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Done Deal

The questions to get your piece of stepped-up m&a activity

By Dennis L. Monroe

There seems to be a more robust market for mergers and acquisitions in the franchise world. Pent-up demand exists (particularly for franchisee units) and many franchisees have been waiting to sell. Even though the senior-debt market is still tight, deals (and lots of deals) are getting done with the influx of private equity and large franchisees wishing to grow.

How can operators participate in this activity? Key thoughts follow about structuring and closing a deal:

Determine what you are buying or selling. Sometimes there is a difference of opinion between buyer and seller as to what is being bought. Often there are assets on the seller's balance sheet that are not part of the operating business. There may be under-performing units that should not be sold as a part of a larger deal. With that in mind, ask the following questions:

- Is real estate included?
- Are all stores included, even bad ones (which may substantially reduce your price)?
- Are development rights included?
- Are personal assets excluded?
- Are current assets (cash, accounts receivable, prepaids and inventory, etc.) included or paid for separately? What about credits or rebates not yet paid?
- What is the treatment of gift cards and credit card receipts in transit?

Structure the deal carefully. Structure can be the single most important aspect of net proceeds (except for price) and needs to be carefully reviewed. Structure is more than just a question of stock or membership versus an asset deal. Here's what to ask about structure:

- Are you going to do a stock or membership deal or an asset deal? (This is not only a tax decision but also may be a way to deal with assignment issues.) There are several ways to deal with tax issues, including certain tax elections, even if it is a different structure than you would like.
- Is it possible to do a merger?
- Can you do a part asset sale and part stock or membership deal?
- What are the concerns of the buyer in being a successor?
- Is there an ongoing relationship that may allow for other types of consideration to be paid?

Test the price by performing due diligence. More time is spent on pricing than any other issue. The price you'll pay is really a product of due diligence. An initial price is usually established and due diligence proves to the buyers their assumptions are valid so they're comfortable paying the ticket. Questions about price:

- Is the price fixed or floating until closing (such as a multiple of EBITDA)?
- Are there automatic adjustments for items discovered during due diligence?
- Are current assets paid for at cost or fair market value?
- What are the walk-away rights if the parties cannot come to an agreement on price at the end of due diligence?
- Is the price a bait-and-switch, where there is a high price offered (particularly in the letter of intent) but in the end the price will be lower?

Discover what liabilities are assumed. Assumed liabilities tie out to pricing, and this area needs to be understood. Many times assumptions are not correct. We normally want to see an attached schedule of assumed liabilities. Liability questions to ask:

- Are just post-closing liabilities assumed?
- How is vacation pay treated?
- Are employee benefits assumed?
- Are vendor contracts assumed?
- Are equipment leases assumed?
- Are software leases assumed?
- What franchisee obligations (such as remodels or development obligations) are assumed or renegotiated?

Keep performing all the way to closing. The due diligence period can be arduous and painful for the CFO. It is also a time when there is uncertainty within the seller's company. During the due diligence period, the seller needs to take steps to assure some type of continuity and ability to perform to closing. Many times pay-to-stay agreements during the due diligence period are appropriate so the transaction can move ahead. It is key during the due diligence period to determine the information being provided and what the outs are if the due diligence reveals something the buyer cannot live with. Questions to ask about the due diligence period:

- How long does the period last?
- What does the seller have to provide?
- What kind of access to people is required?
- How do you maintain confidentiality?
- Is there earnest money prior to the start of due diligence?
- What are the walk-away rights for both parties?

Be careful not to over-promise. Representations and warranties are the buyer's and seller's assurances as to what they will do and what they agree to provide as a condition to closing. It's important the seller does not over- promise and the buyer does not over-reach. Here are some key things to think about:

- What does the seller represent?
- Is the title free and clear?
- Is the business in good condition
- Are there any material terms not disclosed?
- Is the corporate authority to make the sale intact?
- Does the seller have enough knowledge and ability to get the deal closed?
- What does the buyer represent?
- Does the buyer have adequate financing to close the transaction?
- Does the buyer have the right structure and power to close?
- Does the buyer have adequate knowledge and management ability to get franchisor approval?
- Can the buyer represent it has adequate capital to get assignment of leases and contract assumptions?

Examine all conditions to closing. Closing conditions are the necessary items buyer and seller must bring to closing. Below are some of the more important conditions for closing:

- When does the financing contingency end, and is money available?
- Can franchisor approval be secured?
- Will the buyer hire the seller's employees?
- Can lease assignment and landlord consents be secured?
- Can certain waivers from third-parties be obtained?
- Do parties agree to non-solicitation and non-compete arrangements?
- Is seller released from agreed-to liabilities?

Put a cap on indemnification. Too much time is spent on indemnification. Good buyers and sellers normally arrive at effective indemnifications. Indemnification should not be open ended and last forever. Also, it should have a cap. Questions to ask about indemnification:

- To what extend is each party indemnifying the other party?
- What are the caps on liability?
- Is there a basket of liability before the seller is liable?
- How long does the indemnity last?

Realize some items go beyond the closing. Closing is a process. There are items that have post-closing adjustments because they cannot be determined at closing. These items include inventory costs, certain accruals and assumed liabilities. Seller paper or carried interest need to be worked out and provided for in separate documents at closing. This also pertains to non-competes and non-solicitation agreements. Questions to ask about the closing:

- What is paid at closing?
- Is there an escrow?
- Is there seller paper or carried interest?
- Are there any post-closing adjustments?

The above items are a good starting point. The most important thing is a comprehensive, detailed checklist and timeline of all the items that need to be done. A buyer needs to have strong financial counsel. A seller needs to involve its CFO and human resources people to make sure information is fully disclosed. FT

Dennis L. Monroe is a shareholder and chairman of Monroe Moxness Berg, a Minneapolis law firm specializing in multi-unit franchise finance, mergers and acquisitions, and taxation. He can be reached at dmonroe@mmblawfirm.com.