



# Franchise

in 30 jurisdictions worldwide

# 2014

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# India

**Abhijit Joshi, Kunal Doshi and Rishika Harish**

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## Overview

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

Entities through which business is generally undertaken are either a limited liability partnership (LLP) or a limited company. Each has its own specific legal regime and attendant benefits and disadvantages.

Depending upon the type of business that is proposed to be undertaken, the franchisor either incorporates an Indian company which then enters into multiple franchise agreements or grants franchises directly. Franchisors, when they choose to establish a presence in India, typically incorporate themselves as a limited company (for the obvious reason that their liability is limited to the extent of their shareholding). LLPs currently enjoy better tax benefits in some regards, and are quickly developing into a preferred entity. Having said that, it is important to note that the LLP regime in India is very new.

Franchisors might prefer to contract with a company as this is the most thoroughly regulated and has higher compliance requirements.

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

An LLP is governed by the provisions of the Limited Liability Partnership Act, 2008, (the LLP Act) and the relevant authority is the Registrar of Companies.

All types of companies are governed by the provisions of the Companies Act, 1956 (the Companies Act) and the relevant authority is the Registrar of Companies.

Needless to say, there are other laws and agencies that incidentally impinge upon the operation of the aforesaid types of entities and they would necessarily have to comply with the provisions of such laws.

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

At least two partners are required for the formation of an LLP and there is no minimum capitalisation prescribed. The relevant documentation needs to be submitted to the Registrar of Companies and, upon receipt of the certificate of incorporation, the LLP is registered and can commence operations.

A private limited company must have a minimum of two shareholders and a minimum paid up share capital of 100,000 rupees. A public limited company must have a minimum of seven shareholders and a minimum paid-up share capital of 500,000 rupees. The relevant documentation needs to be submitted to the Registrar of Companies and, upon receipt of a certificate of incorporation, a private limited company can commence operations. A public company additionally requires a certificate of commencement of business before it can begin operations.

Under the LLP Act and the Companies Act, there are various

requirements, typically filings, which need to be complied with in the course of business of the aforesaid entities.

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

The Foreign Exchange Management Act, 1999 (FEMA) is the central legislation that any foreign investor or foreign business entity is required to comply with. A foreign entity, depending on its proposed activities, can establish its presence in India by opening a liaison office or a branch office, or by directly investing in an Indian company (either as a joint venture or into a wholly-owned subsidiary). A good starting point for any proposed investment in India would be to consult the consolidated foreign direct investment (FDI) policy, released semi-annually by the Department for Industrial Policy and Promotion, which, among other things, lays down various requirements for foreign investment in India, including the sectors in which investment is permitted, the extent to which investment is permitted, and the conditions and restrictions which apply to such investments. To do business in India, foreign entities must have a presence in India and such presence may be established through a liaison office, a branch office or an incorporated company, each of which have their own nuances and applicable regimes. Ordinarily, a franchisor operates through a company incorporated in India.

As with any exchange controlled economy, regulatory scrutiny is higher in respect of payments to be made by an Indian entity to a non-Indian entity. Such payments often require the prior approval of the Reserve Bank of India (RBI), India's central bank, but in some cases payments under certain specific heads are allowed to be remitted without any prior approval of the RBI, though there may be other restrictions on such amounts.

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

Payments under a franchise arrangement typically attract both direct and indirect taxes in India.

From the perspective of direct taxes, two things are important:

- the location of the franchisor (the jurisdiction in which it is incorporated); and
- where the taxable event has occurred.

Direct taxation in India is governed by the Income Tax Act, 1961. Typically, in respect of payments made by a franchisee, the franchisee is required to withhold tax. If the franchisor is situated within the jurisdiction of the Indian income tax authorities, the income in the hands of the franchisor would additionally be taxable. However, often franchisors are located in jurisdictions which have a double taxation avoidance agreement with India and, therefore, taxation is governed by the provisions of such treaty.

An important issue to be navigated in a franchise agreement is that of permanent establishment. Care needs to be taken in agreements to ensure that by reason of provision of services and related activities, the franchisor does not constitute a permanent establishment in India and thereby avoids exposure to tax in India.

One of the elements of a franchise relationship is the provision of services by the franchisor to the franchisee, and any amounts paid under a franchise agreement would also be susceptible to service tax. Additionally, depending on the nature of the business carried on by the franchisee, there may be additional taxation implications. An example of this would be the applicability of value added tax to a restaurant.

- 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?

Local labour law is a paramount concern for most international franchisors in India. India has historically been pro-employee and there are a host of central and local enactments for the benefit and protection of employees. Most franchisors prefer that the franchisee be the entity which employs the personnel required for the business of the franchise. Usually, there are detailed provisions in the franchise agreement to this effect.

Expatriates who are sent by the foreign entity to either manage the operations, or otherwise, need special immigrant visas, for which comprehensive undertakings would have to be provided by the franchisee, which often becomes a point of negotiation, failing which the expatriate can run into serious issues away from his home when parties are either in dispute or not ad idem in their object.

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

A franchisor may register its trademarks under the provisions of the Trade Marks Act, 1999 (the Trade Marks Act), in the manner provided for, after which it will have the exclusive right to use and deal with the trademarks in India. One of the major advantages of registration is that the proprietor of the mark has a right to institute proceedings for an infringement of the mark and registration acts as prima facie evidence of validity in all legal proceedings.

If a mark remains unregistered, the remedy for any infringement is limited to an action for passing off. In order to be successful in an action for passing off, the plaintiff would have to prove that:

- the defendant's use of the mark is likely to result in deception in the eyes of the public;
- the defendant is taking advantage of the reputation and goodwill of the mark which has been built by the plaintiff; and
- the plaintiff has suffered or will suffer harm or loss due to such use by the defendant.

Know-how, depending on its nature, could be classified as copyrightable or patentable material, and therefore be registered under the provisions of the Indian Copyright Act, 1957 or the Patents Act, 1970. However, it may transpire that the know-how is not amenable to registration as either, and in such a situation there is no statutory protection available to the franchisor. Contractual remedies will always be available to a franchisor, and detailed provisions are normally inserted in agreements to protect the intellectual property (including know-how) of the franchisor.

An important protective measure that becomes available to a plaintiff in a suit for infringement or passing off is to seek an interim injunction preventing use of the infringed material, which is very important as litigation takes considerable time to attain finality in India (please see question 41).

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

Depending on the nature of the franchise, the application of real estate laws will differ. For instance, for a franchise connected with the sale of merchandise, real estate law is incidental to the transaction (ie, in respect of physical stores in which such merchandise is sold). However, in a franchise for a hotel or branded residences, the exposure to the real estate market is far wider and real estate laws play a significant role.

All transfers of immoveable property in India are governed by the provisions of the Transfer of Property Act, 1882. While this is the principal central legislation, there are several statutes specific to each state in India that might be applicable.

In this regard, certain taxing statutes (such as that of stamp duty) need to be considered as these sometimes make a significant addition to the project cost since many states provide for ad valorem duties on a transfer of immoveable property. Generally, in a transaction between an Indian and non-Indian party, the property is owned by the franchisee (an Indian party). Investment in real estate by foreign entities is not encouraged, and only in limited circumstances (such as development of townships or hotels) are conditional investments permitted.

#### \_\_\_\_\_ **Laws and agencies that regulate the offer and sale of franchises**

- 9** What is the legal definition of a franchise?

The one thing that India does not provide is a homogenous experience in most aspects, as compared to developed countries. Unlike in many jurisdictions, the concept of a franchise arrangement is not recognised under a separate law, thereby necessitating analysis under various heads and under various laws. Parties are free to contractually agree to any terms and conditions.

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

There are no laws or government agencies which regulate the offer and sale of franchise. For a description of general laws and agencies which might be potentially relevant to franchises, please see question 22.

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

As per question 10, this is not applicable.

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

This is not applicable.

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

There are no such requirements and any entity competent to contract under the Indian Contract Act, 1872 (the Contract Act) can enter into a franchise agreement and must adhere to the applicable law.

- 14** Are there any laws, regulations or government policies that restrict the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers?

While there is no specific statutory restriction, there are certain conditions that would apply in case a foreign franchisor is seeking to make an equity investment in a local franchisee.

As regards single-brand retail trading (ie, retail trading of products that are sold under a 'single brand' under which brand name the products are sold internationally), equity investment in excess of 49 per cent would require prior regulatory approval. Where foreign direct investment (FDI) exceeds 51 per cent, at least 30 per cent of the value of raw materials or goods purchased are required to be sourced from India, preferably from micro, small or medium enterprises, village and cottage industries, artisans and craftsmen. Some additional conditions are that the products must be sold only under a single brand and products must be branded during the manufacturing process.

FDI in multi-brand retail is permitted only to the extent of 51 per cent, with prior regulatory approval. While the sourcing requirement similar to the one mentioned above is also applicable to the multi-brand retail space, there are further conditions applicable, which include a minimum investment threshold of US\$100 million, and directions on investment in back-end infrastructure. Additionally, each state in India is permitted to prescribe any additional conditions on multi-brand retail that it deems fit.

In this regard please also refer to the section on updates and trends, and for greater detail reference may be made to the FDI Policy, issued by the Ministry of Commerce and Industry, Government of India, which sets out the criteria and conditions in connection with FDI in India.

- 15** 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?

There are no requirements for disclosures and such arrangements may be contractually agreed to between parties.

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

This is not applicable.

- 17** What information must the disclosure document contain?

This is not applicable.

- 18** Is there any obligation for continuing disclosure?

There is no such requirement.

- 19** How do the relevant government agencies enforce the disclosure requirements?

This is not applicable.

- 20** 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?

This is not applicable.

- 21** 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?

This is not applicable.

- 22** 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?

As mentioned above, there are no special provisions of law in respect of the offer and sale of franchises in India. Normally, commercial principles govern the grant of franchises in India and an examination of the provisions of the Contract Act would not be remiss. Indian jurisprudence also recognises the principle of 'caveat emptor' or 'buyer beware', and the Sale of Goods Act, 1930 provides for certain implied conditions and warranties (some of which can be contractually waived).

Franchise arrangements normally include a (limited) licence in favour of the franchisee to use the trademarks of the franchisor. While there is considerable freedom of contract exercisable by the parties in relation to the grant of licence, it is common to seek a registration of the trademarks by the franchisor under the Trade Marks Act.

Furthermore, payment of royalty amounts pursuant to a grant of a licence by an international franchisor to an Indian franchisee would be subject to the provisions of FEMA.

- 23** Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub franchisee regarding predecessors, litigation, trademarks, fees etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

There are no general rules on pre-sale disclosure that apply to franchise arrangements. However, in order to reduce the ammunition that may be available for future litigation between a franchisor and franchisee, detailed representations and warranties are often incorporated in the contract with disclosure schedules when required, which clearly spell out the factual situation at the time of executing the contract. These typically include representations and disclosures on predecessors, litigations, etc.

- 24** What 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?

All agreements, including franchise agreements, fall under the ambit of the Contract Act. As per its provisions, fraud is one of the grounds on which the contract is voidable at the instance of the party who has been defrauded, in which case such party may either repudiate the contract or insist on the performance of the contract such that they would be placed in the position that they would have been in if the fraudulent representations were true. There are also criminal remedies in respect of fraud, if it falls within the definition of the offence of criminal fraud as per the provisions of the Indian Penal Code, 1860.

An action for fraud, like any litigation in India, would take a considerable time to be tried and decided. Therefore, in any such action, interim injunctive protection is often sought.

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

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

As a general rule, only the statutes mentioned above, like the Contract Act, the Trade Marks Act, the Sale of Goods Act and FEMA would apply to a franchise arrangement. Apart from the

aforesaid, the Information Technology Act, 2000 (the IT Act) lays down certain provisions relating to data protection.

However, other statutes may be incidentally applicable or may apply on the basis of the nature of the franchise. For example, local health and sanitation laws need to be complied with by a restaurant franchise.

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

India is a unique place when it comes to doing business. The sheer number of licences and permits required to do business is overwhelming and the accompanying bureaucratic labyrinth is highly complex and often impenetrable for a foreign franchisor. For example, a hotel requires more than a hundred approvals before it can open its doors. Therefore, reliance on the Indian franchisee in relation to navigating the local landscape is very high and this needs to be taken into account while drafting the agreements.

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

Due to the fact that there is no comprehensive franchise legislation, government policies on various aspects of laws as described above may have an effect on the franchise relationship. For example, in the past, payments under hotel agreements were regulated under exchange control laws, which have now been liberalised. This is a typical example of the march of law and policy which, having evolved independently, has had an effect on the franchise relationship.

**28** 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 circumstances in which a franchise agreement can be terminated are spelled out in the contract between the parties. Agreements generally contain provisions for termination for reasons of breach, bankruptcy or even the passing of time. Sometimes contracts even contain provisions regarding lock-in periods. Additionally, the Contract Act also provides for certain circumstances in which the agreement can be repudiated regardless of what is stated in the agreement.

Barring restrictions imposed in the contract, there are no legal restrictions on a franchisor's ability to terminate a franchise relationship.

It is important to ensure that a contract of agency is not created between the franchisor and franchisee, as there are specific issues in relation to termination of agency where the agent has an interest in the subject matter of the agency.

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

Please refer to question 28.

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

Subject to a contract to the contrary, there is no statutory or legal obligation on the franchisor to renew a franchise agreement with a franchisee and the franchisor is entitled to refuse to do so.

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

This is another aspect of the franchise relationship that is left open to the parties to commercially decide. Generally, international franchisors restrict the ability of the franchisee to transfer the franchise

or to transfer or dilute ownership interests in the franchisee entity. Additionally, restrictions may also be placed on the ability of the franchisee to enter into a sub-franchise arrangement.

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

While parties are free to agree on the manner in which royalties and other amounts payable in respect of a franchise are to be computed, the payment of these amounts to an international franchisor would need to traverse the intricate web of exchange control regulations. A franchise arrangement may provide for the payment of royalties for use of a trademark, not to mention fees for technical services, know-how, marketing, advertising etc. However, the fact is that regulators in India sometimes do not even appreciate the concept of a franchise and tend to see franchises narrowly, limited to a combination of technology and trademark licences. In fact payments by an Indian franchisee to an international franchisor are permitted only under the heads of payment of royalties for use of a trademark and fees for technical services. Payments towards reimbursements are also typically permitted to be repatriated without any restrictions. Any other type of payments would require the prior approval of the RBI, which is a lengthy process which does not always result in an approval and is therefore the least desired option. As mentioned above, the franchisee is also required to withhold tax on such payments and also pay the appropriate service tax.

Drafting franchise agreements in India therefore necessarily requires some elegance and great clarity of thought to ensure that payments under the franchise agreement are permitted under these heads. This results in restructuring standard franchise agreements to provide for payments under heads which are permitted.

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

There are restrictions on the amount of interest that can be charged on some types of overdue payments (such as for import of goods or services) and the maximum permissible rate of interest is fixed by the RBI from time to time.

In respect of other types of overdue payments (such as on royalty payments), while there are no restrictions on the amount of interest that can be charged, it would be open to the RBI to question the validity of such an interest payment to ensure that the same is not an artifice to remit money, where such remittance would not ordinarily be permissible.

As per the provisions of the Contract Act, in a situation where the payment of the interest is challenged in court, the reasonableness of the quantum of the interest is left to the discretion of the court, and the court may even rule that no penal or default interest can be levied.

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

Questions 32 and 33 are applicable in the instant case. Additionally, there are certain procedural formalities that an Indian franchisee needs to complete to remit payments to an international franchisor, which largely consists of filing the appropriate paperwork with its banker to enable him to remit funds to the banker of the franchisor. Such payments will be in the domestic currency of the franchisor.

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

Yes, confidentiality covenants included in the franchise agreement are legally enforceable. Additionally, the IT Act statutorily provides

### Update and trends

There have been amendments to the FDI regime for single and multi-brand retail, and as recently as August 2013 the Ministry of Commerce and Industry modified the provisions relating to FDI in the retail sector in India.

One hundred per cent FDI is permitted in a single-brand retail space, and only investments exceeding 49 per cent require prior regulatory approval. Single-brand retail refers to the sale of products in India under the same brand that they are sold internationally. FDI in single-brand retail is subject to certain conditions as contained in the Consolidated FDI Policy, including inter alia:

- products must be branded during manufacturing;
- non-resident entities, whether the owner of the brand or otherwise, are permitted to undertake single-brand retail trading in India either directly or through an agreement to this effect with the brand owner, and the investing entity must provide a copy of such licensing, franchise or sub-license agreement, if any;
- in respect of instances where FDI exceeds 51 per cent, not less than 30 per cent of the value of procurement of products that are manufactured, processed or purchased are to be sourced from Indian micro, small or medium enterprises;

As regards multi-brand retail, FDI has been permitted up to 51 per cent with prior regulatory approval. However, FDI in multi-brand retail is subject to various conditions, as contained in the Consolidated FDI Policy, including inter alia:

- the minimum amount to be invested by any foreign investor is US\$100 million;
- at least half of such amount is to be invested in 'back-end' infrastructure within three years of the investment;
- not less than 30 per cent of the value of procurement of products that are manufactured, processed or purchased are to be sourced from Indian micro, small and medium industries; and
- the entity will be permitted to operate retail outlets only in cities with a population of more than 1 million people or any other cities as per the decision of the respective state governments, and may also cover an area of 10 kilometres around the municipal limits of such cities.

for maintaining the confidentiality of private data that has been collected, and agreements normally impose additional obligations pertaining to data protection. Therefore, apart from statutory obligations, these contractual confidentiality covenants are enforceable.

**36** 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 Indian law, there are only some specific categories of relationships that mandatorily require parties to act in good faith, which are largely with respect to fiduciary relationships. Otherwise, there is, by law, no duty cast upon two principals who enter into a franchise agreement, to act in good faith. However, the parties may, by contract, impose an obligation on each other to act in good faith. All contractual and legal remedies would then be available to either party in case of a default of this obligation by the other.

In addition, in a dispute situation, the equitable principle that no party can take advantage of its own wrongdoing will be considered when granting relief, which indirectly encroaches on the issue of good faith.

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

No. The Consumer Protection Act, 1986 specifically excludes a person who buys goods or hires or avails of services for resale or any commercial purposes from the definition of a consumer. However, the jurisprudence on the subject is expanding and an increasing number of services are being brought under the ambit of the Consumer Protection Act.

**38** Must disclosure documents and franchise agreements be in the language of your country?

No, there is no specific requirement for any documents to be in a particular language. Parties may execute the relevant documents in any language of their choosing. However, it is advisable to have documents in English as it is widely understood across India, including in judicial forums.

**39** What restrictions are there on provisions in franchise contracts?

Other than restrictions that apply to any commercial contract, there are no specific restrictions that apply to franchise agreements.



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Contracts in restraint of trade, contracts without consideration, contracts for any illegal purpose and contracts that are contrary to public policy are some examples of restrictions imposed by law. There are also more nuanced issues in relation to franchise agreements which arise due to applicable laws, which may vary depending on the nature of business to be undertaken.

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

A franchise agreement would not generally attract any provision of competition law. A possible exception would be in the case of the acquisition of equity by the franchisor in an entity whose turnover or net worth triggers the thresholds provided under the Competition Act, 2002 in this regard.

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

The court system in India is elaborate and complex and if anything can be said about it with a degree of certainty, it is that litigation is a lengthy and expensive affair. Due to the large backlog of cases in courts across the country, decades may pass before a matter reaches trial and is finally heard and decided. Once the original action has been finally decided, there are often two levels of appeals that are available to the aggrieved party, only adding to the delay in achieving finality. This excludes the overriding jurisdiction of the Supreme Court of India to grant any party special leave to appeal from any order passed by any court in India.

The popular alternative to court proceedings is arbitration, and apart from being contractually agreed between parties, some statutes even mandate referring certain matters to arbitration. India is

a signatory to the Geneva and New York Conventions, and awards passed in member countries can be enforced as decrees in India, subject to the available grounds of challenge. Practically speaking, in cross border contracts, the contract is normally governed by Indian law with the seat of arbitration in one of the member countries.

Due to the substantial delays in all forms of dispute resolution, the application for and grant of interim protection is the endgame for all practical intents, and parties use such interim protection as leverage to commercially resolve the matter out of court.

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**42** Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

The obvious benefit of arbitration is that it provides a quick and expeditious remedy to the parties in dispute. However, in practical experience, it is often seen that arbitration takes just as long as court proceedings. Coordination between the parties and the arbitral tribunal is a herculean task, as a result of which sittings of the arbitral tribunal are scheduled with gaps of months in between. Arbitration also involves higher costs for the parties. Sometimes, when the venue or seat of arbitration is outside India, it acts as a disincentive and prevents the Indian franchisee from invoking arbitration on a light or frivolous ground.

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

The primary area of difference in the treatment of a foreign franchisor would be with respect to direct and indirect taxes (especially where there is a double taxation avoidance agreement between India and the franchisor's country of incorporation) and various exchange control laws and regulations.

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