, designs or copyrights, may be registered accordingly. In addition, if the know-how falls within the scope of a 'trade secret' under the Unfair Competition Prevention Act (Act No. 47 of 1993), it will be protected against any acts constituting unfair competition.

### 8 What are the relevant aspects of the real estate market and real estate law?

In general, a franchisee leases real estate for its operations directly from a property owner. Disputes may arise when the lessor tries to increase the rent or to terminate or refuse to renew the lease agreement. In such situations, protection would be available to the franchisee under the Land Lease and Building Lease Act (Act No. 90, 1991) and the doctrine of the destruction of a relationship of mutual trust (see question 25 for further details).

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## Laws and agencies that regulate the offer and sale of franchises

### 9 What is the legal definition of a franchise?

There is no uniform definition of a franchise in Japan. However, there are three relevant definitions with regard to franchise businesses. First, the Medium and Small Retail Commerce Promotion Act (Law No. 110 of 1973 – MSRPCA) defines 'chaining business' as a business that, pursuant to an agreement with uniform terms and conditions, continuously sells or acts as an agent for sales of products and provides guidance regarding management, and that primarily targets medium and small retailers. In addition, a 'specified chaining business' is defined as 'any chaining business the agreement for which includes clauses which permit its members to use certain trademarks, trade names or any other sign, and collects joining fees, deposits or any other money from the member when becoming a member'. If a franchise business falls under this definition, the regulations of the MSRPCA apply.

Second, the Guidelines Concerning Franchising (Franchise Guidelines) under the Act on Prohibition of Private Monopolisation and Maintenance of Fair Trade (Act No. 54 of 1947 – Anti-Monopoly Act) provide that: 'The franchise system is defined in many ways. However, the franchise system is generally considered to be a form of business in which the head office provides the member with the

right to use a specific trademark and trade name, and provides coordinated control, guidance, and supports for the member's business and its management. The head office may provide support in relation to the selling of commodities and the provision of services. In return, the member pays the head office.'

Third, the Japan Franchise Association (JFA) defines a franchise as: *A continuous relationship under which a business entity (franchisor) enters into an agreement with another business entity (franchisee) and gives the franchisee the right to sell goods or conduct other businesses under a unified business image by using any signs which can be a symbol of business, such as its own trademarks, service marks and trade names, and any know-how regarding management, while a franchisee pays consideration for such rights and invests the necessary funds into the business in order to conduct a business pursuant to instruction and aid by a franchisor.*

**10** Which laws and government agencies regulate the offer and sale of franchises?

If the franchise business falls within the scope of a specified chaining business, the MSRCPA regulates the disclosure obligations related to the offer and sale of franchises and the Ministry of Economy, Trade and Industry has overall responsibility in this regard.

In addition, from the perspective of competition law, the Franchise Guidelines regulate the offer and sale of franchises in connection with the Anti-Monopoly Act and the Fair Trade Commission has overall responsibility in this regard.

The JFA has also implemented voluntary rules, such as the Ethical Rules of the Japan Franchise Association and the Voluntary Standard Regarding Disclosure and Explanation of Information to Prospective Franchisees.

**11** Describe the relevant requirements of these laws and agencies.

Under the MSRCPA, franchisors whose businesses fall under the definition of specified chaining businesses are required to provide a written document that describes prescribed items and to explain the contents of the written documents prior to executing a franchise agreement with prospective franchisees.

The Franchise Guidelines require franchisors to disclose sufficient and accurate information to prospective franchisees.

**12** What are the exemptions and exclusions from any franchise laws and regulations?

There are no exemptions under the laws. However, if a franchisor's business does not fall within the definition of franchise under any particular law relevant to franchising, the regulations of that law will not apply.

**13** Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

There is no such requirement in general. If the industry of the franchise is regulated by specific laws, it is necessary to check such regulations.

**14** In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

As there is no general law regarding franchises, each law relevant to a franchise business may be applied to a sub-franchisor, so long as the sub-franchising structure falls within the scope of the definition of franchise, etc, in each particular law as discussed above.

**15** What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

Under the MSRCPA, when a franchisor intends to negotiate a franchise agreement with a prospective franchisee, the franchisor must provide written documents describing the prescribed items and explain the contents of the written documents to prospective franchisees. There are no regulations regarding the frequency of updating disclosures.

**16** What information must the disclosure document contain?

Under the MSRCPA, the following information is required to be disclosed by the franchisor to the franchisee (MSRCPA article 11, Enforcement Regulation (ER), articles 10 and 11):

- Information regarding the franchisor, including:
  - the name and address of the franchisor, number of full-time employees and, if the franchisor is a company, the title and names of officers;
  - the amount of capital, the names of the principal shareholders (those holding more than 10 per cent of the shares directly or indirectly) and, if the franchisor is conducting another business, the type of business;
  - the name of any entity of which the franchisor holds a majority of the voting shares;
  - the balance sheet, profit and loss statement and any other relevant documents with regard to the past three business years of the franchisor's business;
  - the date on which the franchisor began its specified chaining business;
  - the number of litigation cases in which the franchisor is the plaintiff and a franchisee or ex-franchisee is the defendant with regard to the franchise agreement and vice versa during the past five business years;
  - business hours, business days and regular or irregular closing days of stores of franchisees;
  - whether there is a provision stipulating if the franchisor will commence or allow other franchisees to commence operations conducting the same or similar retail business near the shops of the franchisee and, if there is such a provision, the contents of the provision;
  - whether there is a provision that prohibits or restricts the ability of franchisees to conduct businesses, such as prohibiting them from joining other specified chaining businesses or from being employed with similar businesses, either during or after termination or expiration of the agreement and, if there is such a provision, the contents of the provision;
  - whether there is a provision that prohibits or restricts disclosure of information that the franchisee may know regarding the specified chaining business, during or after termination or expiration of the agreement;
  - if the franchisees need to remit all or part of the sale proceeds periodically, the timing and method thereof;
  - if the franchisor lends or arranges to lend money to franchisees, the interest rate or the method of calculating the rate and any other conditions of the lending or arranging of lending;
  - whether or not the franchisor adds interest to all or part of the remaining amount after setting off the rights and obligations which accrue in connection with a transaction with the franchisor during a certain period;
  - if the franchisor imposes on franchisees a special obligation regarding the structure or interior or exterior of stores of franchisees, the contents of the obligation; and
  - the amount of money or the method of calculating the amount of money that accrues when the franchisor or a franchisee violates the agreement.

- Information with regard to the initial fee, deposit or any other money that the franchisor will collect at the time when the prospective franchisee becomes a franchisee. Such information must specify:
  - the amount of money to be paid or the method of calculating the amount;
  - the nature of the money to be collected, such as whether it is an initial fee, deposit, equipment fee, etc;
  - the timing of payment;
  - the method of collection; and
  - whether the money will be refunded or not, and the conditions applicable to such refund.
- Information with regard to the type of products that are sold or arranged to be sold to the franchisees and the method of payment for such products.
- Information with regard to management instruction, specifying whether there will be training or a seminar when joining, the content thereof, and the method of continuous management instruction to franchisees and how many times such instruction will be conducted.
- Information with regard to the trademark, trade name, and any other matters regarding the indication of the business name that will be permitted to be used. In addition, if there are any terms and conditions with regard to the use of the indication of the business name, the content thereof must be provided.
- Information with regard to the duration of the agreement and renewal and termination of the agreement, specifying:
  - the duration of the agreement;
  - the conditions and procedure to renew the agreement;
  - the requirements and procedures to terminate the agreement; and
  - the amount of the damages that will be caused by termination or the methods to calculate the damages, and the content of any other obligation.
- Information with regard to changes in the number of stores of franchisees during the most recent three years, specifying:
  - the number of stores of franchisees as at the last day of each business year;
  - the number of franchisees' stores that started operations during each business year;
  - the number of franchisees' stores whose franchise agreements have been terminated during each business year; and
  - the number of franchisees' stores whose franchise agreements were renewed during each business year, and the number of franchisees' stores whose franchise agreements were not renewed during each year.
- Information with regard to any periodic payments, specifying:
  - the amount of money to be paid periodically or the method of calculating the amount of money to be paid periodically;
  - the nature of the payment, such as whether it is a royalty for the use of the business name, a consulting fee, etc;
  - the timing of payment; and
  - the method of collection of the payment.

**17** How do the relevant government agencies enforce the disclosure requirements?

The competent minister may issue a recommendation to comply to a franchisor that does not comply with disclosure obligations under the MSRCPA (paragraph 1, article 12). If the franchisor does not obey the recommendation, the minister may disclose such fact to the public (paragraph 2, article 12).

**18** What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

No special remedy exists for franchisees under the MSRCPA. Therefore, unless otherwise provided in the franchise agreement, franchisees need to base any claims for damages on the general principles of contract under the Civil Code (Act No. 89, 1896). In the event of fraudulent disclosure of information, franchisees can rescind the franchise agreement (Civil Code, article 96). If there is a material misunderstanding about the franchise agreement, the franchisee can claim that the franchise agreement is void (Civil Code, article 95).

As to the damages caused by the violation of the disclosure requirement, franchisees may bring a claim for damages based on contract theory or tort theory (Civil Code, articles 415 and 709). A violation of the disclosure requirement under the MSRCPA can establish the element of illegality required to bring a tort claim. There is no formula to calculate damages but damages are recognised provided the violations are an actual and proximate cause of the damages.

**19** In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

There is no formula to allocate liability between the franchisor and the sub-franchisor. In general, each entity is liable to the extent it is at fault. Generally, individual officers, directors and employees of the franchisor or the sub-franchisor are not exposed to liability. However, if there are breaches of duty of care or faults on the part of these individuals, they may be liable in tort, etc, depending upon each case. In addition, there is a risk that a franchisee will name these individuals as defendants in a suit against the franchisor or the sub-franchisor to seek recovery of damages from them.

**20** In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

See question 18.

**21** What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

See question 18. In addition, franchisees may also claim that a franchisor is violating the Franchise Guidelines thereby violating the Anti-Monopoly Act.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

**22** Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There are no specific laws that were prepared to specifically regulate the ongoing relationship between franchisors and franchisees.

**23** Do other laws affect the franchise relationship?

Various laws affect the franchise relationship. From a competition law aspect, the Anti-Monopoly Act is relevant. The Franchise

Guidelines and the Guidelines Concerning Distribution Systems and Business Practices under the Anti-Monopoly Act (11 July 1991, the Distribution Guidelines) specify what kinds of activities are problematic under the Anti-Monopoly Act. The Trademark Act (Act No. 127 of 1959) and the Act on Specified Commercial Transactions (Act No. 57 of 1976) are relevant in the area of intellectual property and advertisement. As described in questions 18 and 33, the general obligations under the Civil Code often affect the franchise relationship, especially when there is neither a specific law nor a clause in the agreement addressing a particular issue.

**24** Do other government or trade association policies affect the franchise relationship?

There are voluntary rules, such as the Code of Ethics, prepared by the JFA. If a franchisor is a member of the JFA, its voluntary rules are an important consideration in the franchise relationship.

**25** In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Usually, the franchise agreement lists the circumstances in which the franchisor may terminate a franchise relationship. In addition, it is understood that the franchisor may terminate a franchise relationship based on mutual agreement with the franchisee.

If there is no clause in the franchise agreement regarding the termination, the franchisor may terminate the franchise agreement prior to the expiration of the term of the agreement when the franchisee violates the franchise agreement (Civil Code, articles 541 to 543). However, because franchise agreements are usually continuous agreements, it can be expected that courts will be more reluctant to terminate such agreements, compared with normal agreements. On this point, it may be useful to refer to the doctrine of the destruction of a mutual trust relationship, which has been established in the area of lease agreements. With regard to lease agreements, a lessor's ability to terminate a lease agreement is limited to the case that the mutual trust relationship is destroyed because of the lessee's violation of the agreement (Supreme Court, 28 July 1964, 21 April 1966). This means that a lessor may not terminate a lease agreement even if the lessee is violating it provided the violation is not sufficiently material to destroy the mutual trust relationship. This doctrine is usually applied by the court to restrict on a franchisor's ability to terminate a franchise relationship.

**26** In what circumstances may a franchisee terminate a franchise relationship?

Usually, the franchise agreement regulates the circumstances in which a franchisee may terminate a franchise relationship. In addition, the franchisee may terminate a franchise relationship based on mutual agreement with the franchisor. In cases where there is no clause in the franchise agreement, the same considerations as those relating to termination by the franchisor apply.

**27** May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Provisions in the franchise agreement generally determine whether a franchisor may refuse to renew the franchise agreement with the franchisee. In cases where the franchise agreement states that it will not be renewed unless otherwise agreed to between the parties, the franchisor may generally refuse to renew. On the other hand, in cases where the franchise agreement states that it will be renewed automatically, it is unclear in which circumstances the franchisor may refuse to renew. On this point, there is a case in which a court

required 'compelling circumstances which make it difficult to continue the agreement' for a franchisor to be able to refuse to renew a continuous agreement (*Hokka Hokka Tei* case, Nagoya District Court, 31 August 1998).

**28** May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

A franchisor may restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity. Usually, a franchise agreement requires the franchisor's consent for the franchisee to transfer its franchise under the agreement. In addition, it is generally understood that, when a party to an agreement is going to transfer its franchise under the agreement the other party's consent is necessary. Therefore, even if there is no clause in the franchise agreement requiring consent for transfer, the franchisor's consent will be required.

As to the transfer of ownership interest in a franchisee entity, the owner of the ownership interest in a franchisee entity is generally free to transfer its ownership interest. The franchise agreement may require the franchisor's consent for the transfer of ownership interest in a franchisee entity. Such covenants will be only contractually enforceable against the franchisee, and not against the owner of the ownership interest in a franchisee entity unless the owner of the ownership interest in the franchisee is also a party to the franchise agreement.

**29** Are there laws or regulations affecting the nature, amount or payment of fees?

There is no specific limitation on the amount or payment of fees. However, if such fees are unreasonably high, the obligation to pay such fees may be deemed void because it may be construed as an abuse of dominant bargaining position (Designation of Unfair Trade Practice (Designation of UTP), item 14, Anti-Monopoly Act, article 19) or as against good public order and customs (Civil Code, article 90).

**30** Are there restrictions on the amount of interest that can be charged on overdue payments?

As to interest on loans from a franchisor to a franchisee, the restriction on interest under the Interest Rate Limitation Act (Act No. 100 of 1954) applies. However, if the overdue payment is not in connection with a loan, there is no specific restriction on the amount of interest. If the interest charged is unreasonably high, however, it can be held to be void for the reasons stated in question 29.

**31** Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There are no restrictions on the currency.

**32** Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants are generally enforceable. If a franchisee breaches confidentiality covenants, a franchisor may ask for compensation for the damages caused by such violation or ask for a preliminary injunction.

**33** Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Under the Civil Code, there is a general duty to act in good faith (article 1). In addition, if an agreement is unreasonably advantageous to one party, it can be deemed void because it is against good

## Update and trends

On 22 June 2009, the Japan Fair Trade Commission issued a cease-and-desist order (the Order) against Japan's largest convenience store franchisor due to the franchisor's abuse of its dominant bargaining position, which is a violation of article 19 of the Anti-Monopoly Act, Item 14 of the Designation of Unfair Trade Practices. News of the Order was widely reported throughout Japan.

According to the Order, the franchise agreement provided that each franchisee maintained sole discretion to set the sales prices of products sold in the franchisee's convenience stores. However, according to the Order, the franchisor engaged in a practice that

essentially prevented franchisees from discounting perishable foods immediately prior to their expiration. As a result of such practice, the franchisor deprived the franchisees of the opportunity to reduce the costs associated with expired perishable foods by discounting perishable foods based on rational managerial considerations.

Prior to the Order, many of the major convenience store chains used a model that compelled franchisees to pay for the costs of expired perishable food products and that instructed franchisees to sell products at prices set by the franchisor. However, in light of the Order, this business model will likely be revisited.

public policy (Civil Code, article 90). These clauses affect franchise relationships in various ways. One area where the duty to act in good faith under article 1 of the Civil Code plays an important role is with regard to the franchisor's obligation to disclose information. A court has construed that a franchisor owes an obligation to provide prospective franchisees with accurate and adequate information so that they can make decisions (Fukuoka High Court, 31 January 2006, *Shin Shin Do* case, Kyoto District Court, 1 October 1991). In addition, courts use article 90 to limit liquidated damages. For example, in the *Honke Kamadoya* case (Kobe District Court, 20 July 1992), a court stated that liquidated damages of an amount equal to 60 months' loyalty payment were significantly out of balance with the expected amount of damages and consequently the liquidated damages were void to the extent that they went beyond a reasonable amount of damages because such amount was against good public policy (Civil Code, article 90).

- 34 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

In principle, franchisees would not be protected as a consumer for the purpose of consumer protection laws because they are doing business. For example, the Consumer Contract Act (Act No. 61 of 2000) defines a 'consumer' as a natural person but excludes a natural person who becomes a party to a commercial contract to engage in commercial endeavours. However, demonstrated by the courts' inclination to protect franchisees (see question 25), depending on the case, franchisees could be protected by interpretation of the Civil Code or other consumer protection laws.

- 35 Must disclosure documents and franchise agreements be in the language of your country?

There is no requirement that the franchise agreements be in Japanese. However, documents to be submitted to a competent authority

must be in Japanese. In addition, it is better if the franchisor communicates with the Japanese franchisee in Japanese as the franchisor owes an obligation to explain and disclose relevant information to the franchisees.

- 36 What restrictions are there on provisions in franchise contracts?

The most important restrictions on provisions in franchise agreements are the restrictions imposed by the Anti-Monopoly Act. Under the Distribution Guidelines, a provision that assigns a specific area to each distributor and restricts the distributor from selling outside each area (exclusive territory) may be illegal, depending on how powerful the franchisor is in the relevant market. In addition, any other restriction on territory or customers may be problematic under the Anti-Monopoly Act (see question 37).

As stated above, the restriction on liquidated damages may be void or reduced if it is construed as against good public order and customs (Civil Code, article 90).

- 37 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

As stated in the answer to question 36, the Anti-Monopoly Act is relevant to the typical franchise agreement. The Franchise Guidelines and the Distribution Guidelines describe what kind of activities or restrictions are problematic under the Anti-Monopoly Act. First of all, the Franchise Guidelines require franchisors to disclose sufficient and accurate information when they are soliciting prospective franchisees, otherwise their actions can be deemed to be deceptive customer inducement, which is illegal as it falls into the category of unfair trade practice (Designation of UTP, item 8). In addition, the Franchise Guidelines regulate transactions between franchisors and franchisees. They state that it could be an abuse of a dominant bargaining position (Designation of UTP, item 14) to limit parties with whom franchisees can make transactions, to compel franchisees to

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buy a designated amount of goods, to restrict the ability of the franchisees to offer discounts to their customers or to restrict competitive activities after the termination of a franchise agreement. It also states what kind of items should be considered in connection with tie-in sales (Designation of UTP, item 10), dealing on restrictive terms (Designation of UTP, item 13), and resale price restriction (Designation of UTP, item 12).

The violation of the restrictions on unfair trade practices under the Anti-Monopoly Act is enforced by the Fair Trade Commission by ordering the breaching party to cease and desist from the activity, to delete the clauses concerned from the agreement and to take any other measures necessary to eliminate such activities (Anti-Monopoly Act, article 20).

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**38** Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

A dispute regarding a franchise relationship will be brought to one of the district courts. In every prefecture, one or more district courts exist. Decisions by district courts may be appealed to a competent High Court, then to the Supreme Court. In addition to litigation in a court room, arbitration is possible if the parties agree to it.

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**39** In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Because of certain restrictions on foreign business entities and foreign investment (see question 4), foreign franchisors could face different regulations. For example, certain technical licences could be subject to a regulatory filing under the FEL, depending on the contents of the licence. In addition, if the industry of the franchise is regulated by specific laws, such laws may treat foreign franchisors differently.

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