

# A Primer on Franchising in India

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India is home to over 1.34 billion people and has the sixth largest economy in the world with the gross domestic product of \$2.6 trillion (USD).<sup>1</sup> Market studies in this area suggest that India may become the third-largest consumer economy in the world by the year 2025<sup>2</sup> and the second-largest economy in terms of purchasing power parity by the year 2050.<sup>3</sup>

With the liberalization of India's economy in 1991, a large number of international brands have ventured into India using the franchise model. The franchise industry in India is estimated to be at \$47–48 billion (USD) and is growing at approximately thirty percent year-on-year.<sup>4</sup>

This article discusses the important legal issues that the potential franchisor should know before making the decision to expand into India using the franchise model.

## I. The Legal System in India

There are no franchise specific laws in India. The relationship between the franchisor and franchisee is governed by a contract. The franchisor is not required to



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1. Yashwant Raj, *India Is World's Sixth Largest Economy at \$2.6 Trillion, Says IMF*, HINDUSTAN TIMES (Apr. 19, 2018), <https://www.hindustanimes.com/business-news/india-is-world-s-sixth-largest-economy-at-2-6-trillion-says-imf/story-7wXZPXSWlvvImlAvpLKeNL.html>.

2. Press Release, Boston Consulting Group, *India to Become Third-Largest Consumer Economy by 2025* (Mar. 21 2017), <https://www.bcg.com/d/press/21march2017-new-indian-changing-consumer-149010>.

3. PWC, *THE WORLD IN 2015*, <https://www.pwc.com/gx/en/issues/economy/the-world-in-2050.html>.

4. India Adda, *India's Franchise Industry: The Road So Far and Way Forward!*, INDIA BRAND EQUITY FOUNDATION (IBEF) (Aug. 28, 2018), <https://www.ibef.org/blogs/india-s-franchise-industry-the-road-so-far-and-way-forward>.

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make any specific disclosures to the franchisee or to any government authority prior to grant, transfer, and renewal of a franchise business under Indian law.

Although there are no franchise specific laws, franchise arrangements are regulated by various other laws in India. This includes foreign exchange control regulations, antitrust laws, intellectual property statutes, tax laws, data privacy laws, and anti-corruption laws. Some key statutes impacting franchisor-franchisee relationships are discussed later in this article.

## II. Entry Strategies

As the relationship between the franchisor and franchisee is governed by contract, foreign franchisors can select from multiple business structures that are commonly used for setting up a franchise business. This includes the grant of a single-unit franchise, a multi-unit franchise, an area-development agreement, or the grant of master franchise rights to Indian franchisees. Although there is no requirement for the foreign franchisor to have an entity in India, some franchisors incorporate a subsidiary or set up a joint venture to exercise better control over the franchised business.

### A. *Incorporation of a Subsidiary in India*

Under this arrangement, the Indian subsidiary of the franchisor is granted a right to (1) sell sub-franchises in India; and (2) directly open and operate franchise units in India. The key advantage of using a subsidiary is that the franchisor retains maximum control over the franchise business. This structure is best suited for the franchisors willing to actively engage in day-to-day management of the franchisees in India.

### B. *Joint Venture Arrangement with an Indian Party*

Under this model, the franchisor enters into a joint venture arrangement with an Indian party and subsequently grants master franchise rights to the joint venture entity. A joint venture arrangement is generally not a preferred structure for franchise arrangements because of the greater chance of disputes arising between the parties.

A franchisor desirous of incorporating a subsidiary or entering into a joint venture should be aware of some key issues, namely compliance with foreign direct investment policy, transfer pricing requirements, and day-to-day legal compliance.

#### 1. Compliance with Foreign Direct Investment Policy

A franchisor can incorporate a subsidiary company or set up a joint venture entity in India subject to India's foreign direct investment policy (FDI Policy).<sup>5</sup> The FDI Policy provides a detailed prescription on the types of

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5. Consolidated FDI Policy, Dep't of Indus. Policy & Promotion, D/o IPP F. No. 5(1)/2017-FC-1 (Aug. 28, 2017), [https://dipp.gov.in/sites/default/files/CFPC\\_2017\\_FINAL\\_RELEASED\\_28.8.17.pdf](https://dipp.gov.in/sites/default/files/CFPC_2017_FINAL_RELEASED_28.8.17.pdf).

entities that may be set up by a foreign national/entity in India and describes the required approvals, if any, for setting up an entity in India, along with conditions that must be adhered to by the Indian entity in the operation of its business.<sup>6</sup> The existing FDI Policy prohibits a foreign national/entity from setting up an Indian company for carrying out certain specified business activities, such as gambling, betting, and casinos.<sup>7</sup> Additionally, a foreign national/entity cannot have a stake beyond the prescribed limit in an Indian company engaged in certain prescribed business activities,<sup>8</sup> such as “multi-brand product retail trading.”<sup>9</sup> The structure of a joint venture arrangement—including the key provisions of the joint venture agreement that describe the duties of each party, the capitalization of the joint venture entity, the consequences of defaults, and the resolution of deadlocks—should be clearly framed in accordance with the FDI policy, the Companies Act (2013),<sup>10</sup> and prevailing foreign exchange control regulations.

## 2. Transfer Pricing Requirements

A foreign franchisor, and its subsidiary or a joint venture entity in India, could be deemed to be “associated parties,” and transactions between them must be on an arm’s length basis.<sup>11</sup> The franchise fees, royalty fees, and other fees to be charged by the franchisor under the franchise agreement should also be in compliance with transfer pricing regulations prescribed under the Income-tax Act, 1961 (IT Act).<sup>12</sup>

## 3. Day-to-Day Legal Compliance

A franchisor’s subsidiary or joint venture entity will have to comply with all applicable laws of India while undertaking business. This includes compliance with company, employment and tax laws, foreign exchange control regulations, and privacy laws. In addition, the subsidiary or joint venture entity will have to comply with sector-specific laws, depending on their actual business activities. For example, a company that operates restaurants is additionally required to comply with the Food Safety and Standards Act, 2006. The legal landscape requires an understanding of the complex web of laws and statutes.

### III. Considerations When Granting Franchise Rights in India

India is culturally and religiously diverse. People in different states have different cultures, lifestyles, and food habits. Therefore, the potential

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6. *Id.* § 3.

7. *Id.* § 5.1.

8. *Id.* § 5.2.

9. *Id.* § 5.2.15.4.

10. The Companies Act, No. 18 of 2013, INDIA CODE (2013). The central legislation that deals, *inter alia*, with incorporation, compliance, and dissolution of companies in India.

11. The Income-tax Act, No. 43 of 1961, INDIA CODE (1961) §§ 92–92 C.

12. *Id.*

franchisor should undertake extensive market research in India to determine (1) market conditions for the franchisor's products and services in different regions of India and the extent to which product and service offerings need to be customized to suit the various segments of the Indian market; and (2) prospective franchisee's qualifications, and ability to scale the franchise business profitably. Market research also helps to frame realistic minimum development schedules for the franchised business in India.

Due to vastly different cultural practices in different regions, a franchise business in India is largely dependent on the standing of local franchisees. Thus, the franchisor should carry out due diligence on the potential franchisee to determine if the franchisee (1) has adequate net worth and sound financial background to operate and scale the franchise business in India; (2) has a sound legal standing without a history of defaults; and (3) meets the franchisor's eligibility criteria for the business specific to the Indian market conditions.

#### IV. Franchise Business and Taxation

Indian tax regulations are divided into two categories: direct taxation and indirect taxation. Direct tax is levied on income and profit of the taxpayer in India. The IT Act is the primary legislation regulating all income tax.<sup>13</sup> Indirect taxes are levied on the provision of goods and services and are governed by goods and services tax laws (GST Laws).<sup>14</sup>

##### A. Taxation of Franchised Businesses in India

A master franchisee and a sub-franchisee in India will have to pay direct tax under the IT Act and indirect taxes under GST Laws. The obligation to pay direct taxes depends on the residential status of a taxpayer in a particular financial year. The IT Act divides taxpayers in India into seven different categories<sup>15</sup> and prescribes conditions for determination of residential status for various categories of taxpayers in India.<sup>16</sup> All companies incorporated in India are deemed to be resident entities, even if they are owned or controlled by foreign companies or foreign residents.<sup>17</sup> The income tax rate is subject to revision every financial year by the Government of India.<sup>18</sup> In addition to

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13. The Income-tax Act, No. 43 of 1961, INDIA CODE (1961).

14. The Goods and Services Tax law comprises the following: (1) The Central Goods and Services Tax Act, No. 12 of 2017, INDIA CODE (2017); (2) The Tripura State Goods and Services Tax Act, No. 9 of 2017, INDIA CODE (2017) (as notified by the respective States of India); (3) The Union Territory Goods and Services Tax Act, No. 14 of 2017, INDIA CODE (2017); (4) The Integrated Goods and Services Tax Act, No. 13 of 2017, INDIA CODE (2017); and (5) rules, notification and amendments and circulars issued under the respective Goods and Services Tax laws.

15. Different categories of taxpayers include (i) an individual, (ii) A Hindu undivided family; (iii) firm; (iv) company; (v) association of persons or body of individuals; (vi) local authorities; and (vii) all other persons not falling into the aforesaid categories.

16. The Income-tax Act, No. 43 of 1961, INDIA CODE (1961) § 6.

17. *Id.*

18. *Id.* § 4.

income tax, Indian franchisees may have to also pay certain additional direct taxes such as capital gains taxes, or dividend distribution taxes, as the case may be, at the applicable rates.<sup>19</sup>

Effective July 1, 2017, the Government of India revamped the previous indirect tax regime by scrapping a large number of indirect taxes that were levied by state and central governments and replaced them with the GST Laws. In general, all suppliers of goods and services, whose turnover exceed two million (INR),<sup>20</sup> are required to obtain a registration under the GST Laws and pay goods and services taxes (GST) at the applicable rates on the goods and services supplied to their customers.<sup>21</sup> As GST is an indirect tax, the supplier generally collects the GST from its consumers.<sup>22</sup>

## B. Taxation of Foreign Franchisor

### 1. Withholding Taxes on Payments Made by the Franchisee to the Franchisor

The IT Act requires Indian franchisees to deduct appropriate withholding tax on payments made to a foreign franchisor under the franchise agreement. Withholding tax must be deducted and deposited with the government as soon as the sum payable to the franchisor becomes due or at the time of actual payment, whichever is earlier.<sup>23</sup>

The IT Act further provides that withholding tax shall be deducted at the rate prescribed in the IT Act or, alternatively, the double taxation avoidance agreement (DTAA) between India and the home country of the franchisor, whichever is more beneficial to the franchisor.<sup>24</sup> Under the IT Act and DTAA, different withholding tax rates are prescribed for different categories of services. Franchise agreements typically impose a wide variety of required payments on franchisees, such as royalties, fees for technical services, advertising fees, business support fees, and administrative fees. Thus, franchisors must analyze both the IT Act and the DTAA to determine the actual rate of withholding tax for each type of payment. The steps that an Indian franchisee must take for deduction of withholding taxes prior to remittance to the franchisor are discussed later.

### 2. Goods and Services Tax on Payments Made by the Franchisee to the Franchisor

In an international franchise arrangement, because the foreign franchisor is situated outside India, the obligation to pay GST on the services provided

19. *Id.* §§ 45 and 115-O.

20. The Central Goods and Services Tax Act, No. 12 of 2017, INDIA CODE (2017) §§ 22, 24.

21. *Id.* § 9(1); *see also* The Integrated Goods and Services Tax Act, No. 13 of 2017, INDIA CODE (2017), § 5(1).

22. The Central Goods and Services Tax Act, No. 12 of 2017, INDIA CODE (2017) §§ 31–32; *see* The Integrated Goods and Services Tax Act, No. 13 of 2017, INDIA CODE (2017) § 20.

23. The Income-tax Act, No. 43 of 1961, INDIA CODE (1961) § 195.

24. *Id.* § 90(2)1.

by the foreign franchisor is transferred to the Indian franchisee.<sup>25</sup> Therefore, in an international franchise arrangement, the local franchisee will have to pay GST on the payments to be made to the foreign franchisor.

## V. Payments and Cross-Border Remittances Under a Franchise Agreement

The Foreign Exchange Management Act, 1999 (FEMA), along with the rules and regulations framed under the FEMA, regulates all financial transactions that involve remittance of foreign exchange from or into India.<sup>26</sup> Together, these are generally referred to as the “foreign exchange control regulations.” The Reserve Bank of India (RBI) is India’s central bank that administers and enforces the foreign exchange control regulations.

These regulations list out permissible and prohibited foreign exchange transactions, and also prescribe the terms and conditions for permissible transactions. Although most fees (that are typically payable by franchisees under a franchise arrangement) can be remitted to the foreign franchisors without any prior permission of the RBI, in certain special circumstances, or for certain specific transactions, prior permission of the RBI may be required.<sup>27</sup> In addition, even for those transactions that are permissible without RBI approval, franchisees must comply with all other terms and conditions of the foreign exchange regulations. Some of these conditions include prescribed Remittance procedures, the maximum interest rate that can be charged by the foreign franchisor on delayed payments, the maximum permissible time to settle payment, and restrictions on setting-off of payments between the parties.<sup>28</sup>

It is crucial for franchisors to ensure that the terms of their franchise agreements comply with the foreign exchange control regulations.

### A. Remittance Procedures

The existing procedures for remitting foreign exchange from India are fairly complex and time-consuming. The prevailing regulations require the Indian franchisees to comply with the applicable tax regulations prior to making an application with their bank for remittance of money to foreign franchisors. Indian franchisees must obtain a certificate from a qualified chartered accountant in India certifying the amount of withholding taxes to be withheld in India before making a payment to their foreign franchisor.<sup>29</sup>

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25. The Central Goods and Services Tax Act, No. 12 of 2017, INDIA CODE (2017) § 9(4).

26. The Foreign Exchange Management Act, No. 42 of 2017, INDIA CODE (1999) § 3.

27. *Id.* §§ 3–9.

28. Master Direction—Import of Goods and Services, Reserve Bank of India, RBI/FED/2016-17/12

FED Master Direction No. 17/2016-17 (Jan. 1, 2016) § C.2(i), <https://rbidocs.rbi.org.in/rdocs/notification/PDFs/12MDFB8AD1B34BCB4D0A8F6869DA4A53082E.PDF>.

29. Income-tax Rules, 1962, § 37BB.

To compute the applicable withholding tax, the franchisee must provide a copy of the invoice and the franchise agreement, a declaration from the franchisor that it does not have a permanent establishment in India, and a copy of the franchisor's tax residency certificate.<sup>30</sup> Regulations also require that the Indian franchisee submit a declaration with the Indian Income Tax Department in relation to the proposed remittances and taxes withheld.<sup>31</sup> Where the payment to be made is under five hundred thousand (INR), a declaration must include payment information in a pre-designated format. Where the payment to be made is over five hundred thousand (INR), a declaration must include a certificate from an assessing officer, an order from the assessing officer, or a certificate from an accountant, as the case may be, along with payment information in a pre-designated format. Where the payment to be made is not chargeable to tax, the declaration must include payment information in a pre-designated format. But, in some cases, franchisees do not need to submit any information.<sup>32</sup> Upon completion of these procedures, the Indian franchisee can make an application to its bank to remit payment to its foreign franchisor. This entire process for effecting the remittances from India usually takes about seven to ten working days.

Therefore, the frequency of payments made by the Indian franchise, and their due dates, must be carefully determined, to ensure that the Indian franchisee is in a position to comply with the foreign exchange control regulations of India.

### B. *Payment of Interest*

Foreign franchisors typically levy interest on any money unpaid by the Indian franchisee after the due date of payment. Although the applicable regulations permit payment of interest by an Indian party to a foreign party, there is a cap on the maximum interest that can be paid.<sup>33</sup>

### C. *Payment of Damages*

Foreign exchange control regulations neither expressly permit nor restrict an Indian party from paying damages and/or compensation to a foreign party for breach of a contract. Although it can be inferred that the FEMA permits remittance of compensation or damages by an Indian party without any prior RBI approval, some Indian banks may seek a confirmation from the RBI that a specific remittance is permissible before they will proceed with the requested transaction. An Indian party's payment of damages to a foreign party must arise out of a bona fide trade transaction and must not be for the purpose of illegally transferring funds outside India.<sup>34</sup>

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30. The Income-tax Act, No. 43 of 1961, INDIA CODE (1961) § 90(4); see Income-tax Rules, 1962, § 21AB.

31. Income-tax Rules, 1962, § 37BB.

32. *Id.*

33. Master Direction *supra* note 28, § C.2(i).

34. *Id.* § B.2.

#### D. *Loan by the Franchisor to the Franchisee*

Some franchise arrangements contemplate financial assistance by the foreign franchisor to the Indian franchisee by way of loans. The Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000 (ECB Regulation), prescribe eligibility conditions for foreign lenders and Indian borrowers for various categories of loans. In addition, ECB regulations also prescribe other conditions including due date for repayment, interest payable, and RBI approval requirements. If the franchise arrangement contemplates any financial assistance by the franchisor to the Indian franchisee, the parties' agreement should be reviewed in light of ECB Regulation and prevailing foreign exchange control regulations.<sup>35</sup>

### VI. **Guaranteeing the Performance of the Indian Franchisee**

Foreign franchisors often seek a guarantee from owners of Indian franchisees to safeguard the performance of the franchisees in India. In many transactions, Indian franchisees are required to provide a personal guarantee to the foreign franchisor.

The Foreign Exchange Management (Guarantees) Regulations, 2000 (Guarantee Regulations), framed under the FEMA, specifically list out the specific transactions that a resident Indian can provide a personal guarantee to a non-resident.<sup>36</sup> The Guarantee Regulations also set forth the terms and conditions subject to which a guarantee can be provided by a resident in India to a non-resident.<sup>37</sup> The RBI requires pre-approval of a personal guarantee for a transaction that is not covered under the Guarantee Regulations or where the terms and conditions of a guarantee to be given to a non-resident are different from those permitted under the Guarantee Regulations.<sup>38</sup> Some examples of when an Indian resident can (in terms of the Guarantee Regulations) issue a personal guarantee to a non-resident are (1) guarantees for the performance of a project outside India; (2) bid guarantees; or (3) guarantees securing the performance of a wholly owned subsidiary or a joint venture entity set up by an Indian resident outside India.<sup>39</sup>

The Guarantee Regulations do not expressly permit a resident owner of the Indian franchisee to provide a personal guarantee or a bank guarantee to a non-resident for guaranteeing the franchisee's performance of the franchise agreement in India. Thus, the owner of an Indian franchisee will have to seek prior approval of the RBI before executing a personal guarantee in favor of the non-resident franchisor.

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35. External Commercial Borrowings (ECB) Policy—New ECB Framework, Reserve Bank of India, RBI/2018-19/109 A.P. (DIR Series) Circular No. 17 (Jan. 16, 2019), <https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NT1096DD257F73C9F4BD280F9C2A2CAD084F1.PDF>.

36. The Foreign Exch. Mgmt. (Guarantees) Regulations, 2000, 4 Gen. S. R. & O. 391E § 5 (India).

37. *Id.* § 5.

38. *Id.* § 3.

39. *Id.* § 5.

Franchisors should be wary about the enforceability of a personal guarantee issued by an Indian resident to a foreign resident in contravention of Guarantees Regulation. Although very few judicial pronouncements have been made on this subject, the Delhi High Court in *SRM Exploration Private Limited vs. N&S&N Consultants s.r.o.*<sup>40</sup> addressed the issue of the enforceability of a personal guarantee signed by SRM Exploration in favor of N&S&N Consultants, a non-resident entity, to secure the performance of a potential joint venture. The court ruled that a guarantee issued by an Indian resident to a non-resident in violation of the Guarantees Regulations is not void or unenforceable.<sup>41</sup> However, the court noted that any Indian party providing such a guarantee is liable to pay monetary penalties and face consequences because of violation of the FEMA.<sup>42</sup> Nonetheless, the court upheld the guarantee, noting that a ruling otherwise would send a wrong signal overseas and dissuade foreign entities from relying on guarantees given by Indian entities, which could hamper international commercial transactions.<sup>43</sup>

Although the court's ruling in *SRM Exploration* is progressive, it cannot be considered as settled law on the subject unless the present ruling is upheld by other High Courts or India's Supreme Court. Therefore, foreign franchisors should endeavor to have any guarantee given by an Indian resident conform to the Guarantee Regulations and, further, ensure that the guarantee contract is carefully drafted to protect the franchisor with contingencies, in case the guarantee provided by the Indian resident is deemed unenforceable in the future.

Considering that the owner of an Indian franchisee will have to seek prior approval from the RBI, which is a time-consuming exercise, foreign franchisors also may ask the owner of the Indian franchise to provide a bank guarantee instead of a personal guarantee. The Guarantee Regulations presently permit the Indian franchise to provide a bank guarantee to the foreign franchisor up to \$5 million (USD).<sup>44</sup>

## VII. Franchisors Rights After Termination of the Franchise Agreement

Upon termination of the franchise agreement, foreign franchisors often have a right to either buy the entire franchise business, or to buy selected assets of the franchise business. These rights are generally enforceable by foreign franchisors in India subject to compliance with the applicable FDI Policy and other foreign exchange control regulations.

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40. *SRM Exploration Pvt. Ltd. v. N&S&N Consultants s.r.o.* (2012), 4 COMP LJ 178 (DEL).

41. *Id.*

42. *Id.*

43. *Id.*

44. The Foreign Exch. Mgmt. (Guarantees) Regulations, 2000, 4 Gen. S. R. & O. 391E § 4(3)(iv) (India).

### A. *The Franchisor's Right to Acquire the Franchise Entity*

Any provision of a franchise agreement relating to the foreign franchisor's right to acquire the Indian entity upon termination should be framed keeping in mind the various conditions that could be imposed under the FDI Policy. The FDI Policy provides for the following:

#### 1. The Sectors in Which Foreign Investment in India Is Prohibited

Foreign investment is prohibited completely in certain sectors, including gambling, betting, and casinos.<sup>45</sup>

#### 2. The Maximum Stake That Can Be Acquired by a Foreign Party in an Indian Business

The FDI Policy prescribes the maximum stake that can be acquired by foreign parties in an Indian business engaged in certain specific sectors, such as retail trading, insurance, and banking.<sup>46</sup> For example, as per the current FDI Policy, foreign shareholding cannot exceed fifty-one percent in an Indian entity engaged in "multi brands product retail trading business."<sup>47</sup> "Multi brands product retail trading" describes the sale at one location of goods manufactured by different brands. For example, department stores selling goods manufactured by various companies would be considered "multi brands product retail trading business."

#### 3. The Approvals Required for Acquiring a Stake by a Foreign Party

Although the majority of the business sectors in India are now open for one hundred percent foreign investment without the need for government approval, entry into some sectors requires prior approval of the Government of India.<sup>48</sup> For example, government approval is required for acquiring a stake in an Indian entity engaged in multi-brand product retail trading business.<sup>49</sup>

#### 4. The Minimum Price That a Foreign Party Will Have to Pay for Acquiring a Stake in Indian Business

The FDI Policy states that a foreign entity cannot acquire any stake in an Indian entity at a price that is below the fair market price.<sup>50</sup> The fair market price is calculated based on a formula and guidelines prescribed in the FEMA.<sup>51</sup>

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45. Consolidated FDI Policy, *supra* note 5, § 5.1.

46. *Id.* § 5.2.

47. *Id.* § 5.2.15.4.

48. *Id.* § 3.4; *see* § 5.2.

49. *Id.* § 5.2.15.4.

50. Consolidated FDI Policy, *supra* note 5, Annexure 2 § 1.

51. The Foreign Exch. Mgmt. (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000, §§ 5(1), 6(2)(iii), <https://rbidocs.rbi.org.in/rdocs/notification/PDFs/13270.pdf>.

## 5. The Nature of the Entity in Which a Foreign Party Can Acquire a Stake

The FDI Policy specifically prescribes the nature of the entities in which foreign investment is possible in India. As per the FDI policy, a foreign party can generally acquire a stake in an Indian company or a limited liability partnership.<sup>52</sup> With respect to the acquisition of an Indian company, a foreign party can acquire or subscribe to equity shares or fully and compulsorily convertible preference shares and debentures.<sup>53</sup>

In addition to the conditions listed above, the FDI policy also prescribes various other conditions for foreign investment in India.<sup>54</sup> Therefore, parties should carefully structure a franchise arrangement so that the rights of the franchisor to acquire the Indian business are in conformity with the applicable FDI Policy prevailing at the time that the parties execute the franchise agreement.

### B. Right to Acquire Certain Assets of the Indian Franchisee

In certain franchise arrangements, the franchisor has the right to acquire assets of the franchise business in certain circumstances. FEMA prohibits a foreign entity from acquiring any immovable property in India without setting up a local entity in India.<sup>55</sup> If the franchise agreement confers rights on the franchisor to acquire any right in any immovable property of the Indian franchisee's business, the franchisor will have to first set up an entity in India, subject to the regulations of the FEMA and the FDI Policy.

In cases where the foreign franchisor has the right to purchase any moveable property of the Indian franchisee's business, such rights can be enforced subject to compliance of the applicable trade policy of India, including requiring the franchisor to pay the fair price of the movable property.<sup>56</sup>

## VIII. Relief Available for Breaches of Indian Franchise Agreements

Franchisors can seek relief from a defaulting franchisee in certain cases, and this possibility depends on the terms of the franchise agreement as well as the local laws governing the agreement. If the franchise agreement is governed by Indian law, a party to a contract can seek relief in the form of damages, injunctions, and specific performance of contracts, depending on the nature of damage caused by the defaulting party.

52. Consolidated FDI Policy, *supra* note 5, § 3.2.

53. *Id.* § 3.4.1.

54. *Id.* § 3.

55. The Foreign Exch. Mgmt. (Acquisition and Transfer of Immovable Property in India) Regulations, 2018, §§ 4, 10, <https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NTF21R0904182AB07CBE3672402A91BB19E46B81F3D5.PDF>.

56. Customs Act, No. 52 of 1962, INDIA CODE (1961) (1962) § 73; *see* Master Direction, *supra* note 28, § A.2.

## A. Damages

The Indian Contract Act, 1872 (Contract Act)<sup>57</sup> states that a party that breaches its contractual obligations is liable to pay damages to the non-defaulting party for reasonable and foreseeable monetary loss caused to the non-defaulting party.<sup>58</sup> The Contract Act does not provide for damages for non-monetary losses, such as for mental distress, or loss of reputation arising due to a breach of a contract. Some of the critical issues relating to the award of damages for breach of contract are discussed later.

### 1. Direct and Indirect Damages

The Contract Act provides that a non-defaulting party to a contract is generally entitled to damages for reasonable monetary loss arising in the normal course of business, but not for the extraordinary loss of profits due to any special circumstances.<sup>59</sup>

A non-defaulting party in India can seek indirect damages under a contract only where both parties, at the time of execution of the contract, were aware of special loss that could be caused to the non-defaulting party for non-compliance of the contract.<sup>60</sup>

### 2. Reasonable Damages

As per the Contract Act, a non-defaulting party to a contract is entitled to seek only reasonable damages for the actual monetary loss caused. The provisions relating to damages under the Indian Contract Act are based on the premise that the non-defaulting party should be placed in the same position that it would have been in had the contract not been breached. Indian courts generally do not award punitive or exemplary damages for breach of a contract.<sup>61</sup> However, Indian courts award exemplary damages under the intellectual property laws of India in the case of blatant misuse or misappropriation of intellectual property.<sup>62</sup>

### 3. Liquidated Damages

Parties to a contract can specify the quantum of liquidated damages that a defaulting party would have to pay to the non-defaulting party on breach of the contract. The Indian Contract Act requires that liquidated damages provisions should be a reasonable pre-estimate of the expected loss that could be caused to a party on breach of a contract.<sup>63</sup> If the liquidated damages are found unreasonable or in the nature of a penalty, a court could refuse to award the liquidated damages mentioned in the contract. In such cases, the

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57. The Indian Contract Act, No. 09 of 1872, INDIA CODE (1872).

58. *Id.* § 74.

59. *Id.* § 73.

60. *Id.* § 73 Ill. (l).

61. *Id.* § 74.

62. *Microsoft Corporation vs Ms. K. Mayuri and Ors.*, (2007) ILR 2 Delhi 976.

63. The Indian Contract Act, No. 09 of 1872, INDIA CODE (1872), § 74.

court would assess the reasonable damages that should be awarded to the non-defaulting party.<sup>64</sup>

### B. *Specific Performance of a Contract*

In certain special circumstances, where there are no prescribed standards for the determination of damages or where monetary damages cannot be an adequate remedy for breach of a contract, a non-defaulting party may approach the competent court to seek specific performance of a contract.

But the Specific Relief Act, 1963 (Specific Relief Act)<sup>65</sup> further clarifies that the court cannot order specific performance of a contract in cases where (1) the contract is determinable; (2) the performance of the contract involves continuous duty that the court cannot supervise; or (3) the performance of the contract is dependent on the personal qualifications of the parties that the courts cannot enforce in material terms.<sup>66</sup>

### C. *Interim Relief*

Indian courts are empowered to grant interim relief pending the final determination of substantive rights and liabilities of parties. Because of the length of the judicial process and the time taken for final determination of suits in India, interim relief is a significant remedy available to a party. Interim relief is commonly awarded in the form of injunctions, attachment of property, and award of security deposit.<sup>67</sup>

In disputes between the franchisee and the franchisor, interim relief in the form of an injunction is crucial to prevent misuse of the franchisor's intellectual property and franchise systems. Prior to granting injunctions, a court will weigh the loss that would be caused to the plaintiff on the refusal of an injunction request against the hardship that would be faced by the defendant in the case of granting the injunction. To secure an injunction, the plaintiff will have to prove that (1) the disputes between the parties are bona fide; (2) there is a prima facie case and balance of convenience in the plaintiff's favor; and (3) the plaintiff would suffer an irreparable injury if interim injunction is not granted.<sup>68</sup>

### D. *Enforceability of Restrictive Covenants in a Franchise Agreement*

All franchise agreements have certain restrictive covenants relating to non-disclosure of confidential information, non-compete provisions, and non-solicit restrictions. These restrictions are aimed at protecting the franchisor's trade secret and goodwill in the franchise business.

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64. *Id.*

65. The Specific Relief Act, No. 47 of 1963, INDIA CODE (1963).

66. *Id.* § 14.

67. The Code of Civil Procedure, No. 05 of 1908, CODE CIV. PROC. (1908), § 94.

68. Maharashtra Judicial Academy and Indian Mediation Centre and Training Institute, Law of Injunctions: Temporary Injunction Including Ex-Parte Temporary Injunction, Perpetual Injunction and Mandatory Injunction (2015), [http://mja.gov.in/Site/Upload/GR/Summary%20-%20%20workshop%20dt.%2018.01.2015.\(Civil\).pdf](http://mja.gov.in/Site/Upload/GR/Summary%20-%20%20workshop%20dt.%2018.01.2015.(Civil).pdf).

Among other things, in a franchise arrangement, non-compete restrictions prevent the franchisees and their owners from (1) working with other enterprises that are engaged in a business similar to the franchise business and (2) starting a competing business during the term of the franchise agreement. Non-competes also typically extend for a specified duration after the termination of the franchise agreement. In many franchise arrangements, non-compete restrictions also apply to the key employees of the franchised business.

Under Indian law, non-compete restrictions on the franchisee and its owners during the term of the franchise agreement are generally considered enforceable.<sup>69</sup> However, the enforcement of non-compete restrictions extending beyond the term of the franchise agreement could be a challenge as such restraint may be deemed as an undue restriction on the personal freedom of the Indian franchisee and its owners.<sup>70</sup> Furthermore, non-compete restrictions on employees beyond the term of their employment are generally not enforceable in India.<sup>71</sup>

Terms that provide for reasonable restrictions relating to non-solicitation of employees and non-disclosure of confidential information, even those that extend beyond the term of the franchise agreement, are generally enforceable in India.<sup>72</sup>

## IX. Dispute Resolution

Parties to an international franchise agreement have multiple options for resolving disputes. From the foreign franchisor's perspective, dispute-resolution provisions should enable the franchisor to seek effective remedies against the franchisee in India. It is important to understand the various options for dispute resolution and their effectiveness in order to make the right decision when drafting the franchise agreement.

### A. Resolution of Disputes in Indian Courts

India has a unified judicial system with a hierarchy of courts. India's Supreme Court is the apex court of the country. Subordinate to India's Supreme Court are the High Courts of each state. The district court is the highest civil court positioned below the High Court.

In addition to the district and subordinate courts, various tribunals have been set up for specialized matters, such as income taxes, goods and services taxes, debt recovery, intellectual property, and various others. Appeals from the orders of these tribunals/appellate tribunals lie in the High Court and

69. *M/S Gujarat Bottling Co. Ltd. & Ors. v. Coca Cola Co. & Ors.*, AIR (1955) SC 2372.

70. The Indian Contract Act, No. 09 of 1872, INDIA CODE (1872), § 27.

71. *Percept D'Markr (India) Pvt. Ltd v. Zaheer Khan & Anr.* AIR (2006) SC 3426.

72. *Wipro Ltd. v. Beckman Coulter Int'l*, (2006) 131 D.L.T. 681 (India); *see also Titus v. Adebare*, (2006) 130 D.L.T. 330 (India).

the Supreme Court, as the case may be. The organization of the subordinate courts and tribunals varies slightly from state to state.

### 1. Jurisdiction

A suit should be filed in the appropriate court that has territorial as well as pecuniary jurisdiction over the matter. Courts in India have a defined territorial limit beyond which they cannot exercise their jurisdiction. Similarly, courts can exercise jurisdiction over a matter where the value does not exceed the pecuniary limit prescribed for that court. Subject to pecuniary limitations, a suit must be filed in the lowest court in whose jurisdiction the cause of action arose, or where the defendant resides or carries on a business, or where the defendant personally works for gain.<sup>73</sup> However, suits relating to an immovable property should be generally filed in the court where the immovable property is situated.<sup>74</sup>

### 2. Appeals

Appeals from a district court can be filed with the High Court located in the district court's region. India's Supreme Court is the ultimate interpreter of laws in India and is also the highest court of appeal. A party aggrieved from an order of a High Court may prefer an appeal before India's Supreme Court, provided that the concerned High Court has granted a "certificate to appeal."<sup>75</sup> Notwithstanding, India's Supreme Court exercises appellate jurisdiction over not only the High Courts, but all other subordinate courts and tribunals in India. A party may, at any stage of a suit, make an appeal to India's Supreme Court with its special permission.<sup>76</sup>

### 3. Jurisdiction of Indian Courts in a Contract Governed by the Law of a Foreign Country

Often foreign franchisors tend to prefer laws of their home country as the governing law of a franchise agreement. Therefore, understanding the applicability and enforceability of such foreign governing law in India is paramount.

Although there is no prohibition on Indian courts to adjudicate on disputes arising under a contract governed by foreign laws, in the authors' experience, Indian courts are not typically comfortable exercising jurisdiction in cases calling for the application of foreign law due to their unfamiliarity with foreign laws.

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73. Code of Civil Procedure, No. 05 of 1908, CODE CIV. PROC. (1908), §§ 15, 19, 20.

74. *Id.* § 16.

75. INDIA CONST. art 133.

76. *Id.* art. 136.

#### 4. Timeframe for Disposal of a Case in India

On an average, it takes about three to seven years in disposal of a suit by the court of original jurisdiction and another one to three years in appeal cases.

#### B. Resolution of Disputes in Courts Situated Outside India

Some parties to an international franchise agreement prefer to adjudicate disputes arising under a franchise agreement before a court situated outside India. These types of provisions present challenges for enforcement of a final award against the losing party, so franchisors should be careful in selecting foreign tribunals as their preferred dispute resolution venue.

##### 1. Foreign Judgment from a Reciprocating Territory

A “conclusive” foreign judgment passed by a “superior court” situated in “reciprocating territory” can be enforced in India by filing an execution petition before the appropriate court in India.<sup>77</sup>

A “reciprocating territory” means a foreign country that is notified as a reciprocating territory (for enforcement of foreign judgments) by the central government of India.<sup>78</sup> At present, only thirteen countries have been notified by the Indian central government as reciprocating territories for this purpose.<sup>79</sup> The term “Superior Courts” means courts situated in the reciprocating territory that are notified as superior courts by the central government of India.<sup>80</sup>

A foreign judgment will be considered “inconclusive” by Indian courts if<sup>81</sup>

- it is not pronounced by a court of competent jurisdiction;
- it is not given on the merits of the case;
- it is based on an incorrect view of international law or the law of India wherever applicable;
- it is granted in a proceeding that was opposed to natural justice;
- it is obtained by fraud;
- it is founded on a breach of any law in force in India; or
- if any appeal is pending against it in a foreign court.

Despite these broad exceptions, a “conclusive” foreign judgment by a superior court of a reciprocating territory can be executed in India as if the

77. The Code of Civil Procedure, No. 05 of 1908, CODE CIV. PROC. (1908), § 44A.

78. *Id.* §44A, Explanation I.

79. These include the following nations: United Kingdom, Aden, Fiji, Singapore, the United Arab Emirates, Malaysia, Trinidad and Tobago, New Zealand, the Cook Islands (including Niue) and the Trust Territories of Western Samoa, Hong Kong, Papua and New Guinea, and Bangladesh. Naresh Thacker & Rhia Marshall, *Litigation: Enforcement of Foreign Judgments in India*, LEXOLOGY (July 2, 2018), <https://www.lexology.com/library/detail.aspx?g=681612a7-f920-4ad5-8fbb-c37912bb8644>.

80. The Code of Civil Procedure, No. 05 of 1908, CODE CIV. PROC. (1908), § 44A.

81. *Id.* § 13.

foreign judgment was passed by an Indian district court. It takes one to three years to enforce a foreign judgment from a reciprocating territory in cases where the enforcement proceeding is not contested in India on the grounds of inconclusiveness.

Foreign judgments from a superior court of a reciprocating territory that impose punitive damages or penalties, quasi-judicial orders, or judgments from summary trials are generally not enforceable in India.<sup>82</sup> Consequently, any action to enforce a judgment obtained in a jurisdiction outside of India is likely to be very time-consuming and difficult.

## 2. Foreign Judgment from a Non-Reciprocating Territory

Unlike judgments from a reciprocating territory, a foreign judgment passed by a court situated in a non-reciprocating territory cannot be enforced in India directly. A party desiring to enforce a foreign judgment passed by a court situated in a non-reciprocating territory will have to file a fresh civil suit in India with the foreign judgments as supporting evidence.<sup>83</sup> Thus, from a practical perspective, resolution of disputes in a court situated in a non-reciprocating territory should be avoided. The foreign franchisor situated in a non-reciprocating territory, and not willing to subject disputes to the Indian courts, may consider opting for arbitration in a neutral country because it is the most efficacious method for resolving disputes.

### C. Resolution of Disputes Through Arbitration

The government of India has enacted the Indian Arbitration & Conciliation Act, 1996 (Arbitration Act)<sup>84</sup> to provide a framework for facilitating arbitration in India and for enforcing foreign arbitration awards.

The Arbitration Act confers special status to arbitrations involving commercial disputes between an Indian party and a foreign party. The Arbitration Act defines an “international commercial arbitration” as an arbitration involving commercial disputes arising out of a legal or contractual relationship between two or more parties, wherein one of the parties is either a foreign national, company, government, or association of person.<sup>85</sup>

As one of the parties to an international franchise arrangement will be a foreign national/resident, the arbitration between the parties would be deemed an “international commercial arbitration” for purposes of the Arbitration Act. The parties to an international franchise arrangement may select a venue for their disputes either in India, or outside India, in any country that is a signatory to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention) or the Geneva Convention on the Execution of Foreign Arbitral Awards (Geneva

82. *Id.* § 44A, Explanation II.

83. *Marine Geotechnics LLC vs. Coastal Marine Constr. & Eng'g Ltd.*, (2014) 2 Bom. C.R. 769.

84. The Arbitration and Conciliation Act, No. 26 of 1996, INDIA CODE (1996).

85. *Id.*, § 2(f).

Convention). The venue must also be in a country that has been notified by the Indian central government.<sup>86</sup>

Parties to an international franchise agreement that desire to hold their arbitrations in India can opt for either (1) ad-hoc arbitration or (2) institutional arbitration. Institutional arbitration refers to arbitration whose proceedings are governed by the rules of an arbitration institution, for example, Rules of the International Chambers of Commerce. Ad-hoc arbitrations are arbitration proceedings that are not administered by rules of any arbitration institution.

### 1. Non-Interference by Indian Courts Where Parties Have Agreed to Refer Their Disputes to Arbitration

Indian courts cannot assume jurisdiction or interfere in matters where the parties to a franchise agreement have agreed in writing to refer their disputes to arbitration seated in India or in a foreign country pursuant to an arbitration agreement.<sup>87</sup> The terms of arbitration need not to be in a separate arbitration agreement between the parties. Instead, they can be incorporated into the franchise agreement itself.<sup>88</sup>

### 2. Interim Relief

For arbitrations seated in India, both the arbitrator and the jurisdictional court have the power to grant appropriate interim relief to a party.<sup>89</sup> A party can seek interim relief in the form of a temporary injunction, or an order for detention, inspection, and preservation of any property that is the subject matter of a dispute.<sup>90</sup> While awarding interim relief to a party, the arbitrator would be deemed to be discharging the function of a civil court.<sup>91</sup>

In respect of foreign venues for international commercial arbitration, the Arbitration Act confers jurisdiction on Indian courts to provide appropriate interim relief pending the arbitration, provided that the parties have expressly agreed in the arbitration agreement that they will have the right to approach Indian courts to seek interim relief.<sup>92</sup> From the foreign franchisor's perspective, it is likely that interim relief may be required against the Indian franchisee to prevent misuse of intellectual property, the franchise systems, and other assets. Thus, a franchise agreement should clearly mention that the foreign franchisor retains the right to approach Indian courts to seek interim relief in India pending conclusion of arbitration proceedings. In absence of such express provisions, the franchisor may lose its right to seek interim relief from Indian courts.

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86. Currently, the Indian Government has notified fifty countries that are signatories to the New York Convention and the Geneva Convention.

87. The Arbitration and Conciliation Act, No. 26 of 1996, INDIA CODE (1996) §§ 8, 45, 54.

88. *Id.* § 7.

89. *Id.* §§ 9, 17.

90. *Id.* § 17.

91. *Id.*

92. *Id.* § 2(2).

### 3. Choice of Governing Law

In a cross-border franchise arrangement where parties have decided to refer their disputes to arbitration, the parties are free to choose and incorporate the substantive law of any country that would govern the agreement. Franchise agreements with Indian franchisees need not be governed by the laws of India.<sup>93</sup>

### 4. Enforcement of Foreign Arbitration Award in India

A foreign arbitration award will be enforceable in India only if the arbitration tribunal is situated in a country which is a signatory to the New York Convention or the Geneva Convention and also notified as a reciprocating territory by the Government of India.<sup>94</sup> Presently, these territories include the United States of America, Canada, France, and Switzerland.

Indian courts cannot review the merits of foreign arbitration awards. However, the enforcement of a binding foreign arbitration award could be challenged in Indian courts on very limited grounds that are expressly listed out in the Arbitration Act:<sup>95</sup>

- the parties to the agreement were under some incapacity under the laws applicable to them;
- the parties against whom the award is to be invoked were not given proper notice of the appointment of arbitration, or of the arbitration proceedings, or were unable to present their case;
- the award deals with matters that were not submitted to arbitration or outside the scope of the arbitration agreement;
- the composition of the arbitral tribunal, or the arbitral procedure, is not in accordance with the agreement or the law of the country where the arbitration took place;
- the award has not become binding or has been set aside by competent authority of the country in which, or under the law of which, the award was made;
- the subject matter of the dispute is not capable of settlement by arbitration under Indian law; or
- enforcement of the award would be contrary to the public policy of India.<sup>96</sup>

The Arbitration Act was also recently amended in 2015 to provide exactness to the term “public policy of India.”<sup>97</sup> As per the amendment, an award

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93. *Id.* § 28(1)(b).

94. *Id.* § 44; *id.* § 53.

95. *Id.* § 48.

96. The grounds for challenging an arbitration award issued by in an international commercial arbitration seated in India are same as those for challenging the enforcement of foreign arbitration awards. *Id.* § 34.

97. *Id.* § 48, Explanation I.

would be deemed contrary to “public policy of India” only if it is in conflict with the most basic notion of morality and justice or is against the fundamental policy of Indian laws, or where the making of the award was induced by fraud or corruption.<sup>98</sup> The courts are now interpreting “public policy of India” in a very narrow sense. For example, in a recent judicial decision, the court held that a foreign arbitration award that is in contravention of an Indian statutory provision does not in itself amount to a contravention of the fundamental policy of Indian law.<sup>99</sup> Therefore, despite the breadth of the language in the Arbitration Act, the “public policy” defense is not readily available to every party challenging a foreign arbitration award in India. A franchisee would need to prove some patent illegality that goes to the root of the matter on which the award is founded. The court cannot decline to enforce an award merely on the ground of erroneous application of the law by the arbitrator.

A foreign arbitration award passed in an arbitration tribunal seated in a country that is not notified by the Indian central government as a country signatory to the New York Convention or the Geneva Convention may not be enforceable in India.

## X. Conclusion

The rapidly growing Indian economy makes franchising in India seem very attractive to foreign franchisors. Therefore, it is crucial for franchisors to understand the various entry strategies into the Indian market. A wise franchisor must conduct general due diligence of entities in India to ascertain business viability, decide the most attractive entry strategy and structure the franchise arrangement to be compliant with Indian law.

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98. *Id.*

99. *Cruz City 1 Mauritius Holdings v. Unitech Ltd.* (2017) 239 D.L.T. 649 (India).

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