

GUIDELINES CONCERNING THE FRANCHISE SYSTEM UNDER THE ANTIMONOPOLY ACT

April 24, 2002
Fair Trade Commission

Introduction

We have seen in Japan an increase in the kinds of business activities that use the franchise system. This system consists of a franchiser (hereinafter referred to as the “head office”) and franchisees (hereinafter referred to as the “members”). The franchise system is used in many areas including retail businesses and the food service industry, as in the past, as well as a range of service businesses. The relative importance of the franchise system in these industries has been increasing. The franchise system enables the head office to develop its business quickly by using the capital and human resources of other people. The franchise system benefits the member by allowing them to become independent and to launch their business using the expertise and suchlike of the head office. Many enterprising people are expected to enter a number of areas in the future by making the most of the franchise system, thereby intensifying competition in these markets.

With the expansion of business activities using the franchise system, a number of problems have arisen from the business transactions between the head office and the members. In particular, there have been many problems have occurred in relation to the Antimonopoly Act.

The Fair Trade Commission has compiled and published the “Guidelines Concerning the Franchise System from the Viewpoint of the Antimonopoly Act ” (issued by General Secretariat, Fair Trade Commission on September 20, 1983) in a bid to prevent head offices from violating the Antimonopoly Act. The document also strives to promote proper business activities by the head office by specifically identifying the actions that present a problem with the business transactions between the head office and the member under the Antimonopoly Act. In view of recent changes, such as the expansion of business activities using the franchise system and the increase in the relative importance of the franchise system, we have revised the document as shown below. This document will be our basis hereafter.

1. General guidelines

- (1) 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 rights to use a specific trademark and trade name, and provides coordinated control, guidance, and support 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. This document is intended for businesses that fit this definition and that have the characteristics mentioned (3) below, irrespective of what the business is called.

- (2) There are many franchise systems under which a so-called franchise agreement is entered into between the head office and the member. Based on the agreement, the head office and each member conduct their business with an external appearance similar to that of the head office and a branch office of a normal company. However, the member is legally an entrepreneur who is independent of the head office. Therefore, the Antimonopoly Act applies to the trading relationship between the head office and the member.

- (3) The basis of the trading relationship for the franchise system is a franchise agreement between the head office and the member. This agreement is a standardized agreement that generally includes the following provisions:
 - a. A provision that grants the member permission to use the trademark and trade name of the head office;
 - b. A provision for the head office to provide the member with control and guidance to ensure there is a unified corporate identity for the business and to ensure that the member can maintain their business;
 - c. A provision for the member to pay the head office for the services mentioned in the previous two provisions; and
 - d. A provision concerning the termination of a franchise agreement.

The business system and policy established by the head office and the coordinated activities of the member based on the franchise agreement are generally regarded as strengthening and improving the business capabilities of members who run

small businesses and promoting competition in the marketplace.

However, under the franchise system, the member is integrated into the system of the head office, including the system of comprehensive guidance. It is especially important, therefore, that a party contemplating becoming a member makes the proper judgment before deciding to participate. It is desirable that the head office discloses sufficient information to a party contemplating becoming a member when the member is invited to participate in the franchise. In addition, the business transactions between the head office and the member after the franchise agreement has been signed should not cause disadvantage the member unilaterally nor should it place unjust restrictions on the member.

- (4) The cases below are illustrative examples of business transactions between the head office and the member that have caused a problem in relation to the Antimonopoly Act. The cases occurred then the head office of a franchise invited a member into the franchise system and after the franchise agreement was signed. These cases are only the major ones. It is necessary to judge individually whether the specific activities of a head office conflicts with the Antimonopoly Act.

2. Invitation of the head office for a member to join the franchise

- (1) The head office of a franchise, wishing to expand its business, solicits members to join the franchise through advertisements, visits and suchlike. A range of people apply to participate in the franchise. These people include those who have conducted similar businesses in the past, but also salaried workers and people without experience in the business. It is desirable that, when the invitations are issued, the head office discloses sufficient information to enable the people contemplating joining the franchise to make the proper judgment. People contemplating becoming members, of course, should thoroughly investigate on their own behalf the details of the franchise business concerned.

(2)

A. For franchise systems relating to retail businesses, the Law for the Promotion of Small-to-Medium Sized Retail Businesses stipulates that the onus be on the head office to disclose information and to be accountable about certain items. In addition, the retail business industry promotes the registration and disclosure of information on franchise agreements. However, it is desirable that the head office

properly discloses the following matters when inviting members to join the franchise to enable the prospective members make the correct judgment and to prevent a violation of the Antimonopoly Act (Note 1):

- a. Matters relating to the supply of products after the party becomes a member of the franchise (such as a system for recommending suppliers);
- b. Matters relating to the details, procedures, frequency, and the cost of guidance to the member about the business activities;
- c. The nature and the amount of money to be collected when the party joins the franchise, whether the money will be returned, and the conditions for returning the money;
- d. Matters relating to the royalties that the member pays the head office for the use of the trademark and trade name and for guidance in management. These matters include the amount of the royalties, the procedure for calculating the royalties and the time and the method of payment;
- e. Matters relating to the loans the head office extends to the member, including the mechanism, the conditions of settlement and the interest rate;
- f. Matters relating to the compensation of any loss that the business incurs, the details of compensation, whether there is management support from the head office in the event of a business slump, and the details;
- g. Matters relating to the terms of the agreement, and the conditions and procedure for renewing and canceling the agreement, and for canceling the agreement before it expires; and
- h. Matters relating to the restrictions that apply to the head office or other members of the franchise in setting up a similar or identical business close to the proposed business of the party contemplating joining the franchise. These matters include whether there are any plans to set up additional business and the details of the plans.

B. The head offices of some franchises have certain expectations regarding sales and profit when they invite members to participate in the franchise. The expected sales and profits need to be based on established facts, such as the results of an existing shop operating in a similar environment, and a reasonable method of calculation. The head office is required to present these facts and the manner in which they were calculated to parties contemplating joining the franchise. Parties wishing to join the franchise need to invest a considerable amount of money in

the franchise. Therefore, the parties should keep in mind that any person conducting business should consider that (1) the negotiations for joining the franchise will be conducted on the assumption that the business will remain in operation, and (2) the business activities after the franchise agreement is signed will greatly depend on the general economic conditions and the market environment.

(Note 1) The Law Concerning the Promotion of Small-to-Medium Sized Retail Businesses requires that the head office to which the Law applies should deliver a document showing certain items and explain them to any party contemplating joining the franchise before they sign the agreement. From the viewpoint of preventing acts that violate the Antimonopoly Act, it is desirable that the head office allow sufficient time for the party contemplating joining the franchise to examine the document thoroughly before concluding the franchise agreement.

(3) Item 8 (Deceptive customer inducement) of Designation of Unfair Trade Practices (Fair Trade Commission Notification No.15 of 1982: hereinafter referred to as "General Designation") applies where the head office entices the customer of a rival into the franchise by creating the false impression that the franchise system is much better or more advantageous than it really is, through failure to disclose the important matters indicated in (2) above, or false or exaggerated claims when inviting a party to join the franchise .

(4) Whether Item 8 (deceptive customer inducement) applies in a particular case should be judged by considering the circumstances overall. For example, the following matters relating to the business transactions with the head office may cause a prospective member to believe that the business is much better and more advantageous than it is in reality, and may thereby attract the customer of a competitor:

- a. Concerning the expected sales and profit, is the basis and method of calculation rational? Is the amount achievable or is it difficult to achieve?
- b. Are the royalties presented as being lower than they really are by failing to explain fully the method of calculation? For example, where the royalties are calculated by multiplying the gross profit on sales by a certain rate after defining that this gross profit includes the cost of lost and damaged products, is

- the gross profit after sales fully defined or is it misrepresented?
- c. Is the franchise in question portrayed as being better and more advantageous than the system of a competitor by presenting a comparison of the details of the two systems based on unreasonable criteria? For example, although the amount of money that the head office collects from the member is the same, is it suggested that the royalties are lower than that of the competitor's company without explaining the differences how the royalties are calculated?
 - d. Is it explained that, if the franchise agreement is cancelled before it expires, the head office will collect a large penalty? Is it suggested that the penalty will not be collected? (Note 2)

(Note 2) Where the conditions for canceling a franchise agreement before it expires are unclear, the party contemplating joining the franchise cannot make a proper judgment. In addition, if the penalty imposed on the member for canceling the franchise agreement is unclear, it will, in practice, be difficult to cancel. Therefore, it is desirable that the head office clarifies the conditions for canceling the franchise agreement when inviting parties to join the franchise.

3. Business transactions between the head office and the member after the franchise agreement has been signed

Under many franchise agreements, the head office requires the member to designate either the head office or a third party selected by the head office as a supplier of materials and services. The materials may include products, raw materials, packaging materials, facilities and equipment or machines and tools. The services may be the cleaning of the shop and the exterior and interior finishing work. Alternatively, the head office may impose a number of limitations regarding the method for selling the products, the operating hours, the operating area, the selling price and suchlike.

These provisions in a franchise agreement are considered to be aimed at preserving the business confidentiality that the head office divulges to the member, and at maintaining the corporate image. If the purpose of the provisions is limited to the conduct of proper business based on the franchise system, they do not violate the Antimonopoly Act. However, when a franchise agreement or the actions of the head office are considered to exceed the boundaries for the conduct of proper business based on the franchise system, thereby providing the member with undue disadvantage

regarding normal commercial practice, Item 14 (abuse of dominant bargaining position) of the General Designation may be applied. In addition, where the restrictions placed on a member are illegal, Item 10 (Tie-in sale) or Item 13 (Dealing on restrictive terms) of the General Designation may be applied.

(1) Abuse of a position of strength

In some cases, it is acknowledged that the head office, which occupies a stronger position than that of the member (Note 3), engages in one of the following three activities:

- a. establishes trading conditions that unduly disadvantage the member in light of normal commercial practice;
- b. exceeds the boundaries of proper business conduct based on the franchise system; or
- c. disadvantages the member with respect to the conditions and conduct of the business transactions.

In any of these events, Paragraph 14 (Abuse of a position of strength) of the General Designation applies to the franchise agreement or the actions of the head office.

(Note 3) With respect to business transactions between the head office and the member under the franchise system, the head office is deemed as having a stronger position when the member is forced to accept requests from the head office that place the member at a disadvantage to avoid difficulties with the member's business and management. When determining whether the head office occupies the stronger position, we should consider a range of factors. These include:

- the overall degree to which the member depends on the head office, including the degree the member depends on the head office for management guidance, the proportion of products and raw materials that the member purchases from head office or a party recommended by head office;
- the position that the head office holds in the market;
- the degree of difficulty the member faces in leaving the franchise, including initial investment, whether the member has the right to cancel the agreement before it expires, the details of the right to cancel the agreement, the penalty that applies to such cancellation, and the term of the agreement; and

- the difference in the size of the businesses between head office and the member.

A. With respect to the business transactions between the head office and the member under the franchise system, whether Item 14 (Abuse of dominant bargaining position) of the General Designation applies is determined for individual and specific franchise agreements. However, Item 14 also applies when the head office occupies a stronger position and either places the member at a disadvantage in light of normal business practices or exceeds the boundary of proper business conduct based on the franchise system, for example, through the following acts.

Restriction on suppliers

- This restriction refers to the case when the head office prohibits the member without proper justification from trading with companies that can provide cheap, high-quality products and services. The head office may force the member to trade only with the head office or companies appointed by the head office regarding the supply of products and raw materials, the cleaning of the shop, or contractors for interior and exterior finishing.

Forced purchase quota

- A forced purchase quota applies where a the head office forces the member to buy volumes that exceed the volume required for sale, and prohibits the member from returning excess materials or raw materials.

Restriction on bargain sales

- This restriction applies in the case when the royalties are calculated according to the gross profit on sales including the cost of lost or damaged products. The head office may restrict a member without due cause from holding a bargain sale to sell products that are going bad, thereby forcing the member to dispose of the products left unsold. (Note 4)

(Note 4) The royalties are calculated based on gross profit on sales for most franchise agreements that cover convenience stores. The cost of lost or damaged products is not included in the cost of sale for the majority of franchise agreements. As a result, the

method of including the cost of lost or damaged products in gross profit on sales is used. Under this method, when the member disposes of products, the member needs to bear the cost of disposing of the products as well as the royalties based on the gross profit on sales including the cost of the lost and damaged goods. Therefore, the member is significantly disadvantaged compared to a situation in which the gross profit on sales does not include the cost of lost and damaged products because such costs are included in the cost of the sales.

Revisions to the franchise agreement after it has been signed

- This case applies where a member launches a new business under a franchise, but is forced to bear costs that are not provided for in the original agreement, and the costs exceed the profits of the business. Despite this, the head office forces the member to launch the business, implying that otherwise the head office will treat the member in a manner that disadvantages them.

Restrictions on trade after termination of an agreement

- This situation refers to the case when the head office imposes restrictions on the member prohibiting the member from establishing a competitive business for a certain time, in a certain area or with other conditions. The problem occurs when these restrictions exceed the extent necessary to preserve the commercial rights of the head office in the specified area or to protect the expertise provided that the head office has provided to the member.

B. As shown in A above, there are cases when an individual provision in an agreement or the action of the head office becomes subject to Item 14 (Abuse of dominant bargaining position) of the General Designation. There are also cases when the business transactions of the head office from the viewpoint of the entire franchise agreement become subject to Item 14. Whether Item 14 applies to the business transactions of a head office should be judged for individual and specific franchise agreements. In addition to the matters as indicated in A above, the application of Item 14 should be judged by considering other general aspects, such as the following:

- a. With respect to the restrictions on selling products and the sales method, does the level of control exceed the extent necessary to maintain the corporate

identity of the head office?

- b. Is the obligation to achieve certain sales figures unreasonable in the light of prevailing market conditions? In addition, are the prices collected unilaterally?
- c. Does the member have the right to cancel the franchise agreement? Is the penalty for canceling the agreement before the term expires excessive?
- d. Does the term of agreement significantly exceed the period necessary for the member to recover their investment? Or is the term of the agreement significantly shorter than the period necessary for the member to recovery their investment?

(2) Tie-in sales and dealing on restrictive terms

When the head office provides the member with expertise based on the franchise agreement, the head office may force the member to procure products and raw materials from the head office or a company recommended by the head office. Regarding whether Item 10 (Tie-in sales, etc.) of the General Designation applies to the actions of the head office in this case, it is necessary to consider the position of head office, the scope of the head office, the number and size of the other parties, and the frequency of the restrictions. In addition, it should be decided whether these business transactions are subject to Item 13 (Dealing on restrictive terms) of the General Designation by considering the overall the position of the head office, the effect of competition between the companies subject to the restrictions, and the effect of competition between companies recommended by the head office.

(3) Restriction on the selling price

It is acceptable for the head office to regulate the selling prices if it is necessary to provide a clear market position for the company or to coordinate the business operations. However, there are cases in which the member must establish the selling price according to the prevailing market conditions, or has to sell remaining products by discounting the prices. Therefore, when the head office supplies products to the member, restrictions on the selling price that apply to the member are in principle subject to Item 12 (Resale price restriction) of the General Designation. In addition, when the head office does not directly supply products to the member, but unduly restricts the price of products or service supplied by the member, Item 13 (Dealing on restrictive terms) of the General Designation applies. The application of Paragraph

should be determined by considering the overall the condition of the local market and the extent of the involvement of the head office in selling prices.