

Franchising in India

Strategic, Legal and Tax
Issues

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Contact

For any help or assistance please email us on ndaconnect@nishithdesai.com or visit us at www.nishithdesai.com

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1. Introduction

Do you have a new or attractive business model to sell goods or render services across territories? Have you developed a unique and useful invention and wish to maximize your profits from it? Does your company have a reputed name or unique trademark and wish to make a global brand?

If you can answer any of the above questions in the affirmative, then franchising is the strategy you can adopt to earn worldwide fame (and tons of money of course!).

Franchising is not a new concept. Nevertheless, it is a concept that remains misunderstood by many. Franchising is not an industry or a business; rather it is a method of doing business where the franchisor offers his know-how, intellectual property and/or training to the franchisees. It is the franchisee who runs the franchised unit as their own business, but under the guidance and brand name of the franchisor, and pay consideration to the franchisor.

The word ‘franchise’ is of Anglo-French derivation - from *franc* - meaning free.¹ It is believed that the concept of franchise was first developed during the 1840’s, when German ale brewers granted rights to particular taverns to market their ale under their name. Thereafter, the concept truly evolved in the United States, where Albert Singer made use of franchising to distribute his sewing machines over a widespread geographic area, turning a hurdle-rice idea into a profitable enterprise. Singer was the first to prepare franchise contracts, and also required his licensees to teach the consumers how to use the Singer machines.² These documents then became the basis for the modern version of franchise agreements³ earning Singer the well-earned name as one of the first and most-influential franchisers.

In the late 1800’s and early 1900’s, the above format evolved into many other forms of franchising including monopolized franchises for several utilities as well as street car companies. As oil refineries and auto manufacturers found that this method allowed them to sell their products over a larger geographical area, they began to franchise as well.

Early entrants into the franchising sector included General Motors, Ford, and Coca-Cola. Some well-

known franchisers of today like McDonalds and KFC joined the market in the 1950s. Franchising in India, as a way of expansion of businesses, was little known till the 1990s and started gaining popularity with Bata, NIIT, Apollo Hospitals and Titan Watches venturing in this space.⁴ Today, franchising has forayed almost all business areas. Home to over a billion people, including a thriving class of urban consumers possessing considerable amounts of disposable income together with the continued growth of the economy have strengthened India’s claim to be a viable and beneficial destination for a foreign franchisor.

In fact, over the years, the formats and methods of franchising have undergone multiple evolutions, with franchisors capitalizing on their brand name and goodwill and offering franchises for a divergent range of goods and services.

One of the most prominent examples of the value of the franchise system comes from the American giant, Playboy. Earlier well-known as a provider of adult content, Playboy embraced the coming of the digital age by diversifying its products and services to suit changing market requirements. A substantial portion of Playboy’s revenues today come in from its Playboy Clubs, and its café, retail, apparel and luxury goods franchisees, which are spread across countries. Through these franchisees, it has gained prominence across borders and markets, including China, Russia, the United Kingdom, and India. Such examples reflect the potential franchising has in today’s times as well.

1. See, http://www.etymonline.com/index.php?term=franchise&allowed_in_frame=0 as accessed on 18 November, 2015

2. See, <http://franchises.about.com/od/franchisebasics/a/history.htm> as accessed on 18 November, 2015

3. See, <http://franchises.about.com/od/franchisebasics/a/history.htm> as accessed on 18 November, 2015

4. Shruti Narayan, Indian franchise business to grow fourfold by 2017: KPMG, LIVEMINT, <http://www.livemint.com/Industry/rYk34sN037WIx-S4tX9xP9H/Indian-franchise-business-to-grow-fourfold-by-2017-KPMG.html> as accessed on 18 November, 2015

2. Understanding The Concept Of Franchising

I. Franchising Perspectives

Franchising has been a very popular method for companies to expand across borders, as the widespread presence of KFC and Domino's in India indicates. This allows franchisors to expand their footprints internationally easily and quickly, while at the same time helping franchisee owners to set up shops with minimal risks.

However, franchising is a win-win solution not only for the franchisor but for the franchisee and the ultimate consumer as well for the following reasons:

A. From the perspective of a franchisor

franchising represents an efficient method of rapid market penetration and product distribution without the typical capital costs associated with internal expansion;

B. From the perspective of the franchisee

franchising offers a method of owning a business but with a mitigated chance of failure due to the initial and ongoing training and support services offered by the franchisor;

C. From the perspective of the consumer

franchised outlets offer a wide range of products and services at a consistent level of quality and at affordable prices;

Further, one of the greatest benefit for the franchisor is the network of a large number of entrepreneurs (which is an intangible asset) in the form of franchisees who all work together to achieve the goal of the franchisor. The franchisee is a dedicated entrepreneur and not a salaried employee, thus he is more likely to show greater commitment dedication, interest and involvement. The franchisee benefits from a tried tested and proven business concept, which can dramatically reduce the failure chances.

II. Franchise Arrangements

The object of a franchise agreement is either to promote a product or a business format. Historically, franchising developed as a means of distributing products. Thus, the original format of *product and trade name franchising* involves the franchisee concentrating on one franchisor's product, and thereby acquiring the manufacturer's identity to a limited extent.⁵ However, the 1950's witnessed the dawn of a new form of franchising, *business format franchising*, where the format used by the franchisor is paramount. These are detailed below:

A. Product and Trade Name franchising

In this format of franchising, the focus of the franchisee agreement is the *product* of the franchisor. In such cases, there is a sales relationship between the supplier and the dealer (especially for Distribution Franchisees), in exchange for fees and/or royalties. This is usually accompanied with exclusivity agreements binding on the franchisee. There are two broad ways in which such a franchisee arrangements are be implemented:⁶

i. Distribution Franchisees or Manufacturer-Retailer franchisees⁷

In this model, the franchisor supplies its products to the franchisee, who then markets the franchisor's products under the franchisor's marks.

Examples: Clothing and Hardware outlets, car dealerships, petrol dealerships.

ii. Manufacturing Franchisees or Manufacturer-Wholesaler franchise⁸

In this model, the franchisee handles both the production and the sale of products, and the franchisor provides the trademark and other relevant manufacturing necessities, if any.

Example: Soda and beverage bottling plants.

5. David Gurnick and Steve Vieux, "Case History of the American Business Franchise" (1999) 24 Okla. City U.L. Rev. 37 at p. 48.

6. See, <http://www.franchise.org.au/what-is-franchising-.html> as accessed on 18 November, 2015

7. Geoffrey Lancaster & Lester Massingham, ESSENTIALS OF MARKETING MANAGEMENT (Routledge Press, 2010), 195.

8. See, <http://www.franchise.org.au/what-is-franchising-.html> as accessed on 18 November, 2015

B. Business Format franchising

In this arrangement, the focus of the franchisee agreement is the *process, methods or business format* used by the franchisor. The franchisee gets the opportunity to operate a business using the name and trademark of the franchisor, in exchange for the payment of fees and/or royalty to the franchisor. In addition, they may also get access to product, storefronts, staff training and marketing strategies.

Example: Fast food restaurants such as Domino's, Kentucky Fried Chicken and Subway.

With the advent of the digital age, where the internet is in vogue, the above models have adapted and evolved along with evolving technologies. One example of the same is the recent advent of *kiosk-based franchises*, where brick-and-mortar stores are either substituted with or supported by digital kiosks, and customers place their orders directly from the same.

Another interesting variation is a format something loosely termed as '*digital franchising*', where the franchisor licenses to the franchisee owners its software along with its name and business format, and may also provide the franchisee's employees with the requisite training, coordinated online. An example of such an enterprise is the American company OrderUp.⁹ OrderUp functions as an online food-delivery website that coordinates orders between local restaurants and their customers. Its franchisee model functions by allowing prospective franchisees to purchase a full franchisee for a specific amount, which earns them all the necessities they need to run the service, including a license to OrderUp's software and its name, the requisite training for employees to operate the software, and online coordination. The franchisees are allocated a set area in which they handle all online orders going through OrderUp.

These arrangements are executed through franchisee agreements, which are central to how a franchisee functions.

9. See, <http://www.inc.com/minda-zetlin/orderup-founder-tells-vcs-to-get-lost-and-creates-first-digital-franchise-instead.html> as accessed on 18 November, 2015

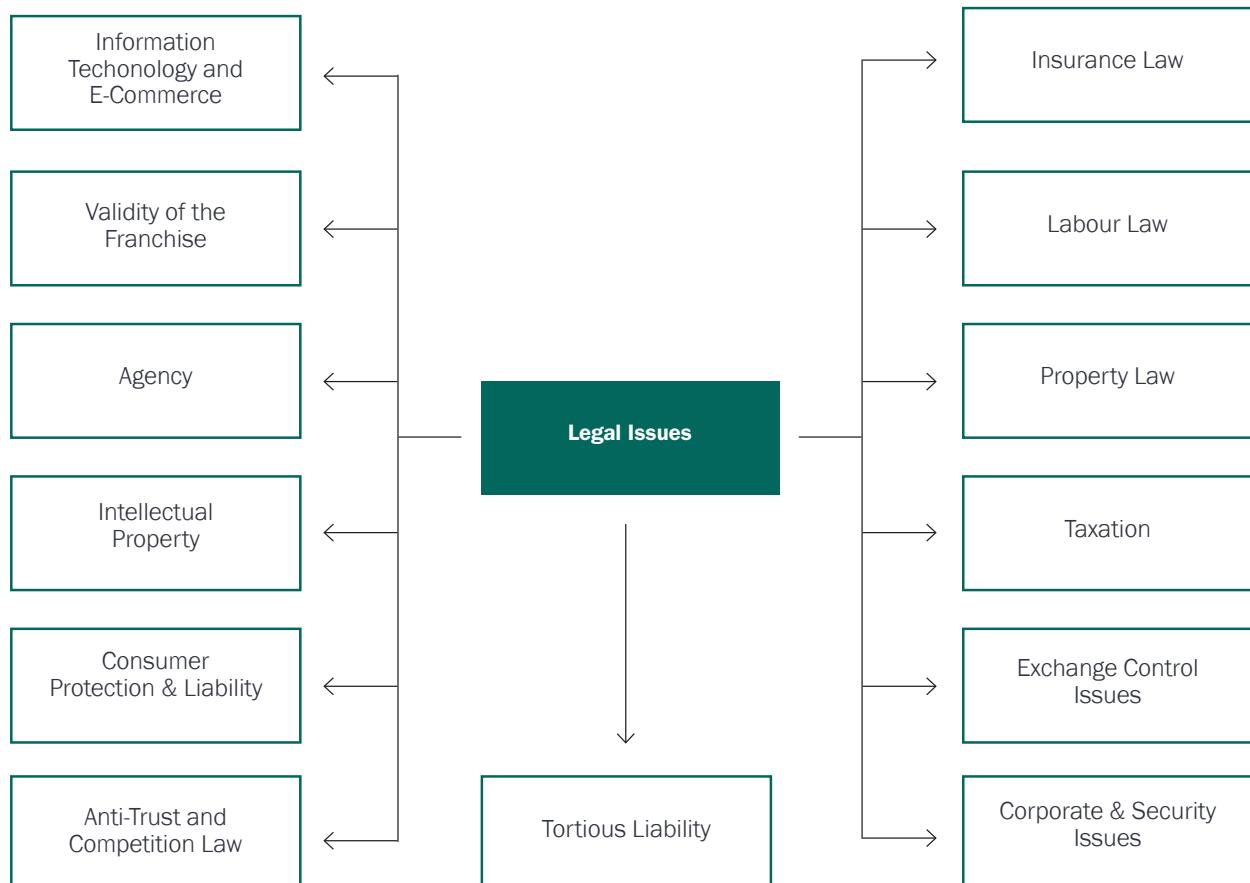
3. Legal Issues In Franchising – An Indian Perspective

Several countries of the world have formulated specific laws to regulate franchising activity. For instance, in the United States, prospective franchisee owners must comply with the Federal Trade Commission's ("FTC") amended version of the FTC Franchise Rule, which requires franchisees to make twenty-three specified disclosures under the Franchise Disclosure Document ("FDD"), which must be updated regularly. Furthermore, fifteen states in the US have their own laws regarding disclosures by prospective franchisee owners. Similarly, franchisees in Australia must mandatorily comply with the Franchising Code of Conduct, which is regulated by the Australian Consumer and

Competition Commission.¹⁰

However, in India, there is no specific law on the regulation of franchised businesses. Franchise arrangement is therefore largely contractual in nature, thereby making the presence of franchisee agreements extremely important.

Further, depending on the nature of franchise arrangement and the industry in which the franchise operates, several other laws can affect a franchising business in India. Some key legal aspects are discussed as below.



¹⁰. Australian Consumer and Competition Commission, Franchising Code of Conduct, <https://www.accc.gov.au/business/industry-codes/franchising-code-of-conduct> as accessed on 18 November, 2015

I. Enforceability and Validity of the Franchising Agreement

Fundamentally, every franchising relationship is a contractual relationship and therefore, the Indian Contract Act, 1872 (“**Contract Act**”) would be applicable to all franchising arrangements.

Under the Contract Act, a “*contract*” is an agreement enforceable by law.¹¹ The following elements are required to constitute a contract:

- i. an agreement, i.e. an offer and an acceptance of the offer;¹²
- ii. lawful consideration for the agreement;¹³
- iii. lawful object and purpose of the agreement;¹⁴
- iv. free consent of the parties to the agreement;¹⁵ and
- v. capacity of the parties to enter into an agreement.¹⁶

Every franchising agreement would have to necessarily meet the above five criteria in order to be legally enforceable. For example, if the franchising agreement is entered into for distributing arms and weapons in India, the same may not be for a lawful object and hence invalid.

While the Contract Act does not stipulate that a contract has to be in writing, it is advisable to have a formal and written franchising agreement to precisely lay down the rights and obligations of the franchisor and the franchisee. This would assist in resolving any future deadlocks and disputes.

Another issue that could arise is of competing with the franchisor’s business during the term of the franchising relationship. In the landmark case of *Gujarat Bottling Co. Ltd. and others v. Coca Cola Co. and others*,¹⁷ Coca Cola Co. had imposed a restriction on Gujarat Bottling Co. Ltd. from entering into an

agreement with any other beverage manufacturing company during the term of their contract.

When the case came up before the Supreme Court as being in restraint of trade,¹⁸ the Court held the following:

“There is a growing trend to regulate distribution of goods and services through franchise agreements providing for grant of franchise by the franchiser on certain terms and conditions to the franchisee. Such agreements often incorporate a condition that the franchisee shall not deal with competing goods. Such a condition restricting the right of the franchisee to deal with competing goods is for facilitating the distribution of the goods of the franchiser and it cannot be regarded as in restraint of trade.”

The Court therefore held that a negative agreement restraining the franchisee from manufacturing, bottling, selling, dealing or otherwise being concerned with the products or beverages of any other brands or trademarks/trade names during the subsistence of a franchise agreement including the period of the period of one years’ notice, is not a violation of Section 27 of the Contract Act.

However, the Court did not address the issue of a negative covenant post-termination of the agreement. Under Section 27 of the Contract Act, such a post term negative covenant is void ab initio. This is an issue that the parties must bear in mind while formulating the contract.

11. Section 2(h) of the Indian Contract Act, 1872 (“Contract Act”).

12. Section 2(a) and 2(b), Contract Act.

13. Section 23, 24 and 25, Contract Act.

14. Section 23 and 24, Contract Act.

15. Section 14, Contract Act.

16. Section 11, Contract Act.

17. Civil Appeals Nos. 6839-6840 of 1995, (arising out of S.L.P. (Civil) Nos. 8800-01 of 1995). Decided on 04.08.1995. See www.manupatra.com Ref: MANU/SC/0472/1995. See also (1995) 5 SCC 545.

18. Section 27, Contract Act: *Agreement in restraint of trade, void*

Every agreement by which anyone is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void.

Exception 1: Saving of agreement not to carry on business of which good will is sold - One who sells the goodwill of a business may agree with the buyer to refrain from carrying on a similar business, within specified local limits, so long as the buyer, or any person deriving title to the goodwill from him, carries on a like business therein, provided that such limits appear to the court reasonable, regard being had to the nature of the business.

II. Constitution of an Agency

While normally franchisors and franchisees intend to create an independent contractor relationship,¹⁹ sometimes, depending upon the nature of the contract, the relationship between the franchisor and the franchisee could be considered to be an agency.²⁰ For example, if the franchisee is given the authority to enter into contracts with third parties on behalf of the franchisor, the relationship could be an agency. Another example could be in a distributor contract, where a wholesaler enters into agreements with several retailers to market and distribute a product to the end-users.

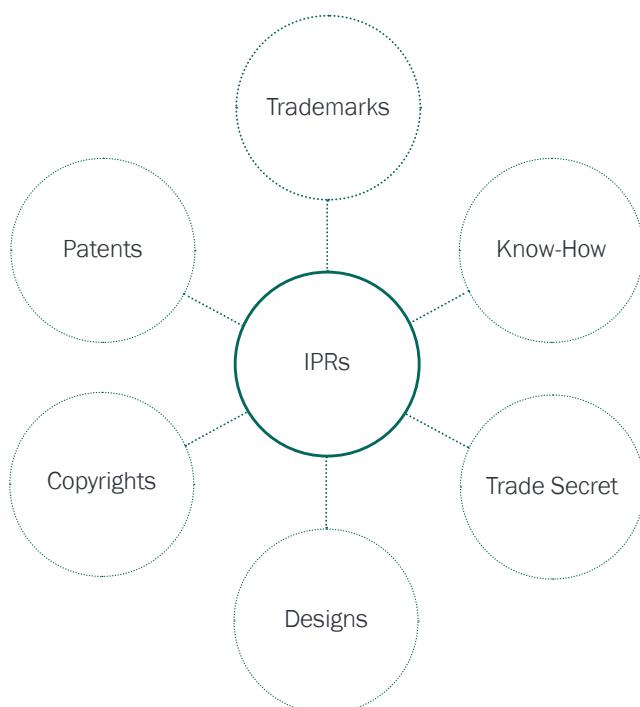
In the event the franchising agreement creates an agency, the franchisor (the principal) could be liable for acts performed by the franchisee (the agent) in the ordinary course of business. Similarly, as per the Contract Act, the franchisee could also be liable to compensate the franchisor for liabilities arising due to acts performed outside the course of the business or contrary to the franchisor's directions.²¹ If a third party acts upon the representation of an agent and suffers any losses, it might create some issues for the franchisor. Further, any limitation on the authority of the franchisee will not bind any third party unless

he is or is made aware of such limitation.²²

Therefore, it becomes crucial to determine the relationship anticipated between the franchisor and franchisee before formalizing any agreements. At the same time, the agreements must be carefully drafted to reflect the true position between the parties, and thereby avoid unnecessary liabilities.

III. Protection of Intellectual Property Rights

All franchising agreements involve the licensing of some form of intellectual property, either an invention or a design (in the case of a manufacturing agreement), or a trademark or trade name (e.g. Apple iPhone) or a business format / know-how / trade secret (e.g. Starbucks coffee chain) or copyright (in the case of character merchandising agreements). Since the intellectual property license lies at the core of a franchise, the laws governing licensing of intellectual property constitute the heart of franchise laws. An understanding of issues that could arise in this arena is vital for any franchising business.



¹⁹. Normally, principals are not liable for the acts of independent contractors. See, David Gurnick, "Intellectual Property in Franchising: A Survey of Today's Domestic Issues" (1995) 20 Okla. City U.L. Rev. 347 at p. 357.

²⁰. Under Section 182, Contract Act, an "agent" is a person employed to do any act for another, or to represent another in dealing with third persons. The person for whom such act is done, or who is so represented, is called the "principal".

²¹. Section 211, Contract Act.

²². *Union of India v. Moti Lal*, (1962) A.P. 384.

A. Due Diligence

Before entering into a franchising agreement, the franchisee must ensure that any intellectual property rights being licensed under the agreement subsist and that the franchisor has the authority to license those rights. Moreover, the franchisee would also need to ensure that the rights being licensed do not in any way violate the intellectual property rights of any third party. If this due diligence is not undertaken, it could result in liabilities being imposed on the franchisee.

B. Licensing

While licensing an intellectual property right, both the parties must follow the necessary provisions of the law. For example, in the case of character merchandising, if the copyright in a graphical or fictional character is being licensed, the license must confirm to certain parameters namely, it must be in writing, signed by both the parties, specifying the rights licensed, the royalty payable if any, the term of the licence and the territory for the rights are licensed.²³ Similarly, while licensing trademarks, the franchisor must ensure that the license does not create exclusive rights to use the mark in more than one person, with respect to using the trademark for the same types of goods and services or similar description of goods or services and such similarity should not be likely to create any confusion or deception.²⁴ The licence must always specify the exact nature of rights granted and the extent to which such rights are granted.

C. Misuse of rights

The franchisor must also ensure that the intellectual property rights licensed to the franchisee are not misused in any manner. For example, the franchisor needs to ensure that the franchisee does not use the franchisor's trademark for purposes outside the purview of the franchise agreement.

D. Post-term use of trademarks

Disputes involving post-term use of the franchisor's mark by the franchisee are potential litigious issues in franchising. Often the franchisee may also use the

trademark *pendent lite*, or even after the termination for reference purposes or as part of a corporate name.²⁵ Careful drafting of the franchise agreement could minimize the risks arising from such litigation. Post termination, the franchisor should either allow the franchisee to dispose of the existing stock of goods within the identified time period or buy the goods at a predetermined price, so that the risk of franchisee misusing/making unauthorized use of the goods does not arise.

E. Dilution of trademark

The franchisor and franchisee should ensure that the brand and goodwill associated with the trademark is not diluted in any manner due to any actions or inactions of the franchisee.

F. Protection of know-how and trade secrets

An important aspect, especially of a business format franchise agreement is leveraging upon the know-how and trade secrets of the franchisor. It is crucial for the franchisor to decide on the amount of know-how and trade secrets he/it wishes to transfer to the franchisee. Moreover, the franchisee must also take adequate precautions to protect the franchisor's confidential information from third parties. The franchisee could also be restricted by a negative covenant from competing with the franchisor during the franchise agreement²⁶ and prevented from divulging any confidential information, trade secrets and know-how during and even post-termination of the agreement.²⁷

A signatory to the international conventions on intellectual property rights, India offers adequate protection to trademarks or brand names as well as copyright and designs of the foreign franchisors.

IV. Consumer Protection

Complaints and legal action from consumers is a potential issue that both the parties must bear in mind. Such lawsuits are not uncommon in other jurisdictions and can definitely arise in the Indian context.

23. Section 30 and 30A, Copyright Act, 1957.

24. Section 40, Trademarks Act, 1999.

25. See *Philadelphia Gear Corp. v. Philadelphia Gear de Mexico S.A.*, Bus. Franchise Guide (CCH) paragraph 10,370 (E.D. Pa. 1993).

26. See *Gujarat Bottling Co. Ltd. v. CoCa-Cola Co. Ltd.*, (1995) 5 SCC 545.

27. See *Niranjan Shankar Golikari v. Century Spg. And Mfg. Co. Ltd.*, (1967) 2 SCR 378.

Under the Consumer Protection Act, 1986, a consumer can file a complaint with the consumer forums for unfair or restrictive trade practices adopted by a trader or for any defects / deficiencies in the goods or services supplied by the trader or if the goods being offered for sale are hazardous to life or do not confirm to certain provisions of the law.²⁸ In case of a franchise, the franchiser and the franchisee could be held liable for any defective goods or services supplied by the franchisee. Therefore, franchisee should take adequate indemnities in case goods are acquired from franchisor and franchisor should obtain indemnities from franchisee if franchisee produces goods. On another level, it may be possible for the franchisee or sub-franchisee, as a consumer, to sue the franchiser on the above-mentioned grounds. Provisions to minimize liabilities arising due to such risks should be properly documented in the franchise agreement.

V. Tortious Liability

A tort is a civil wrong, independent of contract, for which the appropriate remedy is an action for damages.²⁹ Tortious liability could arise in a franchise relationship in the following situations:

A. Negligence

Negligence is a breach of duty caused by an act or omission, which results in damage.³⁰ In a franchising arrangement, the breach of any duty by the franchisor or franchisee, which causes a loss or damage to the franchisee or franchisor, respectively or to any third party, could lead to a civil action for negligence.

B. Vicarious Liability

In the event there is a principal-agent relationship, or an employer-employee relationship between the franchisor and the franchisee, the franchisor could be held liable for any torts committed by the franchisee during the course of the business. However, if the franchisee has acted outside his capacity or contrary

to the instructions of the franchisor, the franchisor may be able to recover damages from the franchisee. If the franchisee is an independent contractor,³¹ the franchisor may not be liable for the tortious acts of the franchisee.

VI. Corporate Issues

An important consideration while doing business in India is the nature of corporate structuring the franchisor/ franchisee should undertake. Depending on the nature of business, the reach of the business, the industry in which business operates etc., various entity forms, both unincorporated (such as partnerships, licensing arrangements, branch offices etc.) and incorporated forms (such as company or a LLP) can be explored.

VII. Anti-Trust and Competition Issues

In the past few years, competition law in India has shifted its focus from restricting monopolies to promoting healthy competition. With the repealing of the Monopolies and Restrictive Trade Practices Act, 1969 and the enactment of the Competition Act, 2002, various provisions have been introduced with respect to anti-competitive agreements³² and abuse of dominant position.³³

Under the Competition Act, agreements that cause an “appreciable adverse effect on competition in India” are considered to be anti-competitive agreements. Such agreements include exclusive supply and distribution agreements, refuse to deal and resale price maintenance agreements or tie-in arrangements. For example, in case of retail, if companies engage in overpricing of their products or are unreasonable with respect to licensing terms, then competition law provisions may be attracted.

In *Surinder Singh Barmi v. Board for Control of Cricket in India (BCCI)*³⁴, the Competition Commission of India (“CCI”) held that BCCI entered

28. Section 2(1)(c), Consumer Protection Act, 1986.

29. Justice G.P. Singh, “Law of Torts” (1997), 23rd Ed., at p. 4.

30. *Jay Laxmi Salt Works (P) Ltd. v. State of Gujarat*, (1994) 4 SCC 1.

31. See, *Guru Govekar v. Filomena F. Lobo*, AIR 1988 SC 1322 at p. 1334 (para. 26), where the Supreme Court held that if an independent contractor as distinguished from a servant, is employed to do some work and in the course of the work, he or his servants commit any tort, the employer is not answerable.

32. Section 3 of the Competition Act, 2002

33. Section 4 of the Competition Act, 2002

34. *Sh. Surinder Singh Barmi v. Board for Cricket Control in India (BCCI)*, Date of order 08.02.2013, available at <http://www.cci.gov.in/May2011/OrderOfCommission/612010.pdf>, as accessed on 18 November, 2015.

into perpetual franchise agreements by granting exclusive media rights. Such agreements lead to anti-competitive consequences and create barriers for new entrants into the market.

Furthermore, with respect to franchise agreements and intellectual property rights, reasonable conditions as may be necessary for protecting IPRs as imposed under the franchise agreements may not be considered anti-competitive.

VIII. Exchange Control Issues

An international franchise arrangement between an Indian resident and a non-resident would have to comply with the Foreign Exchange Management Act, 1999 (“FEMA”) and the rules framed thereunder. Approval to make remittances outside India under the automatic route (“Automatic route”) is available for the purposes of making outbound remittances for the use of trademarks/franchise in India.

IX. Taxation

A. General Overview

Taxation of income in India is governed by the provisions of the Income Tax Act, 1961 (“ITA”). Under the ITA, residents are subject to tax in India on their worldwide income, whereas non-residents are taxed only on income sourced in India. As per Section 9 of the ITA, certain types of income (such as interest, royalty, income from any capital asset situated in India, etc.), are deemed to accrue or arise in India under prescribed circumstances. However, if a non-resident taxpayer is a tax resident of a country with which India has signed a tax treaty, he is entitled to relief under the tax treaty. Business profits (net of permissible deductions) are taxed at 30 percent³⁵ in case of resident companies and 40 percent in case of non-resident companies (to the extent of income sourced in India).

Section 90(2) of the ITA is a beneficial provision which states that, where the taxpayer is situated in a country with which India has a double tax avoidance agreement (“Indian Tax Treaty”), the provisions of the ITA apply only to the extent that they are more

beneficial to the taxpayer. Rules under the Indian Tax Treaties are generally more beneficial to the taxpayer than those under domestic law (ITA) and hence, it is, typically, advantageous for a non-resident taxpayer to structure his investments or business through a jurisdiction which has signed an Indian Tax Treaty.

B. Royalties / Fees for Technical Services

Franchisees are required to withhold tax on royalties and franchise fees paid to foreign franchisors. Royalties paid by the franchisee to the franchisor for the use of the Franchisor’s intellectual property rights, would be subject to tax at the rate of 10 per cent, subject to relief under any tax treaty. In determining whether a payment amounts to royalty, several issues arise in the Indian context as the definition of royalty under the ITA (particularly, after the clarificatory amendment introduced in 2012) is wider than the definition accepted internationally.

The withholding tax rate on fees for technical services is also at the rate of 10 per cent under the ITA. However, this is subject to any relief provided under any tax treaty.

Franchise fees, if not classified as royalty payment or fees for technical services, would fall within the category of business income and would be taxed accordingly. However, there should be no withholding tax requirement on franchise fees paid if the franchise fees are classified, not as royalty or fees for technical services but as business income, and the franchisor is from a treaty country and has no permanent establishment (“PE”) in India.

C. Potential Permanent Establishment issues

Under the ITA, business income of a non-resident is taxable in India (at the rate of 40 per cent) if it accrues or arises, directly or indirectly, through or from any ‘business connection’ in India. Similarly, under the Indian Tax Treaties, typically, the business income of a non-resident is taxable only to the extent that it is attributable to a Permanent Establishment (“PE”) of such non-resident in India. The concept of PE under typical Indian Tax Treaties is expressed as an exhaustive list of factors, as opposed to the “business

35. All tax rates mentioned in this paper are exclusive of surcharge and cess. The tax rates mentioned in this response are exclusive of surcharge and cess; in case of residents, surcharge of 12 per cent / 7 per cent is applicable on the income-tax if their total taxable income is in excess of INR 10 crores / in excess of INR 1 crore but less than INR 10 crores respectively; in case of non-residents, the surcharge is 5 per cent / 2 per cent respectively for such taxable income; for both resident and non-residents, education and higher education cess of 3 per cent (cumulative) is applicable on the total of the income-tax and surcharge.

connection” rule contained in the ITA, which has no exhaustive definition in the ITA and which has been afforded a wide interpretation by Indian courts in the past. Therefore, there may be situations where a non-resident is considered to have a business connection in India, but no PE. As mentioned earlier, since it is open for the non-resident taxpayer to choose to be treated under the more beneficial regime, a non-resident may rely on the PE rule under the applicable Indian Tax Treaty rather than the business connection rule in the ITA. The term PE has been succinctly defined by the Andhra Pradesh High Court in the case of *CIT v. Visakhapatnam Port Trust*³⁶, as follows:

In our opinion, the words ‘permanent establishment’ postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country.”

The Indian Tax Treaties typically lay down certain criteria to determine whether a foreign enterprise earning business income from India would be construed to have a PE in India. Some of these tests are as follows:

i. Fixed place of business PE

A foreign enterprise is deemed to have a PE in India if the business of foreign enterprise is, wholly or partly, carried on through a fixed place of business in India.

ii. Service PE

Further, under some Indian Tax Treaties, a foreign enterprise may be considered to have a PE in India due to the presence of its personnel in India, who render services beyond a specified time period or to a related enterprise. For instance, under the India-US tax treaty, a PE is said to be constituted where there is:

“(l) the furnishing of services, other than included services as defined in article 12 (royalties and fees for

included services), within a Contracting State by an enterprise through employees or other personnel, but only if:

- i. activities of that nature continue within that State for a period or periods aggregating to more than 90 days within any twelve-month period; or
- ii. the services are performed within that State for a related enterprise (within the meaning of paragraph 1 of article 9 (associated enterprises).”

iii. Agency PE

Indian Tax Treaties typically contain a provision whereby an Indian entity may be treated as a PE of a foreign enterprise if the Indian entity, acting on behalf of the foreign enterprise, has and habitually exercises an authority to conclude contracts on behalf of the foreign enterprise. Moreover, some Indian Tax Treaties, such as the India-US tax treaty, also contain an additional provision whereby an Indian entity may be regarded as a PE of the foreign enterprise, if the Indian entity maintains a stock of goods from which it regularly delivers such goods on behalf of the foreign enterprise and contributes to the sale of such goods. An agent of independent nature is considered as an exception to the Agency PE rule.

As is clear from the discussion above, the issue as to whether any activity of a foreign entity in India results in a PE of that foreign entity in India depends on the facts and circumstances of each case.

X. Labour Law

There are Central and State specific labour laws in India. The applicability of these labour laws depends on various factors including the nature of activities carried out by the establishments, number of employees, salary of employees, etc. Further, there are certain registration requirements under some of the labour laws which may be triggered depending on the business activity of the franchisee, for e.g. the franchisee may be required to obtain registration under the state specific Shops & Establishment Act, Factories Act, 1948, etc. The franchisee may also be required to provide certain statutory benefits to its employees, including but not limited to, bonus, gratuity, PF contributions, employees state insurance, etc.

Depending on the nature of the franchise arrangement and the amount of control the

36. *CIT v. Vishakhapatnam Port Trust*, 1983 144 ITR 146 AP

franchisor has over the franchisee's business operations, different labour law issues including claims made by the employees of the franchisee seeking employee benefits with the franchisor. These issues could be based on:

- i. the relationship between the franchisor and the franchisee;
- ii. the relationship (if any) between the franchisor and the employees of the franchisee, for example where the franchisor retains the right to approve the employees of the franchisee; and
- iii. the position of the employees of the franchisee in the franchise system, which includes questions such as the right of the employees to be consulted on important business decisions.

XI. Retail and E-commerce Issues

The Indian retail industry can be broadly divided into two categories – single brand retail trading (“SBRT”) and multi – brand retail trading, which could be offered through a franchise model.

To attract foreign brands for investing in India, there have been various liberalizations in Foreign Direct Investment (“FDI”) policies in relation to single brand retail and multi brand retail.

The erstwhile restrictions on FDI in B2C businesses has led to the development of market place models, where the online platform acts as a trading platform rather than a trader. In this case the online platform's clients are various sellers who own the inventory of goods and advertise their goods on the online platform. The ultimate sale of the goods is completed between the third party seller and the end consumer.

However, the government has recently relaxed conditions for undertaking SBRT (including allowing operations through e-commerce subject to meeting of certain criteria) which will give further impetus to FDI and franchising in this sector. Nevertheless, one needs to be mindful of the legal nuances and sourcing conditions while doing business in this space. Validity of e-contracts, payments through online medium, content related regulations, security and data privacy requirement are some of the few aspects that should also be considered.

4. Negotiating A Franchise Agreement

It is essential that a franchise agreement is drafted and negotiated carefully as it forms the bedrock of the franchising relationship. Some of the important issues that a franchising agreement needs to address are outlined hereunder.

Outline of a Franchise Agreement

- Scope and Subject matter
- Licensing and Protection of IPR
- Obligations of the Franchisee
- Obligations of the Franchisor
- Consideration
- Taxation
- Termination and its Consequences
- Notice Provisions
- Negative Covenants
- Indemnification
- Arbitration
- Governing Law
- Jurisdiction

I. Scope and Subject Matter of the Franchise

At the very outset, the franchise agreement should lay down the nature of the business or project that the parties have in mind, the geographical scope, the subject matter and the term of the franchise. The subject matter could either be a product or a business format or system. Based upon the subject matter, the agreement will need necessary tailoring. This section is crucial to the agreement as it acts like a preamble to the agreement and would be referred to in the event there are any difficulties in interpreting the agreement or deducing the true intent of the parties. It is generally in the form of recitals.

SCOPE

- Details of Contracting Parties
- Subject-matter
- Territorial scope
- Term of the Franchise

For example, the franchisor is a well-known computer institute in India who wishes to start a chain of computer education centres throughout the country. In that case, this section must set out the basis for the agreement by outlining the intention of both the parties to start the chain of computer centres, the areas in which these centres would be commenced, the term for which they will operate under this agreement, and whether the agreement is an exclusive or non-exclusive arrangement.

II. Licensing and Protection of Intellectual Property Rights

Intellectual property rights are the core of any franchising agreement. Therefore, it becomes necessary to determine the intellectual property (such trademark, service mark, trade name, copyright, patent, trade secrets or know-how) associated with the franchisor and the exact and specific intellectual property he/it is licensing to the franchisee. All such licensing must conform to the particular intellectual property legislations in India.

So, in case of the above-mentioned example of a computer centre, the intellectual property licensed could be the trademark of the computer institute, the policy and operating manuals, the teaching and reference material created by the computer institute in tangible and intangible form, stationery material and probably promotional and advertising material for the computer centres. In the event the computer institute has developed a particular invention, which it wants to use while teaching, any patent rights associated with the invention would also need to be licensed.

INTELLECTUAL PROPERTY RIGHTS

- Nature of IPRs granted
- Extent of the grant
- Terms of Use
- Post-termination use
- No infringement

The franchisor must limit the manner and circumstances in which the intellectual property is to be used and should ensure that it is not misused by the franchisee in a manner to cause damage to the brand and goodwill of the franchisor.

In the event the franchisor has transferred or may transfer some trade secrets or confidential information to the franchisee, the agreement could stipulate that such information be kept privileged, during and post-termination of the agreement. For example, if the computer institute has conducted some market research and has gathered a huge database of information that it can use to promote the computer centres, the computer institute would not want such information to be in public domain and hence it should adequately restrict the franchisee from doing so, in the franchise agreement. In the event, the trade secrets are disclosed to the public, they will cease to be trade secrets and the franchisor could lose out on its profitability.

III. Obligations of the Franchisee

Every agreement contains certain activities that each party must perform or refrain from performing during the term of the agreement. These activities are obligations on the concerned party and they must be adhered to, or else it could lead to a breach of the agreement.

FRANCHISEE'S OBLIGATIONS

- Services to be rendered
- Infrastructure
- Minimum Investment
- Location
- Operating Manual
- Protection of IPR and Confidential Information

- Restrictions on Suppliers
- Accounts and Inventory Audit
- Management and Control
- Good Faith

For instance, in a franchise arrangement, the franchisor would stipulate certain regulations and terms that the franchisee must confirm to during the term of the agreement so as to protect the franchisor's goodwill and brand. While drafting these regulations, the franchisor must try and incorporate all conditions necessary to protect his brand and also to ensure that the franchise is successful and profitable. Some of these obligations are stated hereunder.

A. Services to be rendered

The agreement must clearly outline the duties and services to be rendered by the franchisee. If necessary, a separate schedule could be attached to the agreement for clarity. For example, the computer institute could stipulate that the centre must impart training and education to the public, carry out workshops and seminars, make presentations in educational institutions, and even play a part in the advertising and promotion campaign. The computer institute may also want that a hoarding or sign board be displayed outside the centre so as to attract people.

B. Infrastructure and Minimum Investment

The franchisor must also ensure that the franchisee has the adequate financial resources and infrastructure to carry out the business operations. The franchisor could specify that the premise be of a certain size and that the franchisee should have a minimum amount of infrastructure to operate the franchise. In our example, the computer institute may stipulate that the computer centre have a minimum amount of computers and manpower to run the show. The franchisor could also insist on a minimum amount of initial investment to be made by the franchisee. This could be to ensure that the franchise outlet and the franchise operation meet some basic standards and specifications.

C. Location of the franchise outlet

The franchisor would desire that the franchise

outlet is located in a place that would attract several customers. Therefore, the franchisee may be obligated to first select the place and then get it confirmed from the franchisor. The franchisee could also be obligated from not commencing any competing business in the same area or location after termination of the franchise agreement.

D. Operating Manual

The franchisor could also provide the franchisee with a manual that contains information, not limited to, but concerning property specification, layout of the franchise shop, hiring policy to be followed, outfits of staff members, training and education to be imparted, manner of marketing the franchise and any other details to be followed.

E. Protection of intellectual property and confidential information

As mentioned earlier, protection of intellectual property forms a very important aspect of a franchise agreement. The franchisor must stipulate negative covenants to protect the intellectual property and confidential information.

F. Restrictions on suppliers

The franchisor may also have a good negotiating power with certain suppliers and may obligate the franchisee to purchase materials from such suppliers. This may also be to ensure the quality and standard of the final product. For example, the computer institute could specify that all computer equipment be purchased only from a particular vendor so as to ensure uniformity across all its franchise outlets.

G. Accounts and Inventory Audits

The franchisor may also want to supervise the activities of the business operations and may require carrying out periodic inventory and account audits. The franchisor could also ask the franchisee to provide periodic reports on the functioning of the franchisee's business. In the present example, the computer institute would want to monitor the progress of the computer centre and keep a check on the number and type of students enrolling for the computer courses.

H. Management and Control

The franchisor may want the franchisee to personally participate in the direct operation of the franchise or designate some person as a full-time Manager or Supervisor to look into and control the activities of the business. This would be to make sure that the franchise operation is run smoothly.

I. Good Faith

A clause requiring the franchisee to act equitably and in good faith normally finds place in most franchise agreements. This is more of an omnibus clause as it could include any and every possible action of the franchisee.

These obligations placed on the franchisee are critical in determining the popularity and success of the franchise.

IV. Obligations of the Franchisor

The franchisee may also want the franchisor to act in a certain manner during the term of the agreement and thereby impose some obligations mentioned below on the franchisor.

A. Finalization of location

The franchisor may be obligated in assisting the franchisee in locating and negotiating a place to start the franchise outlet, based upon the needs of the franchisor.

B. Provide Operations Manual

The franchisor would normally loan a copy of their confidential and proprietary Operations Manual to the franchisee covering the specifications, standards and operating procedures that the franchisor requires and informing the franchisee about his/its obligations.

C. Education and Training

The franchisor may also be obliged to provide some form of basic training to the franchisee as to how to conduct the business operations and also continue to upgrade the franchisee with new methods, equipment and services.

D. Exclusivity of the Franchisee

Depending upon the negotiating power of the parties, the franchisee may desire that he/it be given exclusivity for a particular area to promote the franchise.

FRANCHISOR'S OBLIGATIONS

- Finalization of Location
- Provision of Operations Manual
- Education and Training
- Exclusivity of Franchisee
- Regulatory and Legal Approvals
- Ongoing Support
- Advertising and Promotion

E. Regulatory and legal approvals

In order to construct and commence a franchise operation, several regulatory and legal approvals may be required from the local municipalities and even at the state and central government levels, depending upon the nature of the franchise. The franchisee may also require the franchisor to assist the franchisee in procuring such approvals. The agreement must clearly spell out all the help the franchisor will provide in this respect

F. Ongoing support

From the franchisee's viewpoint, this clause is also very important as it can impose certain obligations on the franchisor to take interest in the franchise and thereby help it grow and develop. The franchisee could demand that the franchisor guide him/it during the business operations, provide on-going training to the employees and also give ideas to promote the business. The franchisor could also be obligated to make ongoing recommendations regarding the advertising and merchandising services, administrative and accounting practices, and general operational and management procedures. In the current example, the computer centre may want that the computer institute continuously train new employees regarding the manner in which education and training should be imparted.

G. Advertising and Promotion

The franchisee may also want the franchisor to advertise and promote the activities of the franchise, which in turn would increase the overall turnover. The agreement could stipulate the manner in which the franchisor would promote the franchise business and how all funds collected for such purpose will be utilized.

All these clauses could be woven into the agreement, based on the needs of the arrangement and the bargaining powers of the parties.

V. Consideration

The agreement must specify the royalty or a license fee and any continuing fee to be paid by the franchisee to the franchisor for the license obtained and the services rendered by the franchisor on an ongoing basis. The manner in which and the times at which such payments are to be made must also be addressed. In the event, such payments are to be made outside India, then tax and exchange control considerations should also be evaluated.

CONSIDERATION

- Initial Basic Fee
- Royalty on lump sum or percentage basis
- Advertising Contribution
- Mode and Time of Payment

Generally, payments could be on a percentage of the total earnings of the franchisee. However, at times the franchisor may also stipulate a minimum amount to be provided to the franchisor, irrespective of the total earnings. While this may provide an incentive to the franchisee to take active interest in the franchise, it could also result in termination of the franchise due to non-fulfilment of the minimum amount. The franchisor may also want that the franchisee contribute a certain fixed amount towards advertising and promotional expenditure. Depending on the expected success of the business, such terms could be included in the arrangement.

VI. Taxation

It goes without saying that any business transaction must be made to work satisfactorily from a tax point of view, and this will be a major consideration in devising a suitable structure for the franchising arrangement. It is important to know the local sales tax, property tax and withholding tax. Eventually, the local tax laws and the existence of treaties between the countries involved may have considerable influence on the structure adopted.

VII. Termination of the Franchise Agreement

A provision must always be made to terminate the franchise agreement. Grounds for termination could include a material breach of the agreement, legal incapacity of any party to perform the agreement and changes in the legal and regulatory framework in the country.

TERMINATION

- Both parties should have option to terminate
- Grounds of Termination
- Consequences of Termination

As a consequence of the termination, the franchisee should be constrained from using the intellectual property rights and/or the business format of the franchisor. The franchisee must also be asked to return all confidential information obtained during the term of the agreement and completely de-identify itself with the franchisor. The franchisor may also covenant that the franchisee should not open a competing business within the same location. So in our example, the computer institute could stipulate that upon termination, all the confidential information, including customer details be returned to it by the franchisee. On the other hand, the franchisee could also negotiate that he be allowed to use certain rights post-termination for a specific period.

Negative covenants (as outlined below) could also be stipulated in the agreement.

VIII. Notice Provisions

NOTICE PROVISIONS

- Based on principles of equity
- Reasonable Notice

The principles of equity demand that every person must be given a notice and an opportunity to be heard.³⁷ In order to make the franchise contract equitable, a provision should be made for notifying either party before making any changes to the agreement or before rescinding or terminating the agreement. The notice must also be given for a reasonable period. While this provision may seem inconsequential, if the contract does not have this provision, the courts could hold the contract as inequitable.

IX. Negative Covenants

Negative covenants particularly relating to non-competition (especially after the Gujarat bottling case) and protection of intellectual property and confidential information often find place in franchising agreements. However, in case of an international franchise arrangement, such clauses may have to be re-looked upon based upon the laws of the foreign country.

NEGATIVE COVENANTS

- Non-competition clause
- Protection of IPR
- Protection of Confidential Information

The franchisor could stipulate that the franchisee should not start any competing business in the nearby vicinity so as to capitalize on the franchisor's brand equity. However, it is uncertain whether

Indian courts will enforce such post-termination covenants.

X. Indemnification

INDEMNIFICATION

- Who will indemnify?
- When will they indemnify?

A franchising arrangement could give rise to several liabilities as outlined in the section on legal issues. The franchise agreement must therefore provide adequate provisions for indemnification of the parties for any liabilities arising out of the other party's breach of contract. The contract can also lay down an inclusive list of situations in which parties would be liable for indemnification.

XI. Arbitration

Many a times, agreements have an arbitration clause, wherein all disputes arising out of the agreement are subject to arbitration. Arbitration is preferred as it is a speedier, and sometimes more cost-effective method of resolving disputes. The arbitration clause would normally stipulate the manner in which the arbitration is carried out. For example, in case both the parties are Indian, the clause could stipulate that the Indian Arbitration and Conciliation Act, 1996 (or arbitration following the procedural requirements of an institution such as LCIA India) would apply. In the event one party is foreign, the parties may wish to choose an international arbitration forum to adjudicate upon any disputes.

ARBITRATION

- Speedy
- Cost-effective, sometimes
- Procedure to be followed
- International Arbitration

XII. Governing Law and Jurisdiction Clauses

The problem of ascertaining the governing law is more perplexing in the case of agreements than in almost any other topic, as in the case of an agreement there may be a multiplicity of connecting factors such as the place where it is made; the place of performance; the domicile, nationality or business centre of the parties; the situation of the subject matter and so on.

GOVERNING LAW

- Place of performances
- Domicile, nationality or place of business of parties
- Situation of subject-matter

JURISDICTION

- Territorial or activity-based
- Personal
- Subject-matter based

Jurisdiction is another issue that must be carefully thought upon before being documented. Jurisdiction refers to the authority of a court to adjudicate upon a dispute. Generally jurisdiction is of three types:

- i. Territorial or activity-based jurisdiction i.e. relating to activities within the territorial limits ascribed to the court;
- ii. Personal jurisdiction i.e. based on the persons who are parties to a dispute; and
- iii. Subject-matter jurisdiction i.e. based on the location of the subject matter that forms the essence of the dispute.

If both parties to the agreement were based in the same territory, then it would be rational to subject any disputes out of the agreement to courts in that territory. However, if the parties were based in different territories, the choice of jurisdiction becomes a point of negotiation.

While the above list does not purport to be an exhaustive list of clauses required, it could definitely serve as a guideline to formulate a fair franchising agreement.

5. Conclusion

With the wave of globalization and liberalization having hit the Indian markets, franchising continues to be an alluring and attractive option, not only for domestic companies, but even foreign enterprises.

Several foreign companies with strong brand names have now established a presence in India through franchising. In the hospitality and service industries, this has been the preferred method for starting operations in India. International companies that operate through franchises include Zara, Forever 21 and Marks & Spencer for apparel; Radisson, Best Western and Quality Inns for hotels; Burger King, Starbucks Coffee and Jamie Oliver's Pizzeria for food. Similarly, Indian companies with strong brand recognition are also using the franchising route to expand business volumes.

As India and world economies grow with the ever increasing populations, and the move toward free market economies, new franchise concepts (such as franchising through digital medium) will come on the scene and the solid, well managed existing franchise companies will continue to grow.

The future of franchising in India is positive. Industry sources predict that the introduction and penetration of new technology will create new opportunities for franchises. Further mergers and acquisitions will increase as larger franchisers take over smaller ones. These factors combined with the low rate of franchise failure and considerable return on everybody's investment, have made franchising a major force in the Indian economy.

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NDA Insights

TITLE	TYPE	DATE
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Reliance tunes into Network18!	M&A Lab	December 2014
Sun Pharma –Ranbaxy, A Panacea for Ranbaxy's ills?	M&A Lab	December 2014
Jet Etihad Jet Gets a Co-Pilot	M&A Lab	May 2014
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research@nishithdesai.com



Nishith Desai Associates

LEGAL AND TAX COUNSELING WORLDWIDE

MUMBAI

93 B, Mittal Court,Nariman Point,
Mumbai 400 021 India
Tel: +91 - 22 - 6669 5000
Fax: +91 - 22 - 6669 5001

SINGAPORE

Level 30,Six Battery Road,
Singapore 049909
Tel: +65 - 6550 9855
Fax: +65 - 6550 9856

MUNICH

Maximilianstraße 13
80539 Munich, Germany
Tel: +49 - 89 - 203006 - 268
Fax: +49 - 89 - 203006 - 450

SILICON VALLEY

220 S California Ave., Suite 201,
Palo Alto, CA 94306, USA
Tel: +1 - 650 - 325 7100
Fax: +1 - 650 - 325 7300

MUMBAI BKC

3, North Avenue, Maker Maxity
Bandra – Kurla Complex,
Mumbai 400 051, India
Tel: +91 - 22 - 6159 5000
Fax: +91 - 22 - 6159 5001

BANGALORE

Prestige Loka, G01, 7/1 Brunton Rd,
Bangalore 560 025, India
Tel: +91 - 80 - 6693 5000
Fax: +91 - 80 - 6693 5001

NEW DELHI

C-5, Defence Colony
New Delhi - 110024, India
Tel: +91 - 11 - 4906 5000
Fax: +91 - 11- 4906 5001