

# Legal Issues in Franchising

- An Indian Perspective



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Nishith Desai Associates is a research based international law firm based in Mumbai, Silicon Valley and Bangalore specializing in information technology, e-commerce, telecommunications, media and entertainment laws, international financial and tax laws and corporate and securities laws. It has acted as strategic and legal counsel to premier corporates in their Internet forays, including IL&FS, GE Capital, Jasubhai Group, software majors such as i2 Technologies, Mahindra British Telecom and communication companies such as Space Systems/Loral, New Skies Satellite, Flag and WorldTel. Apart from structuring and acting for a large number of private equity funds in India, NDA has been involved in American Depositary Receipt (ADR) offerings of Indian companies, representing Wipro, Rediff.com and Silverline Technologies and acting as underwriter's counsel in Infosys Technologies and Satyam's ADR offerings. NDA was involved in the first cross-border stock swap merger from India - BFL's acquisition of Mphasis besides Silverline's recent acquisition of Seranova Inc in an ADR stock swap deal. It is also on the Executive Council of the Franchising Association of India. NDA was recently recognized as the "Indian Law Firm of the Year 2000" by the International Financial Law Review, a Euromoney Publication. It has also been ranked as having a leading practice in Private Equity, Media and Entertainment and IT and telecommunications law for 2001-02 by the Global Counsel 3000.

# LEGAL ISSUES IN FRANCHISING

## An Indian Perspective

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# LEGAL ISSUES IN FRANCHISING

## An Indian Perspective

Aashit Shah\* and Vaibhav Parikh\*  
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### A. INTRODUCTION

Have you developed a unique and useful invention and wish to maximize your profits from it? Do you have an attractive business system to sell goods or render services? Does your company have a reputed brand or unique trademark?

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!).

The concept of franchising has been existent for several centuries now. Franchising has its antecedents in feudalism and in licenses granted by kings in the middle ages.<sup>1</sup> The guild system that was introduced in the London in the twelfth century is one example.<sup>2</sup> While franchising as a concept, has still not developed into an industry in India, it is a growing phenomenon of business organisation and sales or services distribution<sup>3</sup> world over, especially in the United States<sup>4</sup> and United Kingdom.<sup>5</sup>

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<sup>1</sup> W. Blackstone, "Commentaries on the laws of England" 37-38 (1766) as quoted in Robert W. Emerson, "Franchising and the Collective Rights of Franchisees" (1990) 43 Vand. L. Rev. 1503 at p. 1507.

<sup>2</sup> Martin Mendleson, "The Guide to Franchising" 1993 (5<sup>th</sup> Edn.) at p. 19.

<sup>3</sup> Robert W. Emerson, "Franchising and the Collective Rights of Franchisees" (1990) 43 Vand. L. Rev. 1503 at p. 1506.

<sup>4</sup> David Gurnick, "Case History of the American Business Franchise" (1999) 24 Okla. City U.L. Rev. 37.

<sup>5</sup> Franchising accounts for approximately one third of UK retail sales in applicable sectors. North American-origin franchise systems operate in the UK, with more than 4,200 franchised units employing 35,000 staff, generating a turnover of \$1.6 billion. See, <http://www.usatrade.gov/website/ccq.nsf/CCGurl/CCG-UK2002-CH--005A18D2> (As visited on March 2, 2002).

This paper examines the meaning of franchising and outlines certain distinct advantages, as well as risks associated with franchising. The paper also analyzes the various legal issues pertinent to a franchising arrangement in India and underscores the importance of properly documenting the franchise agreement, whilst highlighting some points that all contracting parties should keep in mind. The main aim and object of this paper is to serve as a basic guideline for any potential franchise arrangement in India.

## **B. WHAT IS FRANCHISING?**

### **1. Meaning**

The Indian law does not define franchising. However, simplistically put, franchising is a method of distributing products or services. The *Blacks Law Dictionary* defines a franchise as a license from the owner of a trademark or trade name permitting another to sell a product or service under that name or mark.<sup>6</sup>

In a normal franchise agreement, there are at least two parties involved:

- (a) the franchisor, who lends his trademark or trade name (or other intellectual property rights) and the business system; and
- (b) the franchisee, who pays a royalty and often an initial fee for the right to do business under the franchisor's name and business system.<sup>7</sup>

### **2. Characteristic Features**

By drawing from the definitions ascribed to franchising by the British Franchise Association,<sup>8</sup> the International Franchising Association<sup>9</sup> and the Federal Trade Commission of the United States<sup>10</sup>, the following characteristic traits of franchising emerge:<sup>11</sup>

- (a) A franchise arrangement is based upon a contractual relationship.
- (b) The franchisor should have developed a business system or format, which is identified with a brand name.
- (c) The franchisee makes a substantial initial capital investment and normally owns the business operation.
- (d) The franchisor normally trains the franchisee to ensure that it is equipped to effectively comply with the business system.
- (e) Once the franchisee's business commences, the franchisor continually supports the franchisee in certain aspects of the business operation.
- (f) The franchisor also regularly supervises the franchisee's business operations in order to protect the franchisor's goodwill and brand name.
- (g) Some form of consideration is paid by the franchisee to the franchisor for the rights licensed and the services rendered.

<sup>6</sup> Blacks Law Dictionary, (6<sup>th</sup> Ed.) Centennial Edition (1891-1991) at p. 658.

<sup>7</sup> <http://www.franchise.org/resourcectr/faq/q1.asp> (As visited on February 25, 2002).

<sup>8</sup> See <http://www.british-franchise.org/whatis.html> (As visited on March 2, 2002).

<sup>9</sup> See <http://www.franchise.org/resourcectr/faq/faq.asp> (As visited on February 27, 2002).

<sup>10</sup> See [http://www.prenhall.com/divisions/bp/app/berman3/cw/retail\\_resources/FTCFranrule.html](http://www.prenhall.com/divisions/bp/app/berman3/cw/retail_resources/FTCFranrule.html) (As visited on March 4, 2002).

<sup>11</sup> See Martin Mendleson, "The Guide to Franchising" 1993 (5<sup>th</sup> Edn.) at p. 11.

### 3. Types of Franchising Agreements

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. *Product franchising* involves the franchisee concentrating on one manufacturer's product, and thereby acquiring the manufacturer's identity to some extent.<sup>12</sup> Typical examples are automobile dealerships and gas service stations. However, the 1950's witnessed the dawn of a new form of franchising, *Business Format franchising*, wherein the franchisee has to follow strict guidelines and operational standards on product development and marketing.<sup>13</sup> Examples of business format franchising include restaurants, convenience stores, and personal and business services.

In order to understand franchising better, it would be useful to consider some of the usual types of franchising agreements.<sup>14</sup>

- (a) *Invention Licensing Agreement*: This kind of an agreement is common in a situation when a person has created a new invention and seeks to maximize the fruits of his invention, by firstly patenting the invention and thereafter exploiting it on a nationwide or worldwide platform. Such an agreement focuses on the licensing of patent and design rights and the manufacturing and marketing of the invention.
- (b) *Trademark Licensing Agreement*: In order to build brand equity, the owner of a trademark can grant a licence to another person to use the trademark on goods, which are associated with that particular trademark. This type of an agreement may be for the manufacture, preparation, marketing, presentation, and sale of goods and would generally contain provisions to preserve the standard of quality of the goods and the goodwill and reputation of the brand.
- (c) *Character Merchandising Agreement*: In such an agreement, the name of a famous entertainment or sports personality or probably a fictional or graphical character is licensed to be used on certain products. This kind of an agreement would necessarily concentrate on provisions to protect the reputation and / or copyright associated with such personalities and / or characters.
- (d) *Dealer / Distributor / Marketing arrangements*: These are the most common franchising agreements where usually the dealers or distributors adopt a particular business system or format of the franchisor. Generally these agreements are entered into in cases of dealerships with automobile companies (such as with Hyundai and Maruti Udyog), food and consumer goods chains (such as McDonalds and Barista), petrol pumps and gas stations (such as Hindustan Petroleum) et al.

### 4. Pros and Cons of a Franchising Arrangement

Though franchising can be a very profitable business arrangement for the franchisor and the franchisee, if not entered into properly or looked after well, it could prove quite the contrary.

<sup>12</sup> David Gurnick and Steve Vieux, "Case History of the American Business Franchise" (1999) 24 Okla. City U.L. Rev. 37 at p. 48.

<sup>13</sup> McDonalds and Domino's Pizza are examples of business format franchising.

<sup>14</sup> Please note that this does not purport to be an exhaustive list of arrangements / agreements.



This section aims at highlighting some of the benefits and assessing some of the risks that could arise in franchising. The following tables briefly summarize the pros and cons from the franchisor and franchisee's viewpoints.

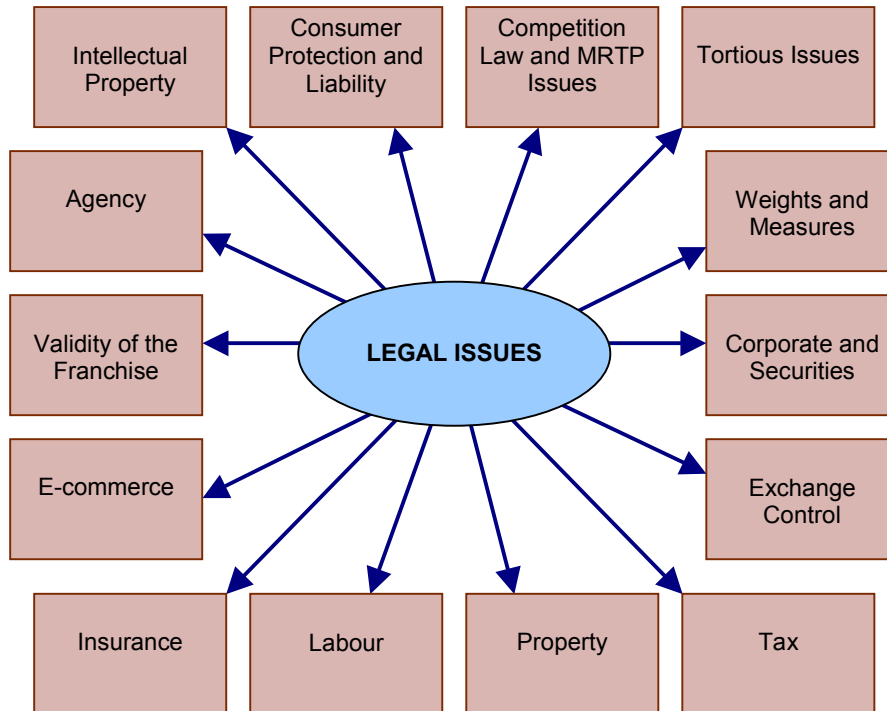
FRANCHISOR'S VIEWPOINT	
PROS	CONS
Financial investment and commitment is limited.	Difficulty in finding a suitable person as a franchisee
Reasonable (some times, high) profits and exponential growth of brand equity, without high-capital risks.	Loss of goodwill / dilution of brand, if the franchisee acts independently and does not adhere to certain basic standards
Exploitation of a wider territorial area, not typically within his/its scope.	Breakdown of a trust-based relationship between the parties or difficulty in receiving co-operation from franchisees
Manpower resources looked after by the Franchisee. Consequently, fewer labour problems to cope with.	Franchisee may not disclose complete and accurate income for calculation of franchise fees

FRANCHISEE'S VIEWPOINT	
PROS	CONS
Capitalizing and benefiting from the Franchisor's invention / brand / business systems / know-how.	Imposition of controls and supervision by the franchisor.
Elimination of unnecessary expenses due to franchisor's experience and pilot operations.	Heavy initial capital investment, in addition to consideration for using the franchisor's invention / brand / business systems / know-how and receiving the franchisor's services.
Continual assistance from the franchisor while operating the business.	Dependence on the franchisor may hinder the franchisee's personal drive.
Benefit from the franchisor's advertising and promotional campaigns.	Franchisor's policies may affect the franchisee's profitability and business operations.
Benefit from the franchisor's negotiating and bulk purchasing power.	

### C. LEGAL ISSUES IN FRANCHISING

While the concept of franchising seems fascinating and simple, there are several issues that must be dealt with before commencing a sound franchising arrangement. Though there is no specific law pertaining to franchising in India, franchising as a business touches upon various business laws and industry specific laws within the country.

It would be important to understand how these different laws can affect a franchising business in India and what are the issues that could arise thereunder.



## 1. 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.<sup>15</sup> The following elements are required to constitute a contract:

- (a) an agreement, i.e. an offer and an acceptance of the offer;<sup>16</sup>
- (b) lawful consideration for the agreement;<sup>17</sup>
- (c) lawful object and purpose of the agreement;<sup>18</sup>
- (d) free consent of the parties to the agreement;<sup>19</sup> and
- (e) capacity of the parties to enter into an agreement.<sup>20</sup>

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

<sup>15</sup> Section 2(h) of the Indian Contract Act, 1872 ("**Contract Act**").

<sup>16</sup> Section 2(a) and 2(b), Contract Act.

<sup>17</sup> Section 23, 24 and 25, Contract Act.

<sup>18</sup> Section 23 and 24, Contract Act.

<sup>19</sup> Section 14, Contract Act.

<sup>20</sup> Section 11, Contract Act.



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*,<sup>21</sup> the 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,<sup>22</sup> 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 trade marks/trade names during the subsistence of a franchise agreement including the period of the period of one years' notice, is not violative of Section 27 of the Contract Act.

However, the Court did not address the issue of a negative covenant post-termination of the agreement. This is an issue that the parties must bear in mind while formulating the contract.

## **2. Constitution of an Agency**

While normally franchisors and franchisees intend to create an independent contractor relationship,<sup>23</sup> sometimes, depending upon the nature of the contract, the relationship between the franchisor and the franchisee could be considered to be an agency.<sup>24</sup> 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.

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<sup>21</sup> 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](http://www.manupatra.com) Ref: MANU/SC/0472/1995. See also (1995) 5 SCC 545.

<sup>22</sup> 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.*

<sup>23</sup> 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.

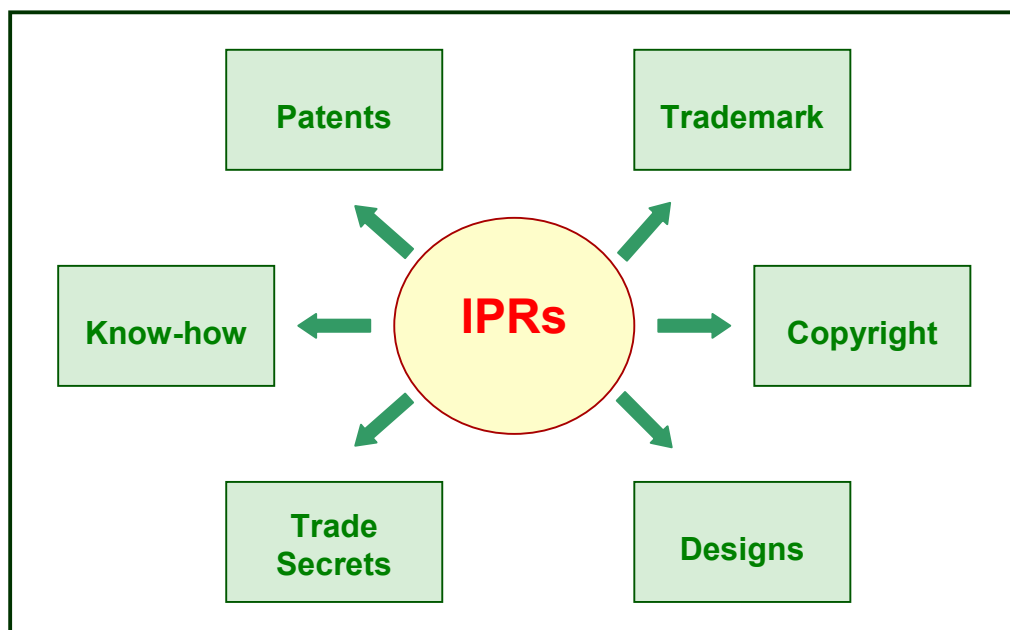
<sup>24</sup> Under Section 182, Contract Act, an "agent" is a person employed to do any act for another, or to represent another in dealing with third persons. The person for whom such act is done, or who is so represented, is called the "principal".

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.<sup>25</sup> 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.<sup>26</sup>

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.

### 3. Protection of Intellectual Property Rights

All franchising agreements involve the transfer of some form of intellectual property, either an invention or a patent for the invention or a design (in the case of a manufacturing agreement), or a trademark or trade name (eg. Bata shoes) or a business format / know-how / trade secret (eg. McDonalds and Barista coffee chain) or copyright (in the case of character merchandising agreements). Since the intellectual property licence lies at the core of a franchise, the laws governing licensing of intellectual property constitute the heart and arteries of franchise laws.<sup>27</sup> An understanding of issues that could arise in this arena is vital for any franchising business.



(a) **Due Diligence:** Before entering into a franchising agreement, the franchisee must ensure that any intellectual property rights being licensed under the agreement exist and that the

<sup>25</sup> Section 211, Contract Act.

<sup>26</sup> *Union of India v. Moti Lal* (1962) A.P. 384.

<sup>27</sup> David Gurnick, "Intellectual Property in Franchising: A Survey of Today's Domestic Issues" (1995) 20 Okla. City U.L. Rev. 347 at p. 348.

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 taken, it could result in liabilities also 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 conform 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.<sup>28</sup> Similarly, while transmitting trademarks, the franchisor must ensure that the transmission 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.<sup>29</sup> 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.<sup>30</sup>
- (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.<sup>31</sup> Careful drafting the franchise agreement could minimize the risks arising from such litigation.
- (e) **Passing off action for trademarks:** 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. Similarly, neither party should use any unregistered trademark of a third person so as to cause confusion in the minds of the public at large.
- (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/she 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 agreement<sup>32</sup> and prevented from divulging any

<sup>28</sup> Section 30 and 30A, Copyright Act, 1957.

<sup>29</sup> Section 40, Trademarks Act, 1999.

<sup>30</sup> In the US case of *Getty Petroleum Corp v. Island Trans. Corp.*, 862 F. 2d 10 (2d Cir. 1988), the defendants who were gasoline distributors (franchisees) were held liable for delivering gas which was not the plaintiff's (franchisor's) brand but was subsequently sold under the plaintiff's trademark. The court found the franchisee liable for intentional misbranding.

<sup>31</sup> See *Philadelphia Gear Corp. v. Philadelphia Gear de Mexico S.A.*, Bus. Franchise Guide (CCH) paragraph 10,370 (E.D. Pa. 1993).

<sup>32</sup> See *Gujarart Bottling Co. Ltd. v. CoCa-Cola Co. Ltd.* (1995) 5 SCC 545.

confidential information, trade secrets and know-how during and even post-termination of the agreement.<sup>33</sup>

#### **4. Consumer Protection and Product Liability**

Complaints and legal action from consumers is a potential issue that both the parties must bear in mind. Such lawsuits are not uncommon in the United States,<sup>34</sup> and can definitely arise in the Indian context.

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.<sup>35</sup> In case of a franchise, the franchiser and the franchisee could be held liable for any defective goods or services supplied by the franchisee. 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.

#### **5. Competition law and Unfair Trade Practices**

Anti Trust or restrictive trade practice, whereby the agreement between the franchiser and franchisee tends to snub market competition is another issue. Interestingly in the US, the ice cream manufacturer Baskin Robbins was accused of imposing an illegal tying arrangement when it required all franchisees to buy their ice cream from Baskin Robbins.

In India, the Monopolies and Restrictive Trade Practices Act, 1969 ("**MRTP Act**") has been enacted<sup>36</sup> to prevent concentration of economic power, control monopolies and prohibit monopolistic trade practices<sup>37</sup> and restrictive trade practices.<sup>38</sup> The franchisor or franchisee must ensure that their practices do not classify as monopolistic or restrictive, or else the Commission under the MRTP Act can grant an injunction to prevent such trade practices<sup>39</sup> and may also award compensation for any losses or damage suffered thereby.<sup>40</sup>

For example, if the franchisor demands that the franchisee must not sell goods below a particular price,<sup>41</sup> or if the franchisee makes a false representation about his services or products,<sup>42</sup> or if the franchise manipulates, distorts, contrives or embellishes the intellectual property of the franchisee,<sup>43</sup> it could give rise to action under the MRTP Act.

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<sup>33</sup> See *Niranjan Shankar Golikari v. Century Spg. And Mfg. Co. Ltd.*, (1967) 2 SCR 378.

<sup>34</sup> A woman initiated a lawsuit against McDonalds for thousands of dollars when she spilt hot chocolate on herself. See, <http://pub50.ezboard.com/fwulfamilyfrm21.showMessage?topicID=61.topic> (As visited on March 4, 2002).

<sup>35</sup> Section 2(1)(c), Consumer Protection Act, 1986.

<sup>36</sup> Preamble, MRTP Act, 1969.

<sup>37</sup> Section 2(i) of the MRTP Act defines monopolistic trade practice.

<sup>38</sup> Section 2(o) of the MRTP Act defines restrictive trade practice.

<sup>39</sup> Section 12A, MRTP Act.

<sup>40</sup> Section 12B, MRTP Act.

<sup>41</sup> See *Warsi Sales Corporation*, RTP Enquiry No. 1618/1987, Order dated 15-1-1988.

<sup>42</sup> See *R.K. Towers India Private Ltd.*, RTP Enquiry No. 342/1988, Order dated 22-7-1988.

<sup>43</sup> See *Manju Bhardwaj v. Zee Tele Films Ltd.* (1996) 20 CLA 229.

Further the MRTP Act also mandates that agreements relating to restrictive trade practices for the provision of services or for the production, storage, supply and distribution or control of goods must be registered<sup>44</sup> with the Director General. However, the mere registration of such agreements does not mean that these agreements are *per se* illegal or void.<sup>45</sup> But if a person, without reasonable cause, fails to register such agreements, he could be liable for imprisonment upto three months, or with a fine of upto Rs. 5,000 or both, and a fine of Rs. 500 for every continuing day of such offence.<sup>46</sup>

A franchising agreement could often come under the purview of such “restrictive trade” agreements and therefore it would be advisable to ensure whether these agreements need to be registered. For example, in one case, the MRTP Commission held that a stipulation in a dealership agreement that sub-serving dealers will be appointed only with prior permission of the manufacturer/supplier would tantamount to a restrictive trade practice.<sup>47</sup>

However, in another case,<sup>48</sup> there was an agreement between two parties, whereby one was to manufacture beer in accordance with the technical expertise and know-how provided by the other party and under the technical direction of the other party. There were certain restrictions concerning the appointment of personnel and also a restriction on the party from manufacturing beer for a third party. It was contended that this agreement was for the mutual benefit of the parties and the restrictions and conditions on manufacturing were necessary as safeguards to ensure the purity and quality of the brands. The Commission held that the restrictions on the appointment of personnel were fine, but the restriction on manufacturing beer for another party was violative and therefore declared void. When a review application of the order was made, the Commission ordered to rephrase the clause rather than completely deleting the same.

Therefore, depending upon the circumstances in each franchising arrangement, the agreement may or may not have to be registered.

## 6. Tortious Liability

A tort is a civil wrong independent of contract for which the appropriate remedy is an action for unliquidated damages.<sup>49</sup> 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.<sup>50</sup> 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.

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<sup>44</sup> Section 33, MRTP Act.

<sup>45</sup> S.M. Dugar, “Law of Monopolistic, Restrictive and Unfair Trade Practices” (1997), 3<sup>rd</sup> Ed., at p. 296.

<sup>46</sup> Section 48, MRTP Act.

<sup>47</sup> See *In re Garware Plastics Polyester Limited*, RTP Enquiry No. 1272/1987, Order dated 5-10-1987.

<sup>48</sup> See *In re United Breweries Limited and Indo Lawenbrau Breweries Limited*, RTP Enquiry No. 62/1984, Order dated 4-6-1986.

<sup>49</sup> Justice G.P. Singh, “Law of Torts” (1997), 23<sup>rd</sup> Ed., at p. 4.

<sup>50</sup> *Jay Laxmi Salt Works (P) Ltd. v. State of Gujarat*, (1994) 4 SCC 1.

However, if the franchisee has acted outside his capacity or contrary to the instructions of the franchisor, the franchisor may be able to recover any damages from the franchisee. If the franchisee is an independent contractor,<sup>51</sup> the franchisor may not be liable for the tortious acts of the franchisee.

## **7. Weights and Measures**

If a franchising agreement pertains to the sale or distribution of goods by weight, measure or number, the Standards of Weights and Measures Act, 1976 and the rules made thereunder could become applicable.

For example, under the Standards of Weights and Measures (Packaged Commodities) Rules, 1977, all commodities which are to be sold in packages must conform to certain standards, and each package must have certain declarations. Even packaged commodities that are exported from and imported into India have to comply with certain norms. Therefore, depending upon the nature of the franchise, the franchisor or the franchisee may have to conform to these laws.

## **8. Corporate and Securities issues**

In the event the franchisor or franchisee is a company, the provisions of the Companies Act, 1956 and other rules and regulations pertaining to companies in India would become applicable. An important issue to bear in mind is that the directors of the company could become liable and responsible for its actions. Moreover, the franchisor or franchisee's income would be subject to tax rates applicable to companies.<sup>52</sup> Further, if the franchisor decides to enter into a joint venture with franchisees, it would have to comply with sector and industry-specific regulations.<sup>53</sup>

## **9. 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.

As per the FEMA rules,<sup>54</sup> prior approval of the Reserve Bank of India ("**RBI**") is required for making remittances outside India for use/and or purchase of trademark/franchise in India. While the RBI has not prescribed any cap on lump sum payments to be made by Indian franchisees to their foreign counterparts, trade usage would be an important ingredient to justify to RBI on the amount of lump sum payments agreed between both the parties.

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<sup>51</sup> 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.

<sup>52</sup> Currently the tax rate for Indian companies is 35.7% and for foreign companies is 48%. The Indian Budget 2002-2003 proposes to amend the tax rate for Indian Companies to 36.75% and for foreign companies to 42%.

<sup>53</sup> The Budget 2002-2003 has announced that the cap on overseas direct investment is to be increased from US\$ 50 million to US\$ 100 million. This increase would encourage joint ventures abroad. Indian companies wishing to franchise abroad should take advantage of this feature.

<sup>54</sup> The Foreign Exchange Management (Current Account transactions) Rules, 2000 Rule 5 read with Schedule III (16)



Further, no prior Government approval is required for royalty payments upto 2% for exports and 1% for domestic sales on use of the trademarks and brand name of the foreign collaborator without technology transfer.<sup>55</sup> However, in case the franchisee and franchisor also have a technology collaboration agreement, then payments by way of royalty upto 5% on local sales and 8% on exports, and lump sum payments not exceeding US\$ 2 million are permitted without approval. In the event the consideration payable under the franchise agreement exceeds this limit, prior approval of the Ministry of Commerce and Industry will be required.<sup>56</sup>

## **10. Taxation**

Royalties paid by the franchisee to the franchisor for the use of the franchisor's intellectual property rights, would be subject to tax at 20% on gross amount paid.<sup>57</sup> In case of an international franchise agreement, this rate could be reduced depending upon the provisions in any double taxation avoidance agreement.<sup>58</sup>

## **11. Property Law**

Laws affecting real estate and leasehold property form an important part of franchising. A careful evaluation of the property laws would be required in order to determine whether the franchising scheme is possible. If the scheme not possible, necessary adjustments would have to be made and possibly fundamental rethinking may have to be engaged in.<sup>59</sup>

## **12. Labour Law**

Depending on the nature of the franchise arrangement and the amount of control<sup>60</sup> the franchisor has over the franchisee's business operations, different labour law issues could arise. These issues could be based on:<sup>61</sup>

- (a) the relationship between the franchisor and the franchisee;
- (b) 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
- (c) 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.

For example, in the US, in one case,<sup>62</sup> the court held that franchised limousine drivers were employees since the franchise was for a short term, the franchisor had complete discretion of renewal, the franchisor chose the franchisee's vehicle, the level of insurance, uniform and the

<sup>55</sup> Press Note 9 (2000 series) issued by the Ministry of Commerce and Industry.

<sup>56</sup> G.S.R. 381(E) dated 3-5-2000 issued by the Central Government in consultation with RBI.

<sup>57</sup> Section 9(1)(vi), Indian Income Tax Act, 1961.

<sup>58</sup> For example, under the Indo-US Double Tax Avoidance Agreement, royalties are taxed at 15% of the gross amount.

<sup>59</sup> Martin Mendleson, "The Guide to Franchising" 1993 (5<sup>th</sup>. Edn.) at p. 212.

<sup>60</sup> In *Dharangadhara Chemical Works Ltd. v. State of Suarashtra*, AIR 1957 SC 264, the Supreme Court held that the right in the master to supervise and control the execution of the work done by the servants is a *prima facie* test.

<sup>61</sup> Legislations and Regulations relating to Franchising, prepared by the Secretariat of the UNIDROIT (1999).

<sup>62</sup> *Fugazy Continental Corp.* 231 N.L.R.B. 1344 (1977).

fare structure. However, in another case,<sup>63</sup> in respect of restaurateurs, the court held that the franchisees were independent contractors since they selected their suppliers, fixed the prices, made large initial investments and made hiring decisions.

### 13. Insurance Law

In a franchising relationship, the franchisor may want that the franchisee insure its business operations from any risks or hazards, which could in any way prove detrimental to the franchisor's operations. Likewise, the franchisee may also desire that the franchisor obtain an insurance policy for any loss that the franchisee may suffer during the franchise agreement. In all such cases, necessary insurance risks would need to be assessed and appropriate policies would have to be obtained by the concerned party.

### 14. E-commerce issues<sup>64</sup>

In the event a franchising operation is set up on the Internet, besides complying with the regular business and commercial laws relevant to franchising, the franchise would also have to deal with various issues specific to e-commerce. Let us take the following example:

A franchisor sets up a website on which people from various locations can place an order. A consumer visits the website, fills in some personal details and places an order for goods or services. Once the order is placed, the franchisor may by e-mail or VSAT or some other mode of communication, transmit the order to a franchisee located in the area of the consumer. The franchisee in turn would deliver the goods or render the services to the consumer. The website could also display advertisements and may contain links to various pages too. Some of the potential issues are outlined hereunder.

- (a) **Security:** All sensitive and customer information on the websites should be adequately secured from any unauthorized intrusion. The franchisor could also face security threats externally as well as internally. Externally, the company could face problems from hackers, viruses and trojan horses. Internally, the business must ensure security against its technical staff and employees. Security can be maintained by using various security tools such as encryption, firewalls, access codes / passwords, virus scans and biometrics. Apart from adopting adequate security measures, appropriate legal documentation would also be needed. For example, a company could have an adequate security policy that would bind all the people working in and with the company.
- (b) **Privacy:** The franchisor's website may have cookies that store personal information of the users, which they fill in while placing the order. This is a threat to the privacy rights of people. However, presently there exists no legislation in India that upholds the privacy rights of an individual or organisation against private parties. While the Constitution of India upholds the right to privacy as a fundamental right of every citizen,<sup>65</sup> the right is exercisable only against a State action. Even the Information Technology Act, 2000

<sup>63</sup> *Kallmann*, 245 N.L.R.B. 78 (1979).

<sup>64</sup> See, Aashit Shah and Parveen Nagree, "Legal Issues in E-commerce" at [www.nishithdesai.com](http://www.nishithdesai.com) (As visited on February 28, 2002).

<sup>65</sup> Article 19 (1)(a) and Article 21, Constitution of India, 1950. Refer to *Unni Krishnan, J.P. v. State of AP* (1993) 1 SCC 645, *Kharak Singh v. State of U.P* AIR 1963 SC 1295, *Gobind v. State of Madhya Pradesh* (1975) SCC (Cri) 468. & *People's Union of Civil Liberties v. the Union of India* (1997) 1 SCC 318.

addresses the issue of protecting privacy rights only from Government action.<sup>66</sup> Nevertheless, in order to gain the confidence of a wary consumer, protecting their privacy rights is a critical concern for the franchisor and franchisee. Moreover, when the franchising business caters to consumers in foreign jurisdictions, the foreign jurisdictions may have laws that could make the franchisor/franchisee liable for violating the foreign consumer's privacy rights.

- (c) **Liability:** Franchisors should also guard against the potential sources of contractual, statutory and tortious liability arising from the website, which could lead to legal claims against them. Since the Internet knows no boundaries, the owner of a website could be confronted with legal liability for non-compliance or violation of laws of almost any country. Liability may arise due to various activities *inter alia* due to hyperlinking (inserting a clickable link to another site)<sup>67</sup> and framing (incorporating another website into a frame or window appearing within a webpage on the linking site),<sup>68</sup> fraud, libel and defamation,<sup>69</sup> invasion of privacy, trademark and copyright infringement.

## 15. Industry specific issues

Different issues may emerge out of a franchising agreement depending upon the industry and sector to which it caters. Some of the promising sectors for franchising include:<sup>70</sup>

- (a) Healthcare and Diagnostic Centers;
- (b) Restaurants/Cafes (particularly "fast food");
- (c) Computer Education Centers;
- (d) Other Education Centers;
- (e) Entertainment Centers;
- (f) Hotels;
- (g) Retailing; and
- (h) Automobile sector.

Depending upon the sector to which the franchising agreement relates, trade and sector-specific legislations will need to be followed. For example, in order to open a fast-food chain, the franchisor and/or franchisee will need to obtain requisite licenses from the food and beverages department. All such specific laws must be carefully analyzed and adhered to before entering into the franchising relationship.

## D. 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.

<sup>66</sup> Section 69 and Section 72, Information Technology Act, 2000.

<sup>67</sup> See, *The Shetland Times Ltd. v. Dr. Jonathan Wills and Zetnews Ltd* (1997) Sess. Cas. 604 (1996); see also, Dan Goodin, "Scientologists' copyright suit shapes Net liability" June 9, 1999, <http://www.news.com/News/Item/0,4,37622,00.html> (As visited on August 31, 2000).

<sup>68</sup> *Washington Post Co. v TotalNews*, 97 Civ. 1190.

<sup>69</sup> *New York Times Co. v Sullivan*, 376 US 254 (1964).

<sup>70</sup> U.S. Commercial Service, United States Department of Commerce at: <http://www.buyusa.gov/india/en/index.php?page=116> (As visited on February 27, 2002).



## 1. 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. As mentioned in Section B, 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 centers 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 centers, the areas in which these centers would be commenced, the term for which they will operate under this agreement, and whether the agreement is an exclusive or non-exclusive arrangement.

## 2. 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 as trademark, service mark, trade name, copyright, patent, trade secrets or know-how) associated with the franchisor and the exact and specific intellectual property he/she/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 center, 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 centers. 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 centers, 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 loose out on its profitability.

### **3. 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.

For instance, in a franchise arrangement, the franchisor would stipulate certain the 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.

#### **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

- (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 center 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 center 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 center 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 in (2), the 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 on 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 to carry 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 center 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.

#### 4. 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. In our example, the computer center may want that that it be given the sole franchising rights for entire South Bombay. In that case, the agreement would need to exactly stipulate such a clause.
- (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 center may want that the computer institute continuously train new employees regarding the manner in which education and training should be imparted.

#### 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

- (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.

## 5. Consideration

The agreement must specify the royalty or a licence fee and any continuing fee to be paid by the franchisee to the franchisor for the licence 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, it should be specified as to who must obtain the necessary regulatory and legal approvals.

### 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-fulfillment 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. For example, in case of the computer institute, the institute may demand a certain minimum fee for every student that is enrolled with the computer center towards advertising expenditure, in addition to a basic initial fee.

## 6. 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.

## 7. 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.

## 8. 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.<sup>71</sup> 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.

## 9. 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.

## 10. 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.

## 11. 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 more speedier, and

<sup>71</sup> Audi Alteram Partem.

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 would apply. However, in the event one party is foreign, the parties may wish to choose an international arbitration forum such as the International Chamber of Commerce or the American Arbitration Association to adjudicate upon any disputes. In doing so, the parties must be aware of the procedural formalities involved under each type of arbitration and opt for a forum that does not have too many procedural hindrances.

#### **ARBITRATION**

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

## **12. Governing law and Jurisdiction Clauses**

One question that needs to be discussed is whether the parties could choose any law in the world, however alien it may be to the factual character of the agreement, or should their choice be restricted to the law of some country with which the agreement is already factually connected.

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 center of the parties; the situation of the subject matter and so on.<sup>72</sup>

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:

#### **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

- (a) Territorial or activity-based jurisdiction i.e. relating to activities within the territorial limits ascribed to the court;
- (b) Personal jurisdiction i.e. based on the persons who are parties to a dispute; and
- (c) 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.

<sup>72</sup> See, Ashni Parikh and Deanne D'Souza, "Joint Ventures" (1998) at [www.nishithdesai.com](http://www.nishithdesai.com) (As visited on February 28, 2002).

## E. CONCLUSION

Though the business and commercial laws in India can protect and govern a franchise arrangement, there is a growing need to improve this regulatory and legal framework. In 1999, a firm step was taken towards consolidating the franchising industry in India, by establishing the Franchising Association of India (“**FAI**”), through the efforts of the Indo-American Chamber of Commerce. FAI represents the interests of franchisors, franchisees, vendors, consultants and other interested individuals and bodies.

Following the economic liberalization of 1991, several foreign companies with strong brand names have 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 Hertz, Avis and Budget for car rental; Radisson, Best Western and Quality Inns for hotels; Kentucky Fried Chicken, Domino's Pizza, Thank God it's Friday (TGIF), Ruby's Tuesday, and Baskin Robbins for food. Pizza Hut has opened its several outlets and McDonald's has been open for business since 1996. Similarly, Indian companies with strong brand recognition are also using the franchising route to expand business volumes. MRF for automotive tires, NIIT for computer training schools and Apollo Hospitals for healthcare are some examples.<sup>73</sup>

In 2000, the total franchises sales in India were estimated at about US\$ 2 billion, with a growth rate of about 40% per annum.<sup>74</sup> Some statistics state that franchising accounts for about 4% of India's Gross Domestic Product!<sup>75</sup> With the wave of globalization and liberalization having hit the Indian markets, franchising seems to be an alluring and attractive option, not only for domestic companies, but even foreign enterprises.

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<sup>73</sup> India Country Commercial Guide FY 2002, prepared by the U.S. Commercial Service at <http://www.usatrade.gov/Website/ccg.nsf/CCGurl/CCG-INDIA2002-CH--006C4DED> (As visited on March 2, 2002).

<sup>74</sup> U.S. Commercial Service, United States Department of Commerce at: <http://www.buyusa.gov/india/en/index.php?page=116> (As visited on February 27, 2002).

<sup>75</sup> U.S. Commercial Service, United States Department of Commerce at: <http://www.buyusa.gov/india/en/index.php?page=116> (As visited on February 27, 2002).