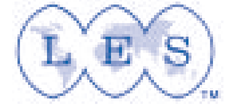
Disclosure And Registration Legal Framework Of Franchise Agreements In Mexico — Legal And Economic Evaluation



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I. Legal Framework Evolution

Traditionally, trademark licensing and franchising had been handled in Mexico as a single concept. The law had assimilated franchise and license agreements without taking into consideration their different natures and specific characteristics. This assimilation, coupled with prohibitions under Mexican law against confidentiality provisions lasting longer than the term of the agreement, and against provisions preventing a franchisee from purchasing supplies from other than approved sources, posed major obstacles to the development of franchising before the 1990s. In addition, before the beginning of the 1990s, consistent with the Mexican government's so-called "substitution of imports" policy, the law imposed severe restrictions on the parties' freedom to negotiate license and franchise agreements, required registration of such agreements, and granted very broad discretionary powers to the authorities to approve or disapprove each and every license and franchise agreement.

Departing from the very restrictive laws which were in force through the 1980s, changes were made to the law in the second half of 1994[1], which returned to the parties of a franchise agreement the power to negotiate their own terms and conditions. These changes to the law, however, did not eliminate mandatory registration. The relationship between trademark licensing and franchising agreements, although now differentiated, continues to exist because whenever a trademark licensing is part of a franchise agreement, the contract must be recorded as any other trademark license agreement[2].

II. Registration

The procedures for recordation of the franchise agreement are the same as those provided for registration of a trademark license agreement and although the authorities make a mere formal review of the application and exhibits, they do not review the application on the merits. The franchise agreement registration application and its attachments must be in Spanish, and must provide general information about the franchisor and franchisee (including name and address), and about the products to be sold and/or services to be rendered and the authorized use of the franchised marks[3]. Evidence of payment of the applicable government fees must be attached to the application form. If the relevant franchise agreement is executed in a language other than Spanish, a nonofficial translation must be attached to the application. A power of attorney authorizing the representative of the applicant must be attached to the application, which if granted abroad should contain a statement relating to the existence of the grantor of the power of attorney. Although the required form of power of attorney is simple and appropriate for registration of the franchise agreement, it is insufficient to address the administrative or litigation processes resulting from such agreement. Finally, unlike U.S. law, in Mexico, both franchise and subfranchise agreements must be registered, as well as agreements by which the franchisor has been authorized to enter into the franchise, even if by an affiliate.

General legal provisions applicable to all kinds of agreements, and those special legal provisions regarding registered users of service marks and trademarks are now the principal legal framework to be considered when negotiating and drafting franchise agreements. Therefore, determining when such general law provisions are mandatory or optional, is of the essence. Some of these key issues are mentioned below.

III. Disclosure

Probably based in part on the mandatory disclosure model followed in the United States, the above-mentioned 1991 legislative amendments created for the first time in Mexico a franchise-specific law[4] requiring that before any franchise agreement could be entered into, the franchisor must provide the potential franchisee information on the status of its enterprise.

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1. Namely, abrogation of the Mexican Law on the Control and Registration of Technology Transfer and the Use and Exploitation of Patents and Trademarks and its Regulations and the repeal of the Inventions and Trademarks Law, and the enactment of a new Mexican Law for the Promotion and Protection of Industrial Property and its major amendments. The name of the law was also changed, to the Industrial Property Law.

2. Article 142 of the Industrial Property Law provides that in addition to know-how, a trade or service mark is a material subject of a franchise agreement.

3. Articles 139, 179, 180 and 181 of the Industrial Property Law and 64 of its Regulations.

4. Article 142 of the Industrial Property Law, with identical language to the same article number of the former Mexican Law for the Promotion and Protection of the Industrial Property.

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Also, regulations adopted in 1994 require that the following information be disclosed on the status of the franchisor enterprise[5]: (i) data/home, address, citizenship of franchisor; (ii) franchise business description, including franchisor time doing business; (iii) industrial property rights involved; (iv) amounts and concepts payable for; (v) technical assistance and services to be provided; (vi) franchised territory; (vii) right to subfranchise (if applicable); (viii) franchisee confidentiality obligation; and (ix) franchisee rights and obligations.

Because the law did not have any specific provision sanctioning a breach of the disclosure obligation, the general provision in the law for any other nonspecific breach would apply, therefore applying an administrative fine of about US $80,000. Other administrative sanctions in the law may not be applicable, in practice, to the lack of disclosure. No law or Court precedents specifically refer to other kinds of sanction which may apply to a franchisor's failure to make the required pre-sale disclosures to the franchisee. Notwithstanding, a risk exists that a franchisee willing to terminate its franchise agreement, argues that it granted its consent to the franchise agreement with a misconception of the franchise business (e.g., the franchisor omitted to provide franchisee in advance a description of the franchise business). Said argument could be raised by franchisee and request a Court to rule that since there was no full understanding of the business on its part when it signed the franchise agreement, no real consent on the subject matter of the agreement may have been formed and then an essential element thereof never existed, thus no agreement was actually entered into.[6]

In practice, the franchisor should either require the franchisee to make a representation in the franchise agreement acknowledging to have known the required franchisor business data in advance, or deliver a specific disclosure document and obtain the franchisee's acknowledgment of receipt. Also, attaching a separate acknowledgment to the then proposed franchise agreement may be advisable to avoid having to describe separately all of the franchisee's rights and obligations, as mentioned in item (ix) above.

IV. Key Contractual Issues

There are many important contractual issues which should be considered in structuring a franchise agreement used in Mexico. One important issue is that to effect a cancellation of the agreement, cancellation must be jointly requested by franchisor and franchisee or by a judicial order instructing the Mexican Industrial Property Institute[7] (MIPI). Notice of termination by franchisor to franchisee and unilateral request for cancellation to MIPI solely by franchisor, will have no effects vis-a-vis third parties. It then becomes critical to cancel registration of the franchise at the time the relationship is terminated; otherwise, an infringement action against a former franchisee, who upon termination of the franchise agreement continues using the relevant mark, becomes a non-authorized franchisee of the subject mark or marks, may not be initiated. It is essential to address this issue properly in advance, because obtaining the franchisee's written confirmation of the termination of the relationship after the relationship has deteriorated is generally very difficult if not impossible, and the franchisee may procedurally object to each and every Court resolution ordering cease of use of relevant mark, thereby stalling a franchisor's ability to obtain a resolution confirming termination for one to two years, or even longer.

Language enabling the franchisor to handle the cancellation of franchise agreements registration at MIPI, by means of an irrevocable power of attorney granted by franchisee upon execution of the franchise agreement, or daily penalty clauses applicable to a franchisee who does not cease to use the franchised mark, have now become customary provisions in franchise agreements. Wording them properly is essential to their enforceability, due to their very technical characteristics.

Freedom of work is protected as a constitutional right, so confidentiality provisions and covenants not to compete in franchise agreements must be linked to industrial and trade secrets legislation, in order to be enforceable in Mexico. The industrial and trade secrets language used in the franchise agreement must be carefully drafted to evidence the infringer's intention either to damage the owner of the secret or to obtain an illegitimate benefit, in case a criminal action may have to be initiated against a franchisee. Provisions for payment of liquidated damages must be studied to avoid the nullification of non-compete provisions. The other mechanism used to make non-compete contractual provisions effective are liquidated damages payable by franchisee upon its breach of such obligation. Both, the risk of the liquidated damages provisions, which may ultimately be characterized as an indirect way to infringe the freedom of work constitutional right by a constitutional Court, and the use of creative language to make liquidated damages measurable and applicable in practice upon infringement of the non-compete provisions by franchisee, should be carefully evaluated when drafting franchise agreements.

By the way, the Regulations to the Law of Industrial Property allow franchisor and franchisee to eliminate from the franchise agreements, to be submitted for registration at MIPI, each and every contractual provision the parties may not want to be made available to any third party, when dealing with royalty/fee or other provided for payments and with confidential information related to the ways and forms to trade goods and provide services as

5. Article 65 of the Regulations to the Industrial Property Law.
6. Article 2224 of the Federal Civil Code.
7. Articles 136 and 142 of the Industrial Property Law provide that registration of franchise agreements and of the trademark license agreements at MIPI is mandatory so they may have legal effects to third parties.

well as those dealing with any technical information. Proper advice is needed to take advantage of this Regulations permission, in order not to submit for registration with MIPI agreements or agreement provisions the parties do not want to be available for public knowledge.[8]

Franchise agreement provisions, for determining from time to time rates of exchange and for conversion of franchisee payment obligations into foreign currency are advisable, not only to avoid losses derived from currency fluctuations or discrepancies in the calculations, but also to verify their correct computation. Payments in currency other than Mexican Pesos must be agreed to be made outside the Mexican territory in order for such contractual provisions to be enforceable.[9]

It is important to anticipate the tax consequences of franchise agreement provisions relating to fees and reimbursable expenses. This will not only avoid unfavorable surprises, because Mexican tax legislation requires franchisees to withhold the applicable tax when payments are made to franchisors who are not residents of Mexico, but will also allow for advantageous tax planning. Tax authorities have not only reduced the income tax rate, but have redefined the concept of technical assistance by distinguishing it from royalty or knowhow payments, based on Treaties to Avoid Double Taxation[10] , and technical assistance payments are exempt from taxation. Nonspecialized professional or advisory services related to the operation of a nonspecialized business may be characterized as "business profits" under the standard text of such Tax Treaties and be exempted from income tax. However, one may need to weigh confidentiality versus tax impact, and it may be necessary to trade off certain trade secret protections contained in standard franchise agreement know how provisions in order to obtain the more beneficial tax treatment afforded to provision of technical assistance.

Although not expressly rejected, tax gross-up provisions may make license agreements very expensive, because according to Mexican Income Tax Law[11] these grossed up income tax must be added to the relevant tax basis and relevant tax rate applied over the grossed up fees.

Also, proper characterization of exclusive territorial rights whereby the franchisor waives its right to, either personally or through other designated franchisees, enter into a certain Mexican defined territory, may be qualified as a commission fee not subject to income tax. Again, adequate use of language used in the relevant tax section of the franchise agreement is essential to obtain such tax benefit.

V. Economic Evolution

Mexico's entrance into GATT in the late 1980s and NAFTA in 1994, made the United State's franchise industry recognize Mexico as a market opportunity. In addition, in view of the U.S. economic recession of the early 1990s, the Mexican market appeared to offer a way to grow their businesses abroad, whereas domestic growth was limited by adverse economic conditions. From the Mexican perspective, Mexican entrepreneurs saw the U.S. franchise industry not only as a new business opportunity, but also as a defense to being displaced by more evolved companies operating in the franchise sector.

Excessive demand for U.S. franchises by Mexican investors, instead of working partners, and the increase in franchise prices, were major obstacles to the development of the Mexican market and the main reasons for the failure of many franchise businesses in Mexico.

The 1995 Mexican economic crisis and specific characteristics of the newborn Mexican franchise industry, such as excessive competition, its concentration in high income level markets and subsequent continued income level reduction, characterized the Mexican franchise industry market in the first half of the 1990s. The second half of the 1990s was however, characterized by a much more stable franchise market where sales of and by franchise businesses[12] grew tremendously and employment offered by franchise businesses contributed substantially to the Mexican economy job offer market. Also, in the second half of the 1990s, several mature businesses turned to franchising as a way of growing and the number of Mexican-developed franchises grew from a very few to about 57% of the total franchise market in the country.

V. Conclusion

In the last decade, franchising business framework has evolved in Mexico to a more mature level both from an economic and legal point of view, which resulted in the need of more sophisticated and detailed legal and tax advice.

8. Article 10 of the Regulations to the Industrial Property Law.

9. Article 8 of the Monetary Law of the United Mexican States.

10. Either by means of express provisions or the applicability of most favored nation clause, the International Agreements to Avoid Double Taxation Mexico has executed with Belgium, Canada, Chile, Denmark, France, Germany, Italy, Japan, Republic of Korea, Netherlands, Norway, Singapore, Spain, Sweden, Switzerland, United Kingdom, United States, make franchise fee taxable at 10% withholding tax rate, rather than at 15% or even 40% withholding tax rate the Mexican Income Tax law has provided for.

11. Article 144 of Income Tax Law.

12. Asociación Mexicana de Franquicias, 1996 2nd Semester Directory shows that sales of franchises would grow more than twice and sale by franchise businesses would be US 4 billion Dollars, while more than 15% of Mexican economy job offers were made by franchise businesses.