ADVANCED ISSUES IN FRANCHISOR ACQUISITIONS OF FRANCHISEES – IS VERTICAL INTEGRATION IN YOUR FUTURE?

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AGENDA

• Review Standard Terms for Acquisitions of Franchisees
• Discuss Unique Aspects of These Transactions
• Review Best Practices for Exercising a Franchisor’s Right of First Refusal

• Questions welcomed throughout the presentation – we want to hear your experiences and thoughts
Business Factors Driving Vertical Deals

- Strategic Markets
- Low Interest Rates
- Private Equity Cash and Dry Powder
- Return on Investment
- Differential Capital Formulas and Market Values
- Refranchising Potential
Typical Franchise Acquisition Categories

- Owner/Operator Purchase
- Multi-Market Purchase
- Financial Seller Purchase
Transaction Structure Depends on Acquisition Category

• Deal Type
• Buyer Ownership Vehicle
• Buyer Debt Financing Options
• Financial Accounting for Buyer under GAAP
• Risk Management
• Purchase Price Holdback
• Diligence Issues
• Important Tax Considerations
Due Diligence

• What are the diligence requirements when a franchisor is acquiring a business that it obviously knows very well?
• What is available from standard records and reports?
• What do the field representatives know and don’t write in the reports?
• Are discretionary reports prepared consistently with franchisor/affiliate methodology and treatment?
• Know before you go?
Due Diligence

• Typical Information Gaps in Franchise Reporting
  • Books and records quality
  • Deferred Maintenance
  • Human Resources Compliance
  • Tax Compliance
  • Revenue Reporting and Cash Flow Accuracy
  • Supply Chain Compliance
  • Marketing Compliance
  • Lease Compliance
Structure Checklist

• Buyer Ownership Vehicle
• Buyer Debt Financing Options
• Financial Accounting for Buyer under GAAP
• Risk Management
• Purchase Price Holdback
• Tax Options and Impacts
  • Gain, Loss, Income
  • Recapture of accelerated depreciation
  • Basis adjustments
  • Deferral/Installment/Shelter
Valuation

• Agreement formula
• Recent sales
• System Lore Formulas
• Other Factors:
  • Outlet condition and capital expenditures needed to meet standards
  • Geography
  • Territorial rights
  • Direction of outlet economics
  • Intrabrando performance
  • Cash Flow
  • EBITDA
How to Value the Deal

• Unique valuation elements for purchasing franchisees
• Critical factors for valuation
• What is the goodwill value?
• Fair Market Value v. Fair Value
• Impact of franchisor call rights
Franchisor Call Rights

• Short form term sheet
• Consider attaching a form Purchase Agreement as an exhibit or maintain as Item 22 exhibit to FDD
• If triggered by change of control, consider timing discretion, right to extend right to exercise and obligation to close
• Specify parties to agreement like all owners and guarantors
• Refer to customary representations and warranties
• Specify indemnity and holdback concept
Letters of Intent

• Getting to yes on commercial terms
• Easier /Cheaper to negotiate than full agreement
• Sets forth structure and financing
• Can the parties reach agreement and develop trust?
• Enforceable or not?
• Preliminary agreement to negotiate in good faith
Important Deal Points

• Representations and Warranties
  • Typical Provisions
  • System Specific
  • Materiality or Flat
  • Sandbag or Not?

• Representations and Warranties Insurance
  • Advantages
  • Types of Policies and Key Terms
  • Exclusions and Retention
  • Premiums and Dispute Resolution
Important Deal Points, cont.

• Indemnification
• Holdbacks and Offsets
• Material Adverse Changes Before Closing

ABA Deal Points Studies

New Resource:
“The Impact on Deal Size on Highly Negotiated M&A Deals,”
Eric Rauch and Brian Burke
*The Business Lawyer, Summer 2016, pp. 835-847*
Key Negotiated Points of Risk Allocation

• Liability Cap
• Liability Basket Amount and Type
• Seller’s Catch All Representation and Warranty
• No Undisclosed Liabilities Representation
• Closing Conditions
Definitions

• Liability Cap – Percentage of Purchase Price exposed for non-fundamental reps and warranties breach

• Liability Basket Amount and Type
  • Percentage of Purchase Price or Dollar Amount
  • Deductible – Seller liable for amount in excess of deductible
  • Tipping Basket – Seller liable from first dollar if threshold met or exceeded
  • Combination or Partial Tipping Basket – Seller liable for amount in excess of threshold and percentage of amount below threshold
  • No Basket – First Dollar Liability
Liability Cap
Baskets
Definitions

• Seller’s Catch All Representation and Warranty – 10b-5 type or Full
  • 10b-5:
    No representation or warranty made by Seller in this Agreement and [all related disclosures] contains any untrue statement or omits to state any material fact necessary to make any of them, in light of the circumstances in which they are made, not misleading.

• Full Disclosure:
  Seller does not have any knowledge of any fact that has specific application to Seller (other than general economic or industry conditions) that may materially adversely affect the business, assets, financial condition, results of operations or prospects of the Business that has not been disclosed to Buyer in this Agreement and the [related disclosures].
Definitions

• No Undisclosed Liabilities –

• **Full Coverage:**
Seller has no liabilities related to or arising from the Business except for liabilities reflected on or reserved for on the Balance Sheet and the Interim Balance Sheet.

• **Seller Friendly**
Seller has no liabilities except for those of a nature required to be disclosed under GAAP or which could not reasonably be expected to have a Material Adverse Effect except for those reflected on the Balance Sheet and the Interim Balance Sheet, and those incurred in the ordinary course of business since the date of the Interim Balance Sheet.
Catch All Reps
Undisclosed Liabilities
Closing Conditions

• Closing certainty affected by allowed variation of representations and warranties between signing and closing

• Buyer Friendly: Each of the Seller’s representations and warranties shall be accurate in all respects as of the Closing Date as if made on the Closing Date

• Less Buyer Friendly: Each of the Seller’s representations and warranties shall be accurate in all material respects as of the Closing Date as if made on the Closing Date

• Seller Friendly: Each of the Seller’s representations and warranties shall be accurate in all respects as of the Closing Date as if made on the Closing Date, except for inaccuracies which individually and in the aggregate would not give rise to a Material Adverse Effect
Closing Conditions

[Chart: Closing Conditions, Segmented by Deal Size]
Deal Points – Size Matters

• More Seller friendly in larger deals
• More Buyer friendly in smaller deals
• Trend toward more seller friendly deals
• More cash chasing fewer opportunities means more competition and more buyer friendly terms
Franchisor Right of First Refusal

• Early involvement of the franchisor
• Transfer requirements
  • Remodels and operational minimum standards
• What’s for sale?
  • Additional development rights
ROFR Process

• Notify the franchisor of a proposed transfer
• Triggering the ROFR
  • Due diligence must be submitted
  • Pros/cons of requiring a form purchase agreement
• Approval of the new franchisee
  • Separate process from ROFR
Franchisor’s Exercise

• Adjusting the purchase agreement for the franchisor
• Closing the deal
  • Taking over the business from the franchisee
  • Transition Services
  • Licenses and Permits
  • Third party consents
  • Important accounts and relationships
Additional Due Diligence Issues

• State Tax Issues
  • Will the target’s state tax the franchisee fee revenues in that state?
  • Was the franchisee compliant with tax laws?

• Federal Tax Audit Changes in 2018

• Predictive Coding
  • Document intensive diligence
  • Contract-oriented franchise
  • Easy to duplicate for pattern transactions
Conclusion

Questions?

Thank You

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