The Role of Letters of Intent in International Franchise Transactions

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Used properly, a letter of intent can save time, money and help advance proposed transactions in foreign countries.

Franchisors pursuing international development to expand their brands can face many obstacles, including cultural, language and legal, in completing international transactions. One tool many franchisors use to assist in overcoming those obstacles is an international letter of intent.

To what extent are letters of intent a help — versus a hindrance — in negotiating an international franchise transaction? What role, if any, should an LOI play in international franchise transactions? Whether you are a franchisor negotiating your first international franchise deal or have an established international brand, an LOI, used properly, can save significant time and expense in negotiating a transaction while a poorly-prepared one can frustrate the parties and lead to unintended disputes or ultimately kill the proposed transaction.

ROLE OF A LETTER OF INTENT

A letter of intent (sometimes called a memorandum of understanding) can establish the contours of a future agreement by outlining the key terms of an agreement between two or more parties before the parties enter into a binding agreement. LOIs are seldom used in domestic franchise transactions as franchisors generally offer franchises under the form of franchise or multi-unit agreement found in the franchise disclosure document.

Prospective franchisees often sign that form of agreement or some close variation of it. International transactions however, often involve an entire country or large portion of it and the structure may vary depending on business, tax and legal circumstances relative to that country. Throw in language and cultural differences and negotiation of an international agreement can be anything but routine. A properly drafted LOI can serve as a bridge between the general agreement of the parties' business leaders and the binding franchise or other legal documents signed by each of the parties.

Many benefits may arise from use of an LOI in a potential international franchise transaction. The primary benefit is the potential time and money saved in negotiating the transaction. If this is a franchisor's first international franchise deal or first deal with a particular prospect, the LOI helps assure the parties that they agree on the key business terms such as the agreement term, fees, and primary duties and obligations of the parties before focusing time and effort on preparing the underlying agreements. In doing so, drafting and negotiating the franchise-related agreements should be far easier. Well-prepared LOIs also establish time frames for completion of the definitive franchise-related agreements and development of the initial group of franchised units.

The letter of intent is a practical tool for due diligence in that it provides, among things, an additional opportunity to assess whether the other party is the right candidate for the franchise opportunity or has the right intentions in entering into a franchise relationship. The letter negotiation process also provides some insight as to whether the potential transaction makes financial sense for each party. Protracted negotiations involving a basic LOI may give some indication of the challenges a franchisor may face in completing the transaction or uncover a prospective franchisee's business attitudes that are inconsistent with the franchisor's expectations of the franchise relationship.

Finally, the LOI likely will contain certain binding provisions that provide a franchisor with some assurance that the prospective franchisee is serious (a deposit or obligation of confidentiality) while assuring the prospective franchisee that the franchisor will not negotiate with potential competitors for a limited time period.

LOIs are not appropriate for all transactions and do not always work to the advantage of the franchisor. Transactions involving a current franchisee for a new outlet or territory, for example, often do not warrant an LOI. In addition, franchisors sometimes avoid using such letters for fear that the prospect may rely more heavily on the content of it and rebuke efforts to add provisions or details to an agreement that were not included.

LOIs also can serve to impede negotiations to the extent the parties spend too much time agonizing over the terms of the LOI and lose focus of the business reasons behind the proposed transaction.

Letters of intent may also lead to unintended consequences. Merely signing an LOI or receiving a non-refundable deposit as part of an LOI may prematurely trigger franchise disclosure or registration requirements in certain countries such as Brazil, South Korea and the US. Failure to understand the scope of these laws can result in violations that lead to agency fines or future franchisee remedies. Poorly drafted LOIs also may be treated as legal contracts binding on the parties in certain countries. Franchisors must understand how LOIs are treated in each relevant country to avoid such unintended consequences.

Franchisors should assess several key considerations in preparing an international letter of intent. As an LOI often serves as a bridge between the general business outline and a legally binding franchise or development agreement, it should be understandable to the parties' business leaders while satisfying necessary legal requirements to reflect the parties' legal and business intentions. Preparing the LOI in understandable English and limiting its key terms of the proposed transaction helps ensure that the business people, not just the lawyers, fully understand the key contract terms and are not left to rely on the lawyers to explain what is in the letter.

For many of the same reasons, length of an LOI is important and generally should not exceed more than four to six pages. A good rule of thumb is that the longer the LOI, the closer it appears to be a binding agreement and likely detracts from the overall negotiation process.

Letters of intent typically are not meant to be binding contracts. They serve as an expression of the parties' understanding of key business terms. Most LOIs will, however, carve out certain terms, including those regarding confidentiality and termination of the negotiation period, as legally binding obligations. Courts have found LOIs to be binding where they contained the terms to form a contract and a mutual reflection of the parties' intent to be bound by the contract.

Even if the LOI terms do not, by themselves, form a binding agreement, the parties may be obligated by local law to continue negotiations in good faith. To limit such a possibility, the letter should clearly identify those sections which are binding and state that the balance of the LOI is not a binding agreement. The LOI also should state that the parties contemplate negotiating and signing a definitive agreement that will include additional terms, and that the parties do not intend to be bound unless and until they have signed the definitive agreement.

A BRIDGE AND A VALUABLE TOOL

Letters of intent should serve as a bridge between a handshake agreement between business leaders and a fully integrated and binding legal agreement. Too often, however, the role of an LOI is misplaced — creating problems that the franchisor failed to contemplate before negotiating the deal or absent when an LOI otherwise would assist in negotiations. Franchisors that understand the proper role of an LOI international transactions and how it may be treated legally in each situation will find it a valuable tool in expediting and successfully completing the negotiation process. ■

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