USING LETTERS OF INTENT, TERM SHEETS AND OTHER INTERIM DEAL DOCUMENTS IN INTERNATIONAL FRANCHISING

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1. INTRODUCTION

International franchise agreements have long been used to grant cross-border franchise rights. Initially, international franchising was considered an unusual event for many franchisors. That has now changed, as a sign of our increasingly inter-connected global economy, as large, small, and medium-sized franchise systems all over the world now frequently enter into cross-border franchise arrangements.

As long-term international commercial contracts, international franchise agreements are complex, often highly negotiated, long-term commercial agreements that frequently obligate both parties to commit and/or invest considerable managerial time and resources, not to mention millions of dollars. Negotiations over such arrangements frequently take months, sometimes years.

Franchisors frequently use preliminary agreements or letters of intent or other preliminary documents as the prelude to the more serious business of drafting, negotiating, and agreeing on the final agreement terms. As international franchising has matured, the use of letters of intent have increasingly become a customary tool used by most franchisors in their cross-border activities.

Although much has been written about international franchise agreements, there is relatively little that specifically addresses the use of preliminary agreements or documents in international franchising. This paper addresses that gap.

In this paper we discuss the use of preliminary “agreements” or documents in international franchising. The first set of issues relates to what constitutes such a preliminary agreement or documents, and then whether to use them at all – i.e., what are the pros and cons of using such agreements. The second set of issues relates to the types of laws that apply to letters of intent. These include franchise sales laws that exist in roughly 18 countries as well as other types of laws – e.g., ‘franchise relationship’ laws, the US Patriot Act, tax laws, and other local laws. Finally, we address some of the specific terms to be included in a preliminary agreement and whether such terms should be binding or non-binding.

2. CATALOGUE OF PRELIMINARY AGREEMENTS

These types of preliminary agreements go by various names, including:

- Letters of Intent (“LOI”)
- Memorandum of Understanding (“MOU”)
- Term Sheet
- Heads of Agreement
- Non-binding Offers
- Confidentiality Agreements
In truth, the name of the document usually does not matter and is a function of either the particular industry in which the business operates or the country in which the negotiations are being undertaken. Often times, one of the parties will propose that the title include the word “non-binding” when, in fact, there are some terms that are intended to be binding on the parties, such as confidentiality, exclusivity, or choice of law provisions.

So why would the parties to a transaction undertake to spend the time and effort on an agreement that is largely intended to be “non-binding?” As this paper will set forth below, there are often good reasons not to enter into a preliminary agreement; however, if drafted correctly these types of documents can provide a useful road map of the essential business terms for the definitive documents.

When used correctly, these agreements can facilitate structuring the deal and keep the parties aligned and focused as they move down the critical path towards closing during protracted negotiations. A good preliminary agreement is a road map for both parties, and will typically address the following deal terms:

- Major business points such as price and territory
- Anticipated due diligence
- Anticipated critical path for the transaction and anticipated closing date
- Confidentiality obligations and allocation of the cost of negotiations and documentation
- What type of documentation will reflect the final deal
- Termination rights and any breakup fees

In the context of a franchise preliminary agreement, an additional useful deal term worth considering is a trademark license and indemnity. As set forth in Section 5 below, it is generally a good idea to avoid granting licenses in preliminary agreements. In many franchise transactions, however, the proposed franchisee may be undertaking to solicit investors or lenders during the negotiations. Such solicitations may be either informal or formal. The franchisor has an interest in such solicitations being made legally and using the franchisor’s name and trademarks in an appropriate manner and in connection with an indemnity by the franchisee. Written documentation of these issues that establishes who bears the risks associated with such solicitations can be beneficial for all parties.

Not every international franchise deal needs a preliminary agreement, however. The goal is to enter into definitive agreements on a timely and cost effective basis. Negotiating a preliminary agreement can take on a life of its own as the parties debate exclusivity provisions that, in the end, may not matter. Sometimes going straight to definitive documents makes sense if the parties clearly agree on the basic business points, especially if the timeframe is compressed. Here, knowledgeable local counsel can be of great assistance in determining if such an approach is consistent with the business and legal culture and whether the legal risks associated with unsuccessful negotiations are greater with an oral understanding.
Simply put, perhaps the greatest risk in using these types of documents is that, with respect to those terms not intended to be binding, a court will find that (i) terms intended as an “agreement to agree” are, in fact, a contract or (ii) the failure of one party to complete the transaction is a breach of a fiduciary duty or duty of good faith or is the basis for a claim of reliance or promissory estoppel. Most courts will attempt to determine the intent of the parties from the language in the preliminary agreement, and if the intent is clear that the parties only entered into an agreement to agree other than with respect to terms such as confidentiality, for instance, than most courts are not going to order a party to enter into a definitive agreement or award damages for the failure to do so. Words, however, have a strange elasticity after the fact, particularly between parties in different countries even if negotiating in the same language (one is reminded of the quip, sometimes attributed to George Bernard Shaw and sometimes to Winston Churchill, that England and the United States are “two countries divided by a common language”). “Non-binding” simply may not mean what you think that words means.¹

A useful exercise for an attorney in this context is to ask the business client what he or she hopes to accomplish with the preliminary agreement. Is it intended to provide an indication of commitment, and, if so, what level of commitment? Mixed motives with preliminary agreements can be dangerous. From a drafting perspective, however, the cure to both risks (i.e., unintended contract and claims of bad faith) is similar: clear language stating which terms are non-binding and that the parties may terminate the transaction at any time (or after the conclusion of the exclusivity period) and in their sole discretion.

3. FRANCHISE SALES/DISCLOSURE LAWS APPLICABLE TO PRELIMINARY DOCUMENTS

a) When Are Disclosure Laws Triggered?

An increasing number of jurisdictions throughout the world are enacting pre-sale disclosure laws regulating the sale of franchises. These franchise disclosure laws require franchisors to provide prospective franchisees with varying amounts of information (depending on the jurisdiction) respecting the franchise opportunity and are designed to provide the prospective franchisee with sufficient information to allow him/her to make an informed decision as to an investment in the franchise offered.

Most pre-sale disclosure laws require the franchisor to provide the prospective franchisee with a disclosure document a set number of days before the parties enter into an agreement or the franchisor receives any franchise-related fee. In addition, several

¹ Probably no better example of this exists in the United States as exemplified by the case of Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 768 (Tex. App 1987). In that case, the parties reached an “agreement in principle” “subject to execution of a definitive merger agreement,” and shareholder and governmental approvals. The courts awarded Pennzoil in excess of $10 billion based on a determination that the primary agreement contained all the essential elements of a contract and was a contract with which a third party could not interfere.
jurisdictions require the franchisor to register the franchise opportunity, which often may require filing of the disclosure document, with the jurisdiction. Certain jurisdictions (such as “registration” states in the U.S. as well as South Korea and Vietnam) require registration before commencing franchise sales activities or otherwise concluding the sale of franchises. These jurisdictions generally require registration before a franchisor can make an “offer” or “sale” of a franchise in the jurisdiction. Other jurisdictions (such as China) require registration within a certain time period after an initial (or each) franchise sale. In each such jurisdiction, franchisors must exercise caution in understanding the nuances of franchise disclosure and registration timing requirements.

Compliance with various disclosure and filing requirements becomes more complex when franchisors enter into preliminary agreements, such as letters of intent and deposit agreements, with franchisees. Depending on the jurisdiction involved, preliminary agreements can trigger disclosure and/or registration requirements and result in a violation of applicable franchise laws. Unfortunately, a summary review of various franchise disclosure and registration laws suggests no uniform treatment of preliminary agreements.

In Alberta, for example, the Alberta Franchises Act obligates franchisors to provide prospective franchisees with a disclosure document and describes in some detail the application of those disclosure requirements to certain preliminary agreements. Section 4 of the Alberta Franchises Act requires a franchisor to provide every prospective franchisee with a disclosure document at least 14 days before the prospective franchisee signs “any agreement relating to the franchise, or the payment of any consideration by the prospective franchisee relating to the franchise, whichever is earlier.” While such language appears relatively unlimited in scope and would seemingly impose disclosure obligations whenever a preliminary agreement in any form is used, Section 4 specifically excludes agreements limited to the following provisions:

(7) For the purposes of [sections relating to disclosure obligations], an agreement that contains only terms and conditions relating to any one or more of the following is not a franchise agreement:

(a) a fully refundable deposit;

(b) the keeping confidential or prohibiting the use of any information or material that may be provided to the prospective franchisee;

(c) the designation of a location or territory of the prospective franchised business.

(8) For the purposes of this section, a fully refundable deposit is a deposit that does not exceed the amount prescribed by the regulations (i.e., 20% of the initial franchise fee) that is refundable without any deductions and that is given under an agreement that in no way binds the prospective franchisee to enter into any franchise agreement.

Few other jurisdictions provide such guidance in determining whether preliminary agreements will trigger franchise disclosure or registration obligations.
In the United States, the Amended FTC Franchise Rule (16 C.F.R. Part 436 et seq.) requires a franchisor to provide the prospective franchisee with a franchise disclosure document (FDD) at least 14 calendar days before the prospective franchisee “signs a binding agreement with, or makes any payment to, the franchisor or an affiliate in connection with the proposed franchise sale.” This language is narrower in scope than earlier draft versions of the Rule, a deliberate action by the FTC to address concerns that a mere confidentiality agreement may trigger an obligation to disclose. Although such language, together with the FTC’s commentary, provides some comfort to franchisors, the scope of disclosure under the FTC Rule remains broad.

Separate from disclosure obligations under the U.S. FTC Rule, franchisors also must comply with state franchise registration laws. These laws generally require registration in advance of any “offer” or “sale” of a franchise. The definition of an “offer” under most state franchise laws is sufficiently broad to encompass most or all preliminary agreements. In Minnesota, for example, a franchisor must register under the Minnesota Franchise Act before it can “offer” or “sell” a franchise in Minnesota or to a Minnesota resident. Section 80C.01(16) of the Act defines an “offer” or “offer to sell” to include “every attempt to offer to dispose of, and every solicitation of an offer to buy, a franchise or interest in a franchise for value.” Such an expansive definition severely restricts any promotional activity an unregistered franchisor may conduct, let alone negotiating or completing a binding preliminary agreement.

Contrasting with the broad scope of state registration laws in the U.S., Italy’s Rule on the Regulation of Franchising (“Italian Franchise Law”) would appear to treat preliminary agreements quite differently. Article 4 of the Italian Franchise Law only requires disclosure at least 30 days before the parties sign the definitive franchise agreement. The definition of “franchise agreement” is specific, referring to the actual “grant” of the franchise rights and would indicate (as commentators suggest) that the execution of most preliminary agreements will not trigger a disclosure obligation.

As the scope of international franchise disclosure and registration laws vary significantly from jurisdiction to jurisdiction, franchisors must view each such law/regulation independently to determine the impact of such laws/regulations on preliminary agreements.

b) Consequences of Triggering Disclosure Laws Through Preliminary Documents

Franchisors who operate under the assumption that a preliminary agreement will not trigger applicable jurisdictional disclosure and registration laws may find themselves in violation of these laws. The penalties associated with a failure to comply with these laws are often severe. Common remedies available to injured parties (franchisees) may include a right to rescind the franchise agreement, including the franchisee’s right to recover the investment they have made in the franchise opportunity, and monetary damages. Even if a franchisee

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does not seek such remedies, he/she may use the threat of such remedies to negotiate a more favorable agreement with the franchisor.

In addition to remedies available to injured franchisees, federal and/or state/provincial agencies likely have recourse against the franchisor as well as those associated with the franchisor. Depending on the scope of violations, a government agency may fine or suspend the franchisor’s right to conduct business in the jurisdiction. In more egregious situations, many government agencies may commence civil or criminal proceedings against the franchisor and its principals. These government agencies often have broad investigative powers and the resulting proceedings can be costly and often delay or derail franchisor expansion plans in the jurisdiction. Before franchisors negotiate any preliminary agreement or, for that matter, pursue any franchise sales activity in a foreign jurisdiction, they must fully understand the scope of applicable disclosure and registration laws.

4. OTHER LAWS APPLICABLE TO PRELIMINARY DOCUMENTS

a) Relationship Laws

The nature, scope and consequences of a preliminary document are defined and determined by its binding or non-binding content, which in most of the cases is stipulated by the parties to such kind of documents.

The possible binding content of preliminary documents (or agreements) shall depend on what the parties to such documents agree upon, provided that their provisions will be subject to commercial and civil general principles or rules applicable to all commercial relations.

In Mexico, as well as in most of the countries with civil law systems, there is not a specific catalogue of preliminary documents and, as previously commented, their binding content will depend on what the parties wish to agree upon.

The issuance and content of a preliminary document, such as a letter of intent, a memorandum of understanding, a term sheet or a confidentiality agreement, among others, must be carefully analyzed. The foregoing, to avoid having a party assuming an obligation which was not willing to assume or was not willing to assume in the manner it was reflected in the preliminary document. Each specific jurisdiction may have different rules and principles applying to the manner a party can be considered to be bound; therefore, it is strongly suggested to obtain advice from local legal counsel in each specific country on what kind of preliminary document may or is advisable to be executed with respect to the pursued business.

Usually, preliminary documents contain a mix of binding and non-binding provisions, being the former most related to obligations of confidentiality, non-compete and other provisions related to the kind of business pursued by the preliminary document. In the specific case of Mexico, the parties are free to contract in a number of issues as a result of the principle of contractual freedom contained in Article 78 of the Mexico’s Commerce Code, as long as the parties comply with the general principles of commercial contracts and do not agree on any stipulations that violate public policy or moral standards.
In addition to the foregoing, it is important to note that article 2.1.15 of the Principles of International Commercial Contracts 2004, International Institute for the Unification of Private Law (UNIDROIT), establishes certain terms in connection with negotiations carried out by commercial parties; particularly, the following terms regarding negotiations in bad faith had been considered under such Principles: (1) A party is free to negotiate and is not liable for failure to reach an agreement; (2) However, a party who negotiates or breaks off negotiations in bad faith is liable for the losses caused to the other party; (3) It is bad faith, in particular, for a party to enter into or continue negotiations when intending not to reach an agreement with the other party.

In the specific case of franchises, it is extremely important not to make the necessary distinction between a preliminary document (notwithstanding its binding or non-binding nature) and a disclosure document. A disclosure document does not imply an offer or an agreement to grant a franchise to a prospective franchisee; it only constitutes a document that provides specific information that a franchisor is obligated to provide in connection with a franchise. However, the content of a disclosure document can be protected by a confidentiality agreement, which is a preliminary document with binding effects.

b) **Patriot Act/Other Laws Restricting Business with Certain Parties/Countries**

The U.S. and a growing number of other countries have anti-terrorism laws and sanction programs that restrict or prohibit a franchisor from conducting business with certain individuals or entities or exporting products, technology or services to certain countries. In the U.S., various government agencies aggressively enforce regulations that restrict U.S.-owned or controlled businesses from conducting business with certain individuals and entities. The most publicized list is the suspected terrorist or “specially designated national” (SDN) list that became a focal point in the war against terrorism following the terrorism actions of 9/11 (2001). The U.S. Department of Treasury’s Office of Foreign Assets Control (OFAC) maintains and closely monitors the SDN list and Treasury regulations prohibit any “transaction or dealing” by U.S. persons or entities with specially designated nationals. Many other countries have adopted similar lists of restricted persons and impose severe penalties on persons and entities conducting business with these “restricted” persons.

The U.S. Government, again under the watch of the OFAC, also imposes economic and trade sanctions against targeted countries. While sanctions vary, depending on the country involved (trade involving Cuba is the most severe), they generally prohibit U.S. persons or entities from exporting goods, technology (including technical data), or services, directly or indirectly, to the targeted country. Further, U.S. persons may not approve, finance, facilitate or guarantee any transaction by a foreign person where that transaction by a foreign person would be prohibited if performed by a U.S. person or from the United States.

The prohibition of any “transaction or dealing” with SDNs under OFAC regulations is intentionally broad in scope and the U.S. Government aggressively pursues and punishes violators. Likewise, the prohibitions involving sanctioned countries also is expansive. As a result, any preliminary agreement would likely result in a violation of OFAC regulations. The question as to whether a preliminary agreement may violate U.S. law or similar laws in
other jurisdictions, however, is of secondary importance as the more significant concern is the inability to pursue completion of any transaction under these circumstances.

c) **Tax Laws and Treatment**

In accordance with the Mexico’s Income Tax Law, any individuals or entities residing in a foreign country, are obliged to pay income tax in Mexico with respect to any revenues proceeding from sources of wealth, including from assistance and/or services, located in Mexican territory, when such individuals or entities possess no permanent establishment in our country or when possessing it, said revenues are not attributable to said permanent establishment.

Article 5 of the Mexican Income Tax Law establishes that the benefits derived from International Tax Conventions between any country and Mexico shall be applicable when the taxpayer evidences residency in the respective country. The Mexican Supreme Court of Justice has determined that the application of the Tax Conventions is over the Federal Tax Laws. For instance, this means that a franchisor, resident for tax purposes in the United States of America, has the right to be subject to taxation under the terms of the Convention to Avoid Double Taxation and Prevent Fiscal Evasion entered into by the governments of Mexico and the United States of America, instead of being subject to the provisions of the Mexican Income Tax Law. Normally, the applicable withholding tax rates included in International Tax Conventions to which Mexico is a party are lower than the income tax rate provided by the Mexican Income Tax Law.

In consequence, if a payment is to be made under a preliminary document, it is important to carefully specify the nature, scope and consequences of said payment, to be able to determine if it may imply the application and consequent compliance of tax rules, which may imply the withholding, by the prospective franchisee, of a certain percentage of the payment made to the franchisor. Deposit payments are, in principle, not subject to a withholding tax obligation unless they may be reclassified or converted to payments of other nature upon the occurrence of one or more specific conditions contained in the preliminary document.

d) **Compliance with Local Laws- Permits, Governmental Approvals**

In Mexico, as in many civil law jurisdictions, preliminary documents related to franchise agreements are not subject to the obtaining of any governmental approvals or permits. However, it is strongly recommended to register before the Mexican Institute of Industrial Property (Instituto Mexicano de la Propiedad Industrial) (“IMPI”), the franchisor’s trademarks involved in the franchise before getting involved in any negotiation or entering into a preliminary document with a prospective franchisee or any third party.

5. **BINDING/NON-BINDING CHARACTER OF PRELIMINARY DOCUMENT**

a) **Presumption of Binding/Non-Binding Effects**

When two parties enter into a letter of intent or other preliminary agreement, is there a presumption that such agreements simply are intended to be non-binding expressions of
intent? Under what circumstances will a preliminary agreement become binding on the parties? What steps can franchisors take to avoid surprises when entering into preliminary agreements? To provide guidance in answering these questions, one must separately examine the treatment of preliminary agreements under common and civil law jurisdictions.

In most common law jurisdictions such as the United States and Canada, courts will only deem a contract to exist if there is a “meeting of the minds” on the essential terms of the agreement and will examine the intent of the parties at the time of the execution of the preliminary agreement. Courts often categorize preliminary agreements into one of three categories: (1) agreements to agree or agreements in “principle” where a more formal agreement is anticipated; (2) agreements with open terms - agreements in which the parties intend to be bound but agree to resolve remaining open terms/issues; and (3) letters of intent.

Agreements to agree, as a rule, are not binding on the parties as there is an intent to evidence the agreement in a more formal document. Agreements with open terms, on the other hand, tend to be binding as the parties have a distinct intent to be bound by certain expressed provisions while agreeing to negotiate (often in good faith) to reach agreement on the remaining terms.

A letter of intent and other similar preliminary agreements often are intended as agreements to agree, presenting an outline of an agreement but simply expressing a current intention to negotiate a more definitive and complete agreement. The binding nature of letters of intent often is determined by an examination of the express provisions of the letter of intent. Most letters of intent contain specific language indicating that the document is not binding, or is binding only with respect to certain provisions (as more fully described below).

The common law of contracts usually starts from the proposition that the document represents the intent of the parties to the extent that the language is not ambiguous. The conduct of the parties should not be admissible to establish intent that conflicts with the written terms. As a practical matter, if the conduct is consistent with the preliminary agreement, it should not be relevant to prove intent even if the conduct could be susceptible of two interpretations. If the conduct is either inconsistent with the terms or simply goes beyond the "four corners" of the document, however, a party should be aware of the potential for conduct to establish a binding agreement.

The parties should be sensitive, however, to the potential of a court or arbitrator to look at the conduct of the parties to determine intent. In the context of a preliminary agreement, if the parties take action and begin performance based on the terms in a "non-

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4 See Skycom Corp. v. Telstar Corp., 813 F.2d 810,815 (7th Cir. 1986).

5 See Ruffing v. Masterbuilt Tool & Die, LLC, No. 8-CV-01264, 2009 Lexis 4754 (N.D. Ohio, January 23, 2009), in which the court found that the letter of intent in question clearly indicated that the parties did not intend to create binding obligations.
binding’ term sheet, such conduct may evidence the intent to represent binding terms, such as would be found in a purchase order. The more performance by one or both parties, the easier it is to reach this conclusion. For example, allowing franchisee use of the trademarks or delivering product or proprietary systems when the term sheet is the only documentation could reasonably indicate that the term sheet reflects a definitive agreement. If some performance is necessitated by business realities, the parties can minimize the possibility of their actions being misconstrued while negotiating definitive agreements by documenting how the actions would be unwound if documentation is not finalized.

The intentions of the parties becomes more obscure when the letter of intent or preliminary agreement outlines essential agreed upon terms and manifests an objective to negotiate in good faith to resolve outstanding issues. Certain jurisdictions in the U.S. have acknowledged that agreements to agree, in the form of a letter of intent or other preliminary agreements, can be binding on the parties where the parties have settled on the essential terms of the agreement and the only remaining act to be completed is the formalization of the agreement. In Channel Home Centers, Div. of Grace Retail Corp. v. Grossman, a commercial lessor signed a detailed letter of intent with a potential tenant that required the lessor to withdraw the space from the market and “only negotiate the leasing transaction to completion.” After two months of negotiation, the lessor unilaterally ended negotiations and signed a lease with another tenant. The appeals court overturned the lower court’s grant of summary judgment, concluding that: (1) the parties manifested an intent to be bound by the agreement; (2) the terms of the agreement were sufficiently definite to be enforced; and (3) consideration has been given.

In Channel at 300.

In situations where no contract is found, an injured party may still pursue non-contract theories to recover perceived damages. The most common theory of recovery in U.S. jurisdictions is promissory estoppel – a promise which the promisor should reasonably expect to induce, and does induce, action or forbearance by the promisee is binding if injustice can be avoided only by enforcement of the promise. The theory, based on principles of equity, have expanded in recent years and results can be unpredictable as courts must conclude when a promise must be enforced to avoid an injustice. In Hoffmann v. Red Owl Stores, the franchisor of grocery stores encouraged Hoffmann, a prospective franchisee, to buy a small grocery store to gain practical experience. Hoffmann did so and was successful. Red Owl then suggested that Hoffmann sell the store to raise capital and acquire a site for a Red Owl store. Again, Hoffmann did so only to find that a credit manager at Red Owl overruled prior decisions and determine that Hoffmann did not have sufficient capital to open the store. The court easily found that promises had been made and relied upon. The court also found that

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6 795 F.2d 291 (3rd Cir. 1986).
7 Channel at 300.
8 Restatement (Second) of Contracts 90.
9 133 N.W.2d 267 (Wisc. 1965).
the third element of promissory estoppel also was present – that it would be an injustice not to enforce the promise.

Although courts in common law jurisdictions will give preference to the express provisions of the preliminary agreement in determining whether it creates a binding obligation, courts in civil law jurisdictions are more likely to stray from that principle and find a preliminary agreement enforceable. In France, for example, courts generally will not enforce a letter of intent where the parties clearly express an intent to enter into a subsequent contract. If the instrument is ambiguous, however, French courts appear more willing to find an enforceable contract.¹⁰ In some civil law jurisdictions (e.g., Italy), there is also a risk of pre-contractual liability if one party interrupts negotiations without reasonable justification and there is a sufficiently definite agreement on the essential terms of a preliminary agreement which the other party relies upon.¹¹

Franchisors choosing to use letters of intent and similar preliminary agreements must first determine the purpose of such an instrument. Is the preliminary agreement truly non-binding, binding in certain respects (e.g., confidentiality) or intended to be binding should the parties not enter into a more formal agreement? Franchisors also need to understand the significance of such instruments in the jurisdiction in which the instrument may be challenged. Although letters of intent are used universally, certain jurisdictions are more likely to enforce such instruments and extra care must be used in drafting such documents.


b) **Specific Binding Provisions**

i) Confidentiality

Confidentiality covenants in preliminary documents may be enforceable in several civil law countries such as Mexico, especially if the breach of such obligations is sanctioned with the payment of a conventional penalty and/or constitutes an infringement to the Industrial Property Law.

In order to protect the inappropriate use of the franchisor’s information, it is strongly recommended to include confidentiality provisions in preliminary documents to a franchise agreement, by means of which the prospective franchisee agrees not to disclose any proprietary information of the franchisor that is considered as confidential or to which the franchisee may have access or knowledge as a consequence of the negotiations or of the execution of such preliminary documents, even if the parties fail to reach a definitive agreement.

ii) Payments/deposits

In connection with payments or deposits, Mexican laws allow the parties to preliminary documents to include covenants related to any payments or deposits in order to warrant the compliance of the prospective franchisee’s obligations established therein.

Regarding the foregoing, it is necessary to distinguish payments from deposits. According to the Mexican legislation, any payment derived from a preliminary document, such as those made by the prospective franchisee to cover any costs and expenses into which franchisor will incur for the analysis and/or investigation of the prospective franchisee’s profile, are considered as a consideration and, therefore, they will be subject to the payment of income taxes through the corresponding withholding.

On the other hand, deposits may be considered as a warranty provision, and the delivery of same to a franchisor does not represent any income or revenue to the franchisor, since the franchisor is bound to return such amount of money after certain period of time and/or upon the occurrence of one or more conditions; in consequence, no income tax must be paid when making a warranty deposit. In this respect, it is important to expressly state in the preliminary document that the prospective franchisee’s obligation of providing a deposit is given as a warranty for the compliance of its obligations under the preliminary document.

Such warranty deposit must be kept by the franchisor until both parties enter into the definitive franchise agreement, in which case the franchisor is obliged to return the warranty deposit to the new franchisee in its integrity. However, if the prospective franchisee decides to cancel the negotiations in an inappropriate time or breaches certain binding provisions, the franchisor may be allowed to definitely retain such amount of money previously granted as a deposit for the payment and reimbursement of any costs, expenses, damages or losses, caused by the franchisee’s abandonment or breach.
iii) Applicable Laws

For all matters related to the interpretation, compliance and execution of preliminary documents, it is recommended to include binding provisions regarding the choice of law applicable to such preliminary document. In this regard, our suggestion is to choose the law of the country where the preliminary document shall be effective, which would facilitate the enforcement of any court or arbitral award against the prospective franchisee.

iv) Dispute Resolution

According to Mexican Laws, for everything related to the compliance and enforceability of preliminary documents, the parties may submit themselves to the competent courts of any place to which they wish to be bound. In such regard, it is recommended to choose the courts of the place where the resolution shall be effective and executed, which would facilitate the execution of any court award against the prospective franchisee.

It is important to note that, under Mexican Law, it is valid to agree on alternative methods for dispute resolution such as arbitration, which may be subject to Mexican or foreign law applicable to preliminary documents. Arbitration awards which do not contravene Mexican public order or public policy laws are enforced in Mexico through a recognition and enforcement procedure before a judicial court, by means of a ratification process, given that Mexico is a party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards.

Alternative dispute resolutions are independent from any administrative infringement action that may be initiated by a franchisor against any person infringing the provisions of Mexico’s Industrial Property Law, in which case the IMPI is authorized to impose provisional or precautionary measures.

In addition to the foregoing, please note that under Mexican law the parties to preliminary documents may also include mediation provisions prior to the commencement of an arbitration proceeding; however, the interested parties should analyze the convenience of including these provisions.

v) Trademarks

As previously explained, it is suggested to register the franchisor’s trademarks and/or any other industrial and intellectual property right of the franchisor before entering into any preliminary document, even before negotiations, in order for the proprietor of the trademarks to protect them against a potential attempt by third parties to register them.

Likewise, it is important to include in preliminary documents provisions by means of which the prospective franchisee acknowledges the ownership of the franchisor’s trademarks and/or any other industrial and intellectual property rights, and also to state that the prospective franchisee will not claim or exercise any action which may affect those franchisor’s industrial and/or intellectual property rights.
Additionally, it is also recommended to include a provision whereby the parties state that said preliminary document does not constitute the granting of any license, franchise or authorization for the prospective franchisee to use the franchisors’ trademarks and, therefore, the non-authorized use of the same shall be considered as a breach of the prospective franchisee’s obligations under the preliminary document, in addition to constitute a violation of any applicable laws.

In general terms the non-authorized use of industrial and intellectual property rights is considered as an administrative infringement under the Industrial Property Law and, therefore, the IMPI is entitled to exercise specific actions against the corresponding infringer. Furthermore, some specific infringements to the Industrial Property Law may be considered as felonies.

6. CONCLUSION

Should you use a preliminary agreement and, if so, how? Really it comes down to the question of whether the document helps you reach the definitive documents in the most expeditious and inexpensive and clear way or whether they become a document that takes on a legal life of its own far beyond what was intended by at least one of the parties.

These preliminary agreements can facilitate structuring the deal and keeping the parties aligned and focused. Moreover, a preliminary agreement can help preserve confidential information, protect a franchisor’s trademarks, and help address challenges presented by different languages by reducing selected fundamental points to writing.

But there can be a cost. Negotiating a preliminary agreement can take time that is unnecessary if negotiations are anticipated to be concluded expeditiously and can subject a party to risk if the agreement is not drafted correctly. Making the legal determinations set forth above is not cheap.

Perhaps the best test the lawyer can employ to analyze the risk of unintended liability is whether the parties are willing unequivocally to establish the non-binding nature of the terms that reflect a preliminary agreement to agree on the business points. If either party is unwilling to include such language, the liability risk may exist and needs to be weighed against the benefits of the document.

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