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Ten legal issues to consider in structuring a refranchising programme

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Abstract

This paper is intended to familiarise the reader with significant issues which need to be addressed in the context of selling retail units to purchasers who will subsequently become franchisees of the seller. This process, called 'refranchising', is especially relevant in the restaurant, hotel and retail industries where franchising is most prevalent. The paper addresses a process which is typically followed from letter of intent through due diligence and the execution of closing of the transaction documents: purchase agreement, franchise agreement and development agreement. The paper also discusses drafting concerns affecting both the letter of intent and the relevant transaction documents.

INTRODUCTION

Many retail/restaurant companies with multiple outlets turn to 'refranchising' as a source of revenue and added capital to grow a brand. While this paper is written from the perspective of a USA-based transaction, most of these concepts are applicable to any jurisdiction. In addition, while the issues discussed are relevant to any purchase and sale transaction, the author has attempted to highlight issues particularly relevant to the franchise community, which primarily involves retail, restaurant, hotel or other speciality operations. Refranchising, as used in this paper, refers to the sale of existing company-operated units to third parties who will continue to operate the units as franchisees pursuant to franchise agreements. Whether the seller is an existing franchisor desiring to increase the number and/or percentage of franchised units, or a company desiring to enter into franchising for the first time, refranchising can be an effective vehicle to achieve many goals, including: raising cash for additional acquisition or new development; debt reduction; brand expansion; unit retrofitting (ie changing the unit to comply with current brand marketing design and/or concept configuration); general remodelling and/or facilities upgrading through franchisee development; and increasing royalty revenues.

This paper addresses ten general legal issues that a seller and its legal counsel should consider in structuring a refranchising programme. The financial condition and nature of the seller and its

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industry, as well as market conditions at the time the refranchising programme is launched and in place, will naturally influence how a seller will respond to these issues. There is often no right or preferred approach. Rather, by focusing on these issues in advance, the seller can at least formulate the basis upon which it desires to sell its units and respond to expected buyer concerns to hopefully streamline the negotiation and closing process.

USE OF A TERM SHEET OR LETTER OF INTENT

Choice of term sheet or LOI

Once the seller has identified a buyer for a specific market and units, the parties will generally desire to distil the basic sales terms into some format to be certain there is agreement prior to incurring the time and expense of preparing an asset purchase agreement (APA). This format can be as simple as a term sheet initialled by the parties, or as formal as a detailed letter of intent (LOI) covering many of the terms that will ultimately be reflected in the APA. Usually the seller will want the buyer to execute a confidentiality agreement regarding information to be disclosed in the sales process which often will be in addition to, and may precede the execution of, an LOI.

This paper will use the term LOI to mean either a term sheet or a more formal LOI. In determining the format to use and the level of detail to be contained in an LOI, the seller must balance the desire to tie the buyer to material terms, such as price, financing contingencies, condition of units, etc, with the need to expedite the process of moving to the APA which will ultimately govern the sale of the units. While prudent sellers and buyers should involve legal counsel early in the sales process, some sellers and buyers may decide not to include legal counsel or spend a lot of time negotiating an LOI that only addresses what are considered to be the most important business points. In this case, the negotiation of the APA becomes more intense.

The following are some legal concerns that should be addressed in a term sheet or LOI, even if there is general agreement about the basic business terms.

Choice of law

Impact of governing law on LOI

The parties should specify the jurisdiction whose laws shall govern the transaction. The laws and court interpretations in various jurisdictions differ on issues such as the criteria for enforceability of LOIs, allowable interest rates for seller financing, the need for consideration to enforce agreements where earnest money is refundable and rights to seek arbitration. In the absence of a clear delineation of choice of law and venue for bringing actions, the parties could incur unnecessary expense and delays in resolving disputes.

The jurisdictions where the seller and buyer are domiciled and/or do business, as well as the jurisdictions where the units are located, could all have sufficient contacts for the assertion of venue and governing law. The seller will often want the law of its jurisdiction

of domicile and the courts where it is located to be chosen for the transaction. Particularly if the refranchising programme involves many markets in many jurisdictions, choosing the laws of the jurisdiction of the seller's domicile gives the seller some comfort that its standard-form APA and other transaction documents, such as its franchise agreement and any development agreement, will generally be enforceable regardless of the jurisdiction of the buyer's domicile or the jurisdictions where the units are located. It should be noted, however, that even if the laws of the jurisdiction of the seller's domicile are chosen as the governing law, local franchise laws, alcoholic beverage laws and real estate laws may, as a matter of public policy, govern certain aspects of the transaction in some jurisdictions.

**Impact of
characterising
LOI as binding or
non-binding**

Binding versus non-binding

The amount of negotiation of, and level of detail contained in, the LOI is often influenced by whether the parties desire the LOI to be 'binding' (ie enforceable). As soon as the parties declare that the LOI is binding they raise the stakes in the negotiations and create potential hazards and liability in the event the deal does not close. By its very nature, an LOI does not contain the parties' full agreement concerning the transactions. Instead, it contemplates the negotiation, execution and closing of various transaction documents including the APA, franchise agreements, development agreements and sale, sublease or assignment documentation regarding transfer of the units and personal property, etc. Until these transaction documents are agreed upon, it is questionable whether the LOI can really be 'enforceable' and what rights and obligations are being enforced. The worst thing that the parties can do is be silent concerning whether the LOI is intended to be binding. Silence invites litigation based upon the fact that both parties change circumstances and incur expenses in reliance upon the LOI and the contemplated negotiation/closing process.

Specific performance

There has been a lot of litigation concerning the enforceability of LOIs. Probably one of the most famous cases in the USA is *Texaco, Inc. v Pennzoil Co.*,¹ in which an instrument entitled 'memorandum of agreement' (MOA) was drafted to reflect the terms that had been agreed upon in discussions between the parties. The MOA purported to become binding only 'after the execution and delivery of this [a]greement'² and was expressly subject to board approval. The board reviewed the proposal and made a counter-offer, which was accepted. The parties subsequently issued a press release announcing an agreement in principal to the terms of the MOA. The press release described the terms of the transaction and expressly stated that the transaction was subject to the execution of a definitive merger agreement, stockholder approval and compliance with government regulations. Even

Enforceability of LOI

Impact of local laws on enforceability of an LOI

though one signature was missing and there was no partial performance, with the exception of some preliminary financial arrangements, the court held that '[t]here was sufficient evidence for the jury to conclude that the parties had reached an agreement on all essential terms of the transaction with only the mechanics and details left to be supplied by the parties' attorneys'.³ This case resulted in a US\$10.53bn award against Texaco.

The laws of the various jurisdictions differ on this issue.⁴ Sellers are much less likely to try to enforce specific performance of a sale based upon an LOI because of the delays inherent in the enforcement process and the fact that the basic premise of the refranchising programme is to sell the units in the relevant market quickly to realise the profit and expand the brand. Protracted litigation frustrates this goal. Buyers will also find specific performance of a transaction based upon an LOI more difficult to achieve, due to the fact that so many transaction documents are not negotiated. For example, the LOI will contemplate the execution of an APA which will contain various representations, warranties, covenants and conditions which will need to be negotiated. The buyer will also have to prove that there is an agreement regarding the terms of a franchise agreement and perhaps a development agreement. In addition, as opposed to a pure sale of a business, the anticipated franchise relationship between the parties is a special one which complicates the sales nature of the transaction due to the continuing relationship between the seller/franchisor and the buyer/franchisee after closing. Nevertheless, a buyer may initially use the threat of a suit for specific performance in negotiations with a seller, realising that protracted litigation could prevent the seller from selling in a timely manner.

Availability of damages

Even if specific performance of an LOI is problematic, lawsuits for damages are a more likely outcome of a decision by the parties to try to make an LOI binding or the failure to specify whether it is binding. Trends in the relevant market and value of the units being sold will influence a party's decision to seek damages. Buyers have to be concerned especially if the value of the market being sold is deteriorating. Sellers have to worry about potential lost profits and other damages, as well as the impact of litigation in general on the refranchising process. Even if the parties decide that the LOI will not be binding, there will usually be some provisions of the LOI that should be binding, such as: the rights to negotiate exclusively during the term of the LOI (a 'no-shop' clause); the confidentiality provisions; obligations to return information exchanged in the negotiation process, such as financial data; and choice of law and arbitration provisions. The parties should also review the laws and case precedent in the jurisdiction whose law is chosen to govern, to see whether equitable principles, such as duties to negotiate in good faith, or reliance and promissory estoppel, might form the basis for a suit by a disgruntled party, notwithstanding statements in the LOI that it is not binding.⁵

Use of earnest money and break-up fees

Damage limitations

Sometimes the parties will try to limit the impact of making an LOI binding by tying the breach of the LOI to either the loss of all or a portion of an earnest money deposit, in the case of the buyer, or a break-up fee, in the case of a seller. This route at least prevents the uncertainty of potential suits for specific performance or general damages which enforcement of the LOI would otherwise entail. The parties may still find it difficult to enforce these damage provisions under an LOI due to the fact that whether a transaction closes depends significantly upon the negotiation of the other transaction documents. The seller sometimes tries to insist that at least some of the earnest money is 'non-refundable' as consideration for the seller agreeing to negotiate exclusively with the buyer for the units to be acquired. Buyers will counter that all earnest money should be returned if the failure to close is based upon a seller's default and/or the inability of the parties to reach agreement on the transaction documents.

Due diligence process

MANAGING THE DUE DILIGENCE PROCESS

A well-organised seller will want to gather all relevant contracts and information concerning the market and units to be sold for several purposes. First, the seller must ascertain the steps necessary to transfer the assets, including relevant contractual rights and obligations to the buyer. Secondly, the seller must determine what third party consents may be necessary to transfer such assets and liabilities and the procedure and criteria to secure such consents. Thirdly, the seller must be able to produce this information for the buyer to review during its due diligence. The seller also must be able to disclose this information in the schedules that are attached to, and incorporated in, the APA. Finally, the seller and buyer will have to ascertain what permits are necessary to operate the business, whether they can be transferred and which party has the responsibility to prosecute the transfer or application for new permits. Many permits, such as alcoholic beverage permits and sometimes health permits, may contain specific requirements that a buyer must satisfy in order to obtain a permit in its name which is required to operate the business.

The buyer will frequently be relying, to some extent, upon the seller for assistance in understanding the steps to be taken to ensure that the buyer has the requisite permits and contracts to operate the business after closing, as well as the expected time to obtain the required consents and approvals. The seller should establish a timeline for obtaining these permits and consents, which can be built into the LOI and the APA given the continuing franchisor/franchisee relationship.

Some sellers will want to establish due diligence procedures that may include a 'discovery day' or similar meeting in which key personnel from the buyer meet their respective counterparts with the seller to understand the business better. Most franchisors will

have training programmes for key management personnel to be certain that their franchisees understand how to operate the business in accordance with the franchise system. Purchasers of products from a franchised concept expect a certain uniformity, and the value of a brand can be greatly diminished if the franchisees do not operate in accordance with company policies and standards. In addition, as opposed to a typical buyer who purchases assets and is no longer associated with the seller, franchisees and franchisors must work together closely, so a discovery day allows both sides to gather more information and make judgments about their ability to coordinate in the future.

WHAT ASSETS ARE TO BE SOLD AND RETAINED AND THE STRUCTURE OF THE TRANSACTION

Treatments of key contracts and assets

The seller should have identified in the due diligence process the assets to be sold and retained. Depending upon the nature of the business, there may be some assets that cannot be transferred, such as liquor licences in some jurisdictions, or computer systems and software that are subject to third-party agreements. In addition, there may be contracts for goods and services for the corporate units which have pricing terms tied to volumes or numbers of units, such as pouring contracts for beverages, contracts for the provision of key supplies such as meat or bread, or equipment leases for computers or software systems. Some of these types of contracts may not be transferable and/or the franchisee may not have the ability to purchase such goods or services at the same price given the smaller number of units it will be operating. Conversely, the sale of company units may adversely affect the costs to the seller for the remaining company stores if purchase volumes are reduced due to the seller operating fewer stores, unless the buyer is required to enter into similar agreements with such vendors and the seller receives a credit for the buyer's purchases. Some of the seller's corporate contracts may require that franchisees enter into similar contracts directly with the vendors. The impact of the refranchising programme on these key corporate contracts and the impact their provisions have on the transaction should be determined as part of the process of setting up the refranchising programme and disclosed to the buyer as part of the due diligence and APA negotiation process. The APA will have to set forth the treatment of these contracts as part of the description of which assets are being sold and retained.

Third party consent requirements

In reviewing consent requirements, the seller should pay attention to the specific language in the relevant documents and provisions of local law. The absence of a specific consent requirement does not necessarily mean an agreement can be assigned. Local law should be checked to see if the respective type of agreement can be assigned without consent. In addition, the structure of the transaction may affect whether consent is required. For example, some leases may contain clauses restricting assignments but not

subleases. Sometimes a transaction may be structured as a sale of stock rather than an asset sale, and the consent language may not be drafted broadly enough to require consent for a transfer as a result of a change in control. Sometimes units may be owned or operated by affiliates of the seller and the seller might be able to transfer the stock of such affiliates in lieu of a direct asset transfer, if that would facilitate the consent process.

Representations and warranties regarding assets

CONDITION OF ASSETS

The parties will have to negotiate concerning what representations and warranties will be given regarding the condition of assets and what, if any, repair/replacement obligations the seller has prior to or after closing. Most sellers will want to sell the assets 'as is, where is, with all faults and without any warranty, express or implied'. Buyers will prefer a representation regarding the condition of the assets and that the units contain all that is necessary for them to operate the units in the ordinary course of business. Buyers will frequently seek purchase price adjustments for necessary repairs which are identified during the inspection/due diligence process. The seller should make it very clear in the initial negotiations, including the LOI, what if any representations and warranties it is willing to make to avoid problems in the APA negotiation process. To the extent that the seller is not willing to make representations and warranties regarding condition of the assets, the buyer may insist on the ability to terminate the transaction if the inspections bring to light significant problems that the seller is unwilling either to resolve or to allow a credit for against the purchase price.

Sale or lease of properties

TITLE, SURVEY AND ENVIRONMENTAL ISSUES

If the seller owns the fee title to all or some of the units to be sold, the parties will have to agree upon whether the real estate associated with such units will be sold to the buyer or retained by the seller with the seller leasing such property to the buyer. Selling the real estate to the buyer will increase the costs to the buyer, and some buyers may not be able or willing to incur the added cost of acquiring the real estate. If a lease is to be used then the parties should agree to the basic terms, such as rent, length of term and any renewal rights, as part of the LOI process. Even if the buyer does not purchase the real estate, the seller may still be able to realise the value of these assets by selling the real estate, with the new purchaser's lease in place, to third-party real estate investors after the closing.

Title and survey

In any event, the seller should obtain title commitments and updated surveys, at least in connection with the owned real estate. Depending upon the requirements of the buyer's lenders for leasehold mortgages and/or the requirements of the buyer's attorneys for review of leasehold title, title commitments for leasehold properties may also be required. If no third-party financing is involved, a buyer may be willing to settle for copies of

Environmental surveys

existing title policies and surveys with a representation from the seller that there have been no changes in title since the date of the existing title policies.

The seller will have to decide if it is going to allow the purchaser to obtain new environmental surveys or just provide copies of environmental materials in the seller's possession, supplemented by representations that the seller has no knowledge of other adverse environmental matters. In some cases the seller or purchaser may be able to secure environmental insurance at a cost that is less expensive than new environmental surveys.

Treatment of leased properties

ASSIGNMENT VERSUS SUBLEASE OF LEASED PROPERTIES

The seller must decide whether it is going to assign or sublease the properties that it leases from third-party landlords. Some sellers prefer to assign leases so that they do not stay primarily liable to the landlord and do not have the responsibility to collect sublease rent and remit it to the landlord. If assignment is the chosen route, the seller should, wherever possible, try to secure a release from liability as part of obtaining a landlord consent and/or in obtaining any landlord estoppel certificate. Most landlords will be reluctant to release the seller from liability as part of the assignment process. If the seller elects to assign leases to the buyer and is not released from liability, the seller should preserve a right of re-entry or reassignment from the landlord, allowing the seller to become the actual tenant again in the event of a default by the assignee/buyer. In the absence of such a right to reassume the lease, the seller is merely a surety or guarantor of the obligations of the assignee and, in the event of a bankruptcy or other default by the assignee, the seller might not be able to avail itself of lease provisions, such as early termination rights, or otherwise be able to reduce its liability under the lease by subleasing or operating the premises, since such rights may only accrue to the 'tenant' and not to a surety.

If the seller decides to sublease units to the buyer, the seller should be careful to negotiate whether the buyer is offered any extension rights under the primary lease, as well as ensuring that the rent and all other costs to the seller under the primary lease are passed through to the subtenant/buyer. The term of the sublease should be at least one day shorter than the term under the primary lease, since in some jurisdictions a sublease for the identical term as the primary lease may be treated as an assignment of the lease.

Other covenants, conditions, representations and warranties

COVENANTS, CONDITIONS, REPRESENTATIONS AND WARRANTIES

In addition to issues regarding the condition of the assets to be conveyed, prudent buyers will want representations and warranties regarding the business to be conveyed as well as covenants regarding actions the seller can take during the time between execution of the LOI or APA and the closing. Representations will

**Use of qualifiers
regarding
representations and
warranties**

usually include disclosure regarding no undisclosed litigation or material controversies; compliance with all federal state and local tax filings and payment of requisite taxes; no undisclosed contracts or other obligations; and the existence of any employment agreements. The APA will typically also include representations regarding the veracity and accuracy of financial statements provided to the buyer as well as statements that the seller has taken all steps necessary to be authorised to transfer the assets.

Sellers will typically seek representations and warranties from the buyer regarding its authority and ability to close the transaction. In addition, assuming the transaction is structured on an 'as is' basis, the seller will want the buyer to acknowledge that it has reviewed the assets and accepts the assets in their current condition.

Representations and warranties are frequently qualified by phrases such as 'to the best of a party's knowledge' and 'no material adverse effect'. Parties will often want to limit 'knowledge' to the knowledge of specific individuals, to avoid implying knowledge of people who are not involved in the sales process. The party receiving a representation qualified as to the knowledge of specific individuals will want some representation that these parties should be aware of the facts being represented and/or have made any reasonable inquiries to ascertain such facts. Materiality, with respect to a 'no materially adverse effect' qualifier, is sometimes defined with reference to a specific dollar amount or as a percentage of the purchase price.

The buyer's valuation of the business assumes no material adverse change in the operations and assets prior to closing. Buyers may insist that the seller continues to operate the business in the ordinary course during the pre-closing time and seek restrictions on transfers of assets and/or the execution of significant contracts affecting the business.

Conditions to closing

Both parties may want to condition the closing of the transaction on the continued veracity of the other party's representations and warranties. In addition, the closing may be conditioned upon the receipt of required third-party consents and releases; no material adverse change in the condition of the assets; and, where applicable, approval of third-party financing. The parties will also want to set an outside closing date to allow the transaction to be terminated in the event that the conditions to close cannot be satisfied.

**CALCULATION OF PURCHASE PRICE AND POST-CLOSING
ADJUSTMENTS**

A fundamental issue that has to be determined is whether the purchase price is to be fixed or subject to potential pre- and/or post-closing adjustments. Formally or informally, the parties will utilise valuation methodologies to determine or evaluate bid offers. The marketing methods used may dictate the determined value. If there is significant interest in the market and many potential

Calculation of purchase price

buyers, the seller will have more negotiating power than it will in situations with only one buyer.

The parties will need to determine how the purchase price is to be calculated and whether there are to be any post-closing adjustments. If the price is a fixed amount, the buyer may insist on a 'no material adverse change in the business' type of condition to its obligation to close. If the price is tied to a multiple of store earnings for some period, the agreement may provide for a recalculation of purchase price based upon the most recent data available prior to closing, depending upon the length of time between bidding and closing. Whether the parties choose to allow purchase price adjustments or to rely instead upon closing conditions as a remedy to changes in the value of the business prior to closing is a matter subject to negotiation. There may be a price at which the seller is not willing to sell or the buyer is not willing to buy. Depending upon the market, extraordinary events, such as the terrorist acts of September 11th, can have an impact upon different industries. Many businesses in the restaurant, hospitality and tourism sectors were especially negatively impacted by this event. Some buyers may insist on a right to terminate an APA in the event of an extraordinary event in the industry, such as a recall of meat or food-borne illnesses which result in a dramatic impact on sales.

Treatment of working capital

Often the parties will agree to a fixed amount of working capital to be conveyed and provide for a post-closing net working capital adjustment once the actual net working capital as of the closing date can be calculated. It is common to select an independent accounting firm to calculate the net working capital in the event the parties cannot agree on this figure. In some asset sales, this concept of net working capital may not be relevant if the parties have not defined a specific amount of net working capital as part of the purchased assets. In any event, the parties will usually agree that a fixed amount of cash must be in the cash drawers of units as of the date of closing. In addition, the buyer will often be obligated to pay for inventory in the units in addition to the purchase price, and a closing-day inventory process will have to be used.

If the assets to be purchased include accounts receivable, the parties will usually also agree on a method to value these accounts receivable, typically based upon historical collectibility. The parties will also have to decide if there is going to be post-closing true-up (ie reconciliation) if the receivables are not collected at historical rates.

SCOPE OF INDEMNIFICATION AND USE OF BASKETS, DEDUCTIBLE AND CAPS

The APA will typically include mutual indemnification by the parties for breaches of representations and warranties as well as for the pre- and post-closing operations of the assets. There may also be specific issues which arise in the due diligence process for which special indemnification may be offered to allow the closing to

Damage caps

proceed, such as the failure to obtain all requisite third-party consents or some pending litigation or other such matter.

Parties, and in particular the seller, will generally want some limitation or 'cap' on the amount of the indemnification obligation. The 'cap' is calculated either as a set amount or as a percentage of the purchase price. Parties will frequently negotiate a 'floor' or base amount that a claim must reach prior to being subject to indemnification. In addition, a 'basket' or aggregation of claims may be required prior to seeking indemnification to avoid the hassles of multiple claims involving minor amounts.

Parties should be wary of the possibility of 'double dipping' in situations where representations and warranties contain materiality qualifiers. For example, if a representation is made that there are 'no material claims' against the seller, a buyer would first have to prove that a non-disclosed claim was 'material' before the representation was breached. This means that claims which do not meet the materiality requirements could not be considered in calculation of whether a floor amount has been met because, technically, the representation has not been breached. This problem is exacerbated if the parties define 'materiality' with some dollar or percentage threshold. A solution is to separate the concept of materiality for the purposes of conditions of closing from the concept of losses for indemnification, so that any breach of a representation, whether or not it is deemed 'material' for other purposes, would be a breach for the purposes of calculating whether the floor and/or basket in the indemnification provision has been met.

Expiration of indemnification period

The parties will also want to specify an expiration date for the indemnification. Sellers generally prefer shorter periods, while buyers want a longer period to be sure that they have operated the business for a sufficient period of time to discover any breaches of representations and warranties. In the absence of an expiration date, the parties will have to look to local law to determine the time period during which indemnification claims could be brought.

Another problematic area with indemnification provisions involves the difference between payment for claims in final and quantifiable amounts versus defending claims which have not been finally quantified. The parties should specify who has the obligation to defend and settle claims, and when claims need to be brought to the attention of the indemnifying party.

POST-CLOSING RELATIONSHIPS — FRANCHISE AGREEMENTS, DEVELOPMENT AGREEMENTS AND CROSS-DEFAULTS

The scope of this paper does not include a discussion of the seller's US federal and state Uniform Offering Circular disclosure and marketing obligations for the sale of a franchise. Laws and regulatory requirements surrounding these documents are complex and the seller/franchisee needs to be certain that franchise law counsel is involved throughout the planning and implementation phases of the refranchising programme.

Use of franchise agreements

The seller, as franchisor, will have to enter into a franchise agreement for each unit being sold. Franchisors will frequently also require the buyer to enter into a development agreement requiring the construction of new units in defined, and sometimes exclusive, territories in accordance with a development schedule. The development agreement and/or APA may also require the expenditure of money by the buyer to retrofit or remodel some or all of the units being sold to comply with current prototype or new unit standards. One of the advantages of refranchising, in addition to the immediate consideration from the sale of units, is the expansion and improvement of the brand using the buyer's capital.

Use of development agreements

When development agreements are used, remedies for failure to meet the development schedule should always be clarified. Termination of future development rights and a loss of exclusivity or first refusal rights in a territory are among the usual remedies. Some sellers may also want the right to repurchase the units which were sold and/or to have rights with regard to the newly developed stores. This becomes the goal particularly if one of the primary reasons for the refranchising programme is to sell 'seed markets' with existing stores to franchisees for the purposes of developing specific markets. The ability to develop a market may diminish if the seller cannot gain control of its former units, because the economies of scale associated with operating multiple units decrease dramatically if some or all of the existing units are operated by one party and the rights to develop are being offered to another party.

Some sellers do not offer exclusive territories and/or limit development rights to rights of first refusal. In addition, sellers owning multiple brands may have more than one franchisee in a territory depending upon the brand, which can cause complications in the growing market of multi-branded units or non-traditional units, such as restaurant units associated with service stations and retail outlets. Sometimes sellers also wish to retain rights to develop company stores in all markets.

Sellers will frequently want to cross-default development agreements, subleases and franchise agreements. Buyers may resist, arguing that one default in the timing of development of a new unit should not trigger a loss of the entire business. The remedies in the event of such a cross-default and the method of calculating any repurchase price, as well as the methodology of implementing any repurchase regime, can be hotly contested and may be further complicated by the rights of third parties in the units after closing, such as buyers' lenders, equipment purveyors and landlords.

Ultimately, realistic planning by the parties concerning the ability to develop units in accordance with the agreed-upon timetables in the market and flexibility in satisfying the development schedule may be the best course to avoid default problems in development agreements. Overly aggressive timetables can lead to early defaults and the need to restructure or renegotiate the development agreement.

CONCLUSION

The issues raised in this paper are just some of the many issues that need to be addressed in the refranchising process. Other issues which are common to any sale of a business include the treatment of employees with regard to labour and benefit plans, tax structuring, compliance with antitrust laws such as the US Hart-Scott-Rodino Act, and compliance with securities laws in the case of a stock sale. The seller should be certain that it has consulted with appropriate legal counsel in addressing these issues as it creates the structure for its refranchising programme.

To the extent that sellers take the time to structure and implement a well-formulated and articulated refranchising process which explains the sales process, the manner in which the units will be sold and the rights the buyers will have, the process can be more streamlined. Frequently sellers will attempt to avoid some of these negotiations simply by stating that the programme is non-negotiable and the sales are made on this 'as is' basis.

Most franchisees have little ability to negotiate heavily the terms of a franchisor's standard franchise agreement. The relative strength of the brand and value expected by the seller, coupled with the bargaining strength of the parties will obviously colour the rate of success a seller can achieve with this 'take it or leave it' approach. Still, well-informed buyers can attempt to negotiate some of these key points in the LOI stage to be sure that they can live with the final outcome before expending the time and money associated with the due diligence process and the negotiation, execution and closing of the APA.

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References and notes

1. *Texaco, Inc. v. Pennzoil Co.* 729 SW 2d 768 Tex. App.-Houston [1st Dist.] 1987, writ refiled, cert. dismissed. 485 US 994 (1988).
2. *Ibid.* at 790.
3. *Ibid.* at 795.
4. In *John Wood Group USA, Inc. v ICO, Inc.* 26 SW3d 12, 24 Tex. App.-Houston [1st Dist.] 2000, pet. denied), ICO, Inc. (ICO) sought to enter into an APA with the Wood Group. The parties negotiated and entered into a letter agreement that outlined the essential terms of the proposed sale, but specified that it did not 'address all of the terms and conditions which the parties must agree upon to become binding and consummated'. *Ibid.* at 15. The agreement contained a clause which indicated that certain provisions (addressing the assets to be acquired, conditions to closing, purchase price and the issuance of ICO shares) would be non-binding, while others (including a confidentiality agreement, a no-shop clause and a good faith provision) would be binding. Subsequent to the execution of the letter agreement, the deal fell through; however, neither party had begun performance. The Wood Group ultimately closed the deal with a rival of ICO. Thereafter, ICO purchased a comparable business and sued the Wood Group for breach of the letter agreement. The jury in the trial court found that the Wood Group had breached the letter agreement and ICO received US\$8.5m in actual damages, US\$4,504,766 in attorneys' fees and US\$2,761,917 in pre-judgment interest, plus post-judgment interest and costs. On review, the Texas Court of Appeals acknowledged that

'a binding contract may be formed if the parties agree on the material terms, even though they leave open other provisions for later negotiation'. *Ibid.* at 19. It further observed that an LOI 'may be binding even though it refers to the drafting of a future, more formal agreement'. *Ibid.* However, the appeals court overturned the jury verdict and held that the LOI clearly and unequivocally expressed the parties' intent not to be bound, and that '[a]bsent mutual consent to bound on the essential elements of a sale, ie, the thing to be sold and the price, there can be no sale'. *Ibid.* at 20.

In *Heritage Broadcasting Co. v Wilson Communications, Inc.* 428 NW2d 784 Mich. Ct. App. 1988, the parties orally agreed on a purchase price for the sale of two television stations. Subsequently, they entered into an LOI which indicated that it was 'subject to the further condition ... [of] a definitive agreement'. *Ibid.* at 785. Ultimately, the deal fell through and the parties never executed a definitive agreement. The plaintiff filed suit for specific performance. The trial court determined that a contract existed between the parties and the defendant had breached it. The Michigan Court of Appeals found that the LOI could be deemed a contract to make a subsequent contract and as such 'it may be just as valid as any other contract'. *Ibid.* at 787. The appellate court held that the LOI was binding because it contained all the essential terms to be included in the final contract, and the 'definitive agreement would have added only the mechanics necessary to accomplish the conveyance'. *Ibid.* at 787.

In *Skycom Corp. v Telstar Corp.* 813 F2d 810 7th Cir. 1987, the agreement in principle outlined the terms and conditions of the proposed sale of Skycom's assets. But it indicated that a 'formal agreement' would follow, and gave Telstar the option to walk away from the deal if the parties failed to reach an agreement on refinancing. Telstar sent the agreement in principle and Skycom signed under the word 'accepted' and returned it. The deal fell through and Skycom filed suit alleging that a contract existed and demanding specific performance. The district court held that the agreement contemplated a subsequent definitive agreement, consequently a contract did not exist. In deciding whether the parties intended the agreement to be enforceable, the Seventh Circuit Court of Appeals indicated that the binding quality of an LOI depends upon the parties' intent. *Ibid.* at 814. The court noted that "'intent" does not invite a tour through [the drafter's] cranium, with [the drafter] as the guide'. Instead, the court stated that the parties' intention to be bound 'must necessarily be derived from a[n objective] consideration of their words, written and oral, and their actions'. *Ibid.* Moreover, the court asserted that '[a]s a rule, "agreements in principle" that refer to subsequent "formal agreements" are not binding'. *Ibid.* at 815. The court held that the agreement was unenforceable.

5. In the absence of a binding agreement, pre-contractual liability in the USA is customarily predicated on the theory of promissory estoppel, which 'implies a contract in law where none exists in fact'. *Casazza v Kiser*, 313 F3d 414, 421 8th Cir. 2002. In most states, 'a promise that is designed to induce commercially reasonable detrimental reliance will be enforced to the extent necessary to compensate the relying party for his injury in relying'. *Skycom Corp. v Telstar Corp.* 813 F2d at 817. Promissory estoppel requires an unambiguous promise, a reasonable and foreseeable reliance on that promise, and a determination that equity requires enforcement of the promise. See *Gibson v Arnold* 288 F3d 1242; 1245 n3 10th Cir. 2002; Restatement (Second) of Contracts § 90(1) (1981). When evaluating promissory estoppel claims, some courts have simply required that the promise be unambiguous as to the essential terms, while others have required that the promise must be so definite with respect to all details that, if the promise had been supported by consideration, a contract would result. See *Jensen v. Taco John's Intl, Inc.* 110 F3d 525, 528 8th Cir. 1997 (affirming summary judgment dismissal of a claim for promissory estoppel when the plaintiff failed to show a 'clear and definite promise' made by the defendant regarding an alleged franchise agreement); *Rosnick v Dinsmore* 457 NW2d 793, 799-801 (Neb. 1990) (rejecting a requirement of definiteness and finding that a suit for promissory estoppel depends not on the promise, but rather the nature of the reliance, ie its reasonableness and foreseeability). With regard to the reliance issues in promissory estoppel, reliance is more likely to be reasonable and foreseeable when the parties have engaged in extensive negotiations. In contrast, reliance is unfounded if a reasonable businessperson would know that the negotiations were inchoate and that no ostensible agreement could be relied upon. *Gibson v RTC* 51 F3d 1016, 1025 (1995). The third element of promissory estoppel involves whether equity requires enforcement of the promise. *Hoffman v Red Owl Stores* 133 NW2d 267 Wis. 1965, provides a vivid illustration of the use of this element in a pre-contractual context. In this case Hoffman was assured that he could purchase a franchise for a Red Owl grocery store for \$518,000. Red Owl encouraged Hoffman to buy and sell several businesses (sometimes at a loss)

and to make a down payment on a site in anticipation of receiving a franchise. However, when Red Owl's credit manager was consulted, he determined that US\$18,000 would be insufficient to finance the store and the deal fell through. Hoffman filed suit. The defendants argued that an agreement had never been reached on essential terms necessary to establish a contract. The Supreme Court of Wisconsin found that the defendants had given Hoffman a number of promises and assurances upon which he had relied and acted to his detriment. The court found that an injustice would result if plaintiffs were not granted some relief when Red Owl had induced Hoffman to act to his detriment and had breached Hoffman's reasonable expectations that he would be able to buy a franchise for the agreed-upon amount.