

Legal considerations in operation

by Vivek Ka hpalia & Prerak Hora

Though there is no specific statute on franchising in India, there are a number of laws and regulations that would apply to it. It would be pertinent to understand how these different laws and regulations apply to franchising in India and the various issues one needs to be conversant about.

Enforceability & validity of franchise agreement

Fundamentally, every franchising relationship is formed as per a contract and therefore, the Indian Contract Act, 1872 ("Contract Act") would be applicable to all franchise arrangements which are governed by Indian laws. As per the Contract Act, certain elements such as competency to contract and consideration are required to constitute a valid contract.

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

Constitution of agency: While normally franchisors and franchisees intend to create an independent contractor relationship, sometimes, depending upon the nature of the contract, the relationship between the franchisor and the franchisee could be considered to be an agency. 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. 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.

Protection of Intellectual Property Rights: All franchise systems involve the license to some form of intellectual property (IP), either in the form of an invention or a patent or a design, or a brand, trade mark or trade name or a business format/know-how/trade secret or copyright. An understanding of the laws dealing with IPR is crucial for both the franchisor and the franchisee.

Before entering into a franchise agreement, the franchisee must seek representations and warranties from the franchisor with respect to the franchisor's rights to the IP. The franchisee should also seek a representation and warranty that the IP does not infringe any third party IP. On the other hand the franchisee must undertake and covenant not to misuse the IP. An understanding of all the IP laws governing the IP in question is very important to be able to structure an enforceable IP licensing regime under a franchise relationship.

Consumer Protection and Product Liability: Complaints and legal action from consumers is a potential issue that both the parties must bear in mind.

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 conform to certain provisions of the law. In case of a franchise, the franchisor and the franchisee could be held liable for any defective goods or services supplied by the franchisee.

Competition Law and Unfair Trade Practices: Anti-trust or restrictive trade practice, whereby the agreement between the franchisor and franchisee tends to snub market competition is another issue.

Section 3(4) of the Competition Act, 2002 (Act) states that any agreement amongst enterprise or persons at different stages or levels of the production chain in different markets, in respect of production, supply, distribution, storage, sale or price of, or trade in goods or provision of services, including tie-in arrangement; exclusive supply agreement; exclusive distribution agreement; refusal to deal or resale price maintenance shall be a void agreement if such agreement causes or is likely to cause an appreciable adverse effect on competition ("AAE") in India. Thus, it is to be noted that the vertical agreements shall only be void in the event such agreement causes an AAE within India.

It is noted that the Act only prohibits agreements which have an AAE and not those

agreements whose effect is only partial or otherwise reasonable.

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

- **Negligence:** 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.
- **Vicarious liability:** In the event there is a principal-agent relationship, or an employer-employee relationship between the franchisor and the franchisee, the franchisor could be held liable for any torts committed by the franchisee during the course of the business. However, if the franchisee has acted outside his capacity or contrary to the instructions of the franchisor, the franchisor may be able to recover any damages from the franchisee. If the franchisee is an independent contractor, the franchisor may not be liable for the tortious acts of the franchisee.

Corporate, Securities and Exchange Control 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. Further, if the franchisor decides to enter into a joint venture with franchisees, it would have to comply with sector and industry-specific regulations. 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 there under.

Taxation: Franchisees are required to withhold tax on royalties and franchise fees paid to foreign franchisors. The withholding tax rate on royalty and fees for technical services will be at least 10 per cent under the Income Tax Act, 1961.

The Government of India has recently decided to permit payments for royalty, lump sum fee for transfer of technology and payments for use of trademark/brand name on the automatic route i.e. without any Government approval. All such payments will be subject to Foreign Exchange Management (Current Account Transactions) Rules, 2000 as amended from time to time.

Tax is also required to be withheld by the franchisee on payment of franchise fees to the franchisor. Franchise fees, if not classified as royalty payment or fees for technical services, would fall within the category of business income and would be taxed accordingly. However, there would be no withholding tax requirement on franchise fees paid if the franchise fees are classified, not as royalty or fees for technical services but as business income, and the franchisor is from a treaty country and has no permanent establishment in India. The parties should be well aware of the various applicable tax rates before venturing into the franchise business.

Further, where non-resident franchisor sends management and other personnel to India, it may be required to withhold tax on salaries payable to such personnel for services rendered in India.

Labour laws: Depending on the nature of the franchise arrangement and the amount of control the franchisor has over the franchisee's business operations, different labour law issues could arise.

E-commerce Issues: In the event a franchising operation is set up on the Internet or a part of which uses 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 such as security, privacy, jurisdiction, liability, etc. The Information Technology Amendment Act, 2008 which amended the Information Technology Act, 2000 is the main applicable cyber law of India. The amended 2008 act brings in more offences and penalties under its ambit as compared to the 2000 act. The main objective of both the acts is to promote/facilitate e-commerce as well as give legal recognition to electronic transactions.

Conclusion

With the wave of globalisation and liberalisation having hit the Indian markets, franchising seems to be an alluring and attractive option, not only for domestic companies, but even foreign enterprises. The future for franchising in India seems very bright.