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FRANCHISING IN INDIA: A BRAVE NEW FRONTIER

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India is an ancient, complex society. A blend of old and new, it is said to be living in all centuries simultaneously. It is the seventh largest and second most populous country with over 1.15 billion people.

The disparity of wealth among the population in India, combined with the multiplicity of cultures, languages, and religions, leads to a complex and chaotic political landscape.

Despite these recent developments, conducting business in India remains a challenge. India's provincial governments and its union government (akin to our federal government) are often characterized by political gridlock, incompetence, and accusations of corruption. ⁿ² It is often said that the British invented bureaucracy, and the Indians perfected it. The legal system is based on English common law. Indians tend to be litigious (India has more lawyers than the United States), resulting in incredibly overburdened court systems. ⁿ³ There are twenty-five million cases pending in India with an average of ten judges per million in population, the lowest ratio in the world. The judges are underpaid and are prone to accusations of corruption. Civil cases can take twenty years or more to get to trial.

ⁿ² On the heels of the Mumbai terrorist attack, prominent lawyers, frustrated with the government's inaction, obtained in the Mumbai High Court a mandatory injunction forcing the provincial government to implement antiterrorist measures that had been studied and promised for many years.

ⁿ³ Recently, the high courts in New Delhi and Bangalore have created mediation centers that have enjoyed considerable success in dispute resolution.

Notwithstanding these challenges, India is expected to become a major economic power in the future. For instance, India has the twelfth largest economy in the world ⁿ⁴ and the fifth largest in terms of purchasing power. ⁿ⁵ Even with the global recession, India's economy grew 6.7 percent in 2009, and the International Monetary Fund projects it to grow by 7.7 percent in 2010. ⁿ⁶ It is clear that those companies that can successfully navigate the chaotic economic, political, and cultural climate in India stand to reap significant benefits.

n4 *India Twelfth Wealthiest Boss in 2005: World Bank*, ECON. TIMES, http://economictimes.indiatimes.com/Mr_Rupee_pulls_India_into_1_trillion_GDP_gang/articleshow/1957520.cms. (retrieved Jan. 26, 2010).

n5 *Country Comparison--Gross Domestic Product (Purchasing Power Parity)*, THE WORLD FACTBOOK (CIA 2009), available at <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html> (retrieved May 9, 2010).

n6 IMF RAISES INDIA'S GROWTH PROJECTIONS FOR 2010 (Jan. 27, 2010), www.topnews.in/imf-raises-india-s-growth-projections-2010-2252514.

India has increasingly close political and economic ties with the United States. The Atomic Energy Treaty was a significant symbolic gesture of trust and cooperation between the countries. Moreover, the United States was actively involved in assisting India in resolving the diplomatic quagmire resulting from the Mumbai terrorist attack in November 2008. The U.S. government is seeking to foster strong relationships with India, with more State Department personnel located in India than in any other country and the Department of Commerce having a presence in all major cities in India.

Most recently, President Obama hosted Manmohan Singh, India's prime minister, at his first state dinner on November 24, 2009 with the theme of "forging friendships, exchanging knowledge and building bridges that last for years." n7 During the dinner, President Obama delivered an apt toast to Prime Minister Singh: "To the future that beckons all of us. Let us answer its call. Let our two great nations realize all the triumphs and achievements that await us." n8

n7 *Obama's First State Dinner Blends Pageantry with Politics*, CNN.COM, Nov. 25, 2009, available at www.cnn.com/2009/POLITICS/11/24/obama.state.dinner/index.html.

n8 *Id.*

Serious interest in franchising as a business model is relatively new in India. Franchising started to flourish only after the government started loosening financial regulations in the early 1990s to encourage a free-market economy. India now has two franchise associations, the Franchising Association of India and the Indian Franchise Association. Although franchising represents a very small segment of the Indian economy, the Franchising Association of India claims that there now are over 600 franchise systems in India; and U.S. franchisors with a presence in India include McDonald's, Pizza Hut, UPS, Medicine Shops, Gold's Gym, and KFC, among others. The Indian Franchise Association claims that there are over 1,100 franchise systems, with over 70,000 franchisees doing over US \$ 4 billion in revenues, employing about 500,000 people, and representing less than 4 percent of India's gross domestic product.

Many of the major Western hotel chains are present in India and have used franchising as a means of expansion. Additionally, due to restrictions on foreign investment in the retail sector, franchising is a viable alternative for foreign retailers.

LEGAL ASPECTS OF FRANCHISING IN INDIA

India has no laws specifically directed at franchising. There is no requirement to register franchise offerings or to use franchise disclosure documents. Additionally, there are no laws in India restricting franchise terminations, transfers, or other aspects of the franchise relationship. Even though India has no laws specific to franchising, there are a number of areas of law that are potentially implicated by cross-border franchising into India.

FOREIGN EXCHANGE CONTROL LAW

Historically, the principal impediment to cross-border franchising in India was the Indian foreign exchange control law. Foreign exchange is governed by the Foreign Exchange Management Act 1999 and the rules and regulations promulgated thereunder. Depending on the payment provisions of the franchise agreement, approval may be required from the Foreign Investment Promotion Board (FIPB). The Indian government has delegated certain powers to the Reserve Bank of India (RBI) to allow for automatic approval of foreign exchange payments for use of trademarks and technology transfers. Royalties of up to 1 percent on domestic net sales and 2 percent on exports are automatically approved for use of trademarks. If the license also involves royalties for technical know-how, automatic approval is granted for royalties of up to 5 percent of domestic net sales, 8 percent of export sales, and an initial fee not to exceed US \$ 2 million.

If the fees exceed these limits (or if the manner of calculating fees are different than permitted under the automatic route), the fees will not be eligible for automatic approval, and the franchisor will be required to apply for FIPB approval. Since 1991, when the country started to liberalize its economy and industry, the government has approved 8,035 technology collaborations between Indian and foreign companies, the bulk of them with companies in the United States, Germany, Japan, the United Kingdom, and Italy. This approval process can be time-consuming and the outcome often uncertain, with FIPB sometimes weighing in on other issues, such as choice of law, in these transnational arrangements. On the other hand, the benefit of explicit approval is that the payment terms are enforceable against the Indian party because the automatic approval criteria are somewhat vague. Possibly due to these regulatory limitations and uncertainties, India seems to lag behind other developing countries in franchising as a method of business expansion. Franchisors are not exactly encouraged by the regulatory obstacles and uncertainties in getting "market rate" fees out of India.

Relief, however, is on the way as the Indian government recently lifted the limits on the automatic route for all foreign exchange payments for use of trademarks and technology transfers. n9 This means that the limits on automatic approval of technology transfers (\$ 2 million initial fee, 5 percent on domestic sales, and 8 percent on exports) and trademark use (1 percent on domestic sales and 2 percent on export sales) will no longer apply and will be unrestricted, subject only to the Foreign Exchange Management Act (Current Account Transactions) Rules 2000. n10 Additionally, the project approval board of the FIPB will be dismantled and replaced with a reporting mechanism led by the RBI and the Ministry of Finance.

n9 Anindita Dey, *Gov't to Free Tech Tie-Ups, Trademark Use*, Bus. STANDARD (Mumbai), Nov. 16, 2009, available at www.business-standard.com/india/news/govt-to-free-tech-tie-ups-trademark-use/376582/.

n10 *Id.*

By eliminating the uncertainty of receiving approval for market fees, many expect that a large influx of foreign brands will begin operating in the country. According to one source, "It will be easier for manufacturing companies in various sectors to bring in the best R&D and high-technologies. It will also help high-margin companies that rely on sought after foreign brands for their business, including companies taking the franchisee route, consulting firms and advertising companies." n11 For franchisors, removing the uncertainty about being able to obtain market rates for their franchising arrangements eliminates the major legal hurdle in forging ahead in India.

n11 *Cap on Technology Transfer Fee, Royalty to Be Scrapped*, FIN. EXPRESS, Sept. 6, 2008, available at www.financialexpress.com/news/cap-on-technology-transfer-fee-royalty-to-be-scrapped/357943/.

TRADEMARKS

As a trademark license typically is the cornerstone of a franchise relationship, trademarks should be properly protected in the host country. In India, trademarks are governed by the Trademark Act 1999 and its Trademark Rules 2002. n12 These statutes provide for protection of trademarks through registration, the ability to bring infringement actions against third parties to seek injunctions, damages, and an accounting of profits. Criminal sanctions are also available, at least in theory.

n12 Trade Marks Act 1999 (47 of 1999), available at www.indiaip.com/india/trademarks/acts/tmact1999/act1999tm.htm; Trade Mark Rules 2002, available at www.indiaip.com/india/trademarks/rules/Rules2002/rules2002.htm.

COMPETITION LAW (ANTITRUST)

As franchise agreements often times contain various restrictions on the manner in which a franchisee conducts business, [*250] the competition laws of the host country may also be implicated. India now has a Competition Act 2002 that outlaws anti-competitive behavior in a manner similar to the antitrust laws in the United States. n13 For example, it declares practices such as price fixing to be unlawful. Additionally, practices such as tying arrangements and exclusive-dealing requirements may be unlawful if they are likely to cause an appreciable adverse effect on competition in India.

n13 Competition Act 2002, available at www.unctad.org/sections/ditc_ccpb/does/ditc_ccpb_ncl_India_en.pdf.

TAXES

As one would expect, India imposes nonresident withholding taxes. Under the India-U.S. double taxation treaty, the relevant withholding tax on franchise fees is 15 percent. n14 However, under the most recent amendment to the Income Tax Act, agreements entered into after June 2005 are subject to a reduced 10 percent withholding tax. n15

n14 Convention Between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, *available at* www.unclefed.com/ForTaxProfs/Treaties/india.pdf.

n15 EMBASSY OF INDIA--WASHINGTON, D.C., TAXATION SYSTEM IN INDIA, www.indianembassy.org/newsite//doing_business_in_india/fiscal_taxation_system_in_india.asp.

BANKRUPTCY

India does not have a functional equivalent of the U.S. Bankruptcy Code. Instead, an Indian company that experiences financial distress will need to go through the dissolution procedures under corporate law. n16

n16 *See generally* NitendraSinghTomar, *CorporateInsolvencyLaws in India*, www.companylawonline.com/search/articles/?b8314145-3399-406f-901c-e72325c521aa.

ARBITRATION/ENFORCEMENT

India was one of the earliest signatories to the 1958 New York Convention on the Recognition and Enforcement of International Commercial Arbitration Awards; the Indian government acceded to the Convention in 1961. n17 Since then, the implementation legislation has been updated. In 1996, India passed a new arbitration act, the Arbitration and Conciliation Act of 1996 (1996 Act), which is based on the UNCITRAL model law, thereby facilitating the enforcement of international commercial arbitration awards. n18 Generally, according to the 1996 Act, an international arbitration award would have equal effect as an Indian court order if (1) the award related to a commercial matter (generally an easy test to apply), (2) the award was from a list of countries to which the New York Convention applies, and (3) the award does not conflict with the public policy of India. n19 The enforcement of a foreign award would be refused on the ground that it is contrary to public policy if such enforcement would be (1) contrary to the fundamental policy of Indian law, (2) contrary to the interests of India, (3) contrary to justice or morality, or (4) tainted by fraud or corruption. n20 Only on these limited bases, which exclude general violations of Indian law and argu-

ments on the merits of the case, would an Indian court review a foreign arbitral award issued under the New York convention. n21

n17 INDIA COMM. OF THE INT'L SECTION OF THE AM. BAR ASS'N, RECOGNITION AND ENFORCEMENT OF FOREIGN JUDGMENTS AND ARBITRAL AWARDS IN INDIA, *available at* www.abanet.org/dch/committee.cfm?com=IC906787.

n18 *Id.*

n19 Section 48 of the 1996 Act lists procedural grounds upon which a court may refuse to enforce a foreign arbitral award. Briefly stated, they are (a) invalidity of the arbitral agreement; (b) violation of due process; (c) the arbitrator exceeding his authority; (d) irregularity in the composition of the arbitral tribunal or the arbitral procedure; (e) failure of the award to become binding, or its being set aside or suspended in the country in which, or under the law of which, that award was made; (f) nonarbitrability of the dispute; and (g) violation of public policy. A court may on its own motion, on either of the last two grounds, decline to enforce a foreign arbitral award.

n20 *Renusagar Power Co. v. Gen. Elec. Co.*, [AIR 1994 SC 860: (1994) CLA Suppl 1 (SC)].

n21 Accordingly, it is advisable that the arbitration clause specifically invoke the New York Convention in contracts with Indian parties or with respect to property located in India.

Recent court decisions, however, have complicated the analysis. The 1996 Act, much like the U.S. Federal Arbitration Act, addresses domestic arbitration awards (part I of the Act) in addition to international arbitration awards (part II of the Act). With respect to domestic awards, the case could be reviewed based on violation of Indian law, whereas, under part II of the Act, foreign arbitration awards could not. In direct contradiction of the language of the 1996 Act, the Indian Supreme Court applied part I of the Act to an international dispute and held that the Indian courts can review a foreign arbitration award for violation of Indian law if (1) the property subject to the award was in India, and (2) the parties did not expressly exclude application of part I of the 1996 Act in the contract. n22 This decision has been met with heavy criticism both internationally and domestically but currently is the state of the law.

n22 *Venture Global Engineering v. Satyam Computer Servs. Ltd.*, *Civil Appeal No. 309 of 2008* (Supreme Court of India Jan. 10, 2008).

As a result, foreign parties seeking to contract with Indian companies or seeking to contract with respect to property located in India should take special care to include proper waiver language in arbitration clauses. n23

n23 Recommended waiver language by Mr. Fali Nariman, a senior advocate of the Supreme Court of India: "In the case of a dispute arising between parties and dispute being referred to arbitration, it is hereby agreed that the defense of public policy will be available only in terms of decision of Supreme Court of India in the case of *Renusagar Power Co. v. General*

Electric Co. [AIR 1994 SC 860: (1994) CLA Suppl 1 (SC)]." INDIA COMM., *supra* note 17; *see also* Tamil Nadu Elec. Bd. v. Videocon Power Ltd., MANU/TN/0135/2009 (decided on Jan. 27, 2009) (holding that based on an express exclusionary clause, a foreign arbitrational award could not be reviewed under part I of the 1996 Act).

The most significant obstacle to enforcement of franchise agreements in India is the overburdened and unpredictable judicial system. Consequently, to the extent possible, one should try to resolve disputes in a forum outside of the Indian court system. As noted above, India is signatory to the New York Convention, and it is commonly recommended that international franchise agreements for India contain mandatory arbitration clauses that specifically invoke the New York Convention and include the waiver language noted above.

Yet, one should recognize that mandatory international arbitration is an imperfect solution. First, international arbitration can only deal with monetary disputes; it is not a vehicle by which disputes over the use of intellectual property rights can be resolved through the issuance of injunctions. Second, any arbitration award is not self-executing, and abiding by the decision of the arbitration panel is a voluntary act. Taking the next step of enforcing an arbitration award in India can be an extremely time-consuming process requiring a considerable amount of perseverance. To convert an international award into a final enforceable judgment, one must proceed through the trial court, the High Court, and potentially the Supreme Court, a process that can take many years. As noted above, India has the lowest per capita ratio of judges in the world, and even international arbitration awards are at risk of being mired in the delays endemic to the Indian judicial system.

Unless the Indian party against whom an award is rendered has assets in other countries with more efficient and predictable judicial systems, the prevailing foreign party will need to enforce the award through the Indian judicial system. Despite the delays discussed above, it is possible to achieve a favorable result using the Indian courts in a reasonable time period. Negotiation and compromise become critical tools to achieve a timely resolution. Often, upon favorable ruling by the trial court, the High Court will require a bond or guarantee of the judgment amount in order to proceed with the appeal, motivating the defendant to settle. Many within the Indian legal system have advocated a streamlined process for enforcement of international arbitration judgments (e.g., direct review by the Supreme Court), with little progress to date. n24

n24 INDIA COMM., *supra* note 17.

INTELLECTUAL PROPERTY RIGHTS AND RESTRICTIVE COVENANTS

Even more challenging for a franchisor are the difficulties of judicially enforcing covenants, such as requirements on the use of trademarks and other intellectual property rights, requirements [*251] to de-identify after termination, and maintenance of the confidentiality of trade secrets. In fact, except in the sale of business context, there is an absolute bar on post-term noncompete provisions and a partial bar on in-term noncompete provisions, which are analyzed for reasonableness on the facts of the particular case. n25 Trade secret and confidentiality protections are also still evolving as an exception to these broad bars on noncompete covenants. n26 Moreover, although the Indian judicial

system is based on common law principles and civil procedures, including the ability to obtain equitable remedies and preliminary injunctive relief, the practicalities of obtaining these pretrial or emergency remedies need to be considered in the context of the severely strained and overburdened court systems. All of this suggests that enforcement of typical covenants in franchise agreements relating to use of intellectual property rights, confidentiality, and noncompetition is likely to be problematic.

n25 Indian Contract Act, § 27 ("Every agreement by which any one is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void.")

n26 *See Zee Telefilms v. Sundial Commc'ns Private Ltd.*, (2003) 27 PTC 457.

DILIGENCE/STRUCTURE

As a practical matter, this highlights the importance of engaging in typical cautionary steps when entering into these types of long-term international relationships. As important as it is to take these steps in connection with any international franchise transaction, it is crucial to do so in countries that have practical limitations on obtaining effective legal recourse. Thus, it is critical to do background checks and financial due diligence, including investigating the candidate's other relationships and dealings with U.S. and other western companies. One should consider whether the candidate has any assets in the United States or elsewhere outside of India that might be attachable in the event of a dispute. One should be cautious in assuming that the candidate will have the same strategic goals, and the candidate's motivations in entering into the relationship should be thoroughly explored. The candidate's ability to perform should also be confirmed. (One should recognize the culturally propensity to say "can do" even though there may be little objective ability to fully perform.) One should also consider to what extent the candidate's payment and performance obligations might be secured in some fashion, such as with standby letters of credit.

CONCLUSION

The future for franchising in India is bright. With a surging economy, large consumer market, and loosening government restrictions, the window of opportunity in India is opening. Despite these positive trends, franchisors should take special care to understand all regulatory, legal, political, and business ramifications of entering the Indian market. In connection with entering the Indian market and monitoring and enforcing franchise systems in India, one needs to recognize the realities and challenges inherent in doing business in India. Enforcing contractual rights remains a challenge due to the ongoing delays within the Indian system. Even with the best of intentions by the Indian franchisee, the project is likely to be challenging due to dealings with government bureaucracies and an inadequate infrastructure. Moreover, if the parties' interests are not aligned or performance is at an unacceptable level, the resolution of any disputes is likely to be problematic. Notwithstanding the challenges, with a thorough understanding of the legal, business, and political landscape together with sound advice and strategy, franchisors can position themselves to succeed in India's potentially lucrative market.