Buying Bankrupt Franchises

By Barry Kurtz and Nevin Sanli

PICKING AND CHOOSING FRANCHISES OUT OF BANKRUPTCY COURT

Buying assets out of bankruptcy court is time-consuming but usually easy. But if your target is a franchisee and you get choosy – meaning, for example, that you want to buy only 10 outlets in a bankrupt 20-outlet franchise restaurant chain – things get dicey. Why? Because it's hard to determine a fair value for such assets, and if you fail to do so, you could find yourself back in court fighting angry creditors who think you've cheated them.

That can turn any effort to pluck diamonds out of bankruptcy court into a disaster, and the threat leads many would-be bargain hunters to look elsewhere for their gems. But it needn't do so, because there's a solution to the problem – a thorough-going legal due diligence campaign coupled with an appraisal designed specifically for bankruptcy court that factors out the earnings drag of unprofitable outlets in a franchised chain, not to mention the drag created by, say, a big recession.

What's involved in carrying out such a campaign? How can the buyers in any such transaction protect themselves from unhappy creditors?

Bankruptcy proceedings often create a marketplace with more sellers than buyers – a distinct advantage to the savvy bidder. In addition, because bankruptcy law requires that debtors detail their financial troubles, bidders may find themselves in better position to develop offers than when negotiating acquisitions outside of bankruptcy court. Last but not least, although it costs money to buy assets out of bankruptcy court, a first bidder can often limit the risk of loss by securing the right to match or beat competing offers or, in the alternative, to recover due diligence costs from the bankruptcy estate.

Put together, these factors make it possible for the savvy bidder to come away from bankruptcy court with a prize bought on the cheap, free of debt and possibly of employee benefit obligations, and in all likelihood positioned to operate under more favorable lease and vendor agreements than those born by the bankrupt.

Getting to that point, however, takes doing. The goal of bankruptcy law is simple – to settle the affairs of the bankrupt party and send creditors on their way having taken as painless a haircut as possible. But simple ends do not translate into simple means in bankruptcy court; indeed, many cooks stir the pot in this kitchen, often concocting prolonged and messy proceedings. Put another way, in doing a bankruptcy deal, bidders learn the soldier's lament, because in bankruptcy court as in the army, it's hurry up and wait.

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Even so, the first goal of a would-be buyer is to gain precedence in line by submitting the first bid, and to get this done, the parties involved – the lawyer overseeing the due diligence and the appraiser in charge of the valuation – must work closely together from beginning to end.

Indeed, it is crucially important to coordinate the appraisal and legal due diligence in any effort to buy assets out of bankruptcy court, since many questions addressed by the appraisal affect the legal due diligence, and vice versa. Take for example the question whether the bidder intends to operate the outlets as a franchisee or independently.

Clearly, a fair appraisal of the business assets in question must derive a different value for each possibility. Meanwhile, assuming the bidder intends to become a franchisee, the legal due diligence must investigate all existing contractual arrangements between the franchisor and the debtor, probing in particular for terms that the bidder might induce the franchisor to renegotiate. State laws require that franchisors use one and the same franchise agreement when recruiting new franchisees, but this does not mean that a franchisor entangled in bankruptcy proceedings will not talk terms.

Another important question involving both the appraisal and the legal due diligence effort is whether the debtor is a master franchisee with development or other specific rights as defined in an agreement with the franchisor. Master franchisees often possess valuable expansion rights, with obvious impact on value. They may also enjoy certain economies of scale in employee training programs, in supply costs, and in rental and leasing costs. The relationships among these factors can be complex, and only a thorough-going appraisal can determine to what extent each has contributed value to the debtor's operation and to what extent the bidder might realize new value from them.

Behind these considerations lies another factor with obvious impact on value – turmoil in the U.S. economy, which has hit the restaurant industry hard. Buying any business is like buying a house in an important way. During good times, a healthy housing market generates plenty of pricing data, and the comparable sales give buyers confidence in estimating value. Such information becomes scarce when the housing market contracts, making any purchase more of a gamble. Similarly, when businesses sell in an expanding economy, the transactions yield plenty of data on which to base valuations, but the opposite is true in a contracting economy.

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DEAL OR NO DEAL? DUE DILIGENCE KEY TO BUYING BANKRUPT FRANCHISES

Last issue we began the discussion of how buying assets out of bankruptcy court is time-consuming but usually easy – when done properly. But if you try to pick and choose, it can become more difficult. It's hard to determine a fair value for such assets. If you're not careful you could find yourself back in court fighting angry creditors who think you've cheated them.

Let's turn our attention to a number of factors that, as a buyer, you can examine more deeply to determine what kind of deal you're looking at. The appraisal of such hard assets as plant, equipment, supplies, and inventory can be complicated. To overcome the problem, the valuation and legal due diligence efforts must work in tandem to "drill-down" into a number of factors, among them:

- **Brand value, or goodwill.** If the franchisor possesses a strong brand, the bidder might choose to operate as a franchisee, with obvious impact on valuation. If the goal is to operate independently or sign on with another franchisor, the impact on valuation would differ. Also, revenues and profits will vary from location to location in any franchise chain, and brand value may also vary. Indeed, in our example of a chain with 10 good and five poor outlets, the good 10 may derive a value from the brand name that is distinct from that of the five poor outlets. The appraisal must tease out that value by exploring all of the financial, operational, marketing and other factors that affect each outlet in the chain.
- **Market condition.** Demographic, economic and social conditions may differ in the markets where the debtor now operates, with differing impacts on the debtor's operations. The appraisal and legal due diligence efforts must seek to distinguish the impact of those conditions, whether positively or negatively, on the debtor's operations.
- **Local goodwill.** In most franchise deals, goodwill attaches entirely to the franchisor. It is possible, however, for local franchisees to build goodwill on their own that contributes to profitability. Here again, the appraisal and legal due diligence programs must coordinate closely.
- **"Leftovers."** Assuming a winning bid for the 10 good outlets, what will happen to the unprofitable five? The franchisor might choose to close them down, sell them to another franchisee, or even offer the winning bidder future development rights in valuable territories in exchange for taking them over. Whatever the scenario, the appraisal must assess the possible impact on the winning bidder. Would the disappearance of the five prompt their customers to patronize the surviving 10? Might their failure detract from the business of the good 10 if the winning bidder opted to become a franchisee under the existing franchisor?
- **Overhead costs.** The debtor's costs for advertising, rent, utilities, pensions and other employee benefit programs may differ between the good 10 and the poor five, with obvious impact on value. And since the bankruptcy action may free the winning bidder of such obligations, the legal and financial due diligence efforts must explore the impact of a number of differing strategies on value.
- **Franchisee and franchisor rights.** Assuming the bidder intends to operate as a franchisee, the legal due diligence must explore the existing franchise and development agreements. This includes detailing what expansion rights the winning bidder might enjoy and what rights the franchisor possesses to increase royalties, fees, or rents, or to

require the bidder to remodel outlets or upgrade equipment. The franchise agreement will also specify the conditions under which the franchisor might terminate the arrangement, with obvious impact on value.

• **Franchisor support.** Franchisors sometimes support long-term expansion programs or local marketing efforts by their franchisees, often with a substantial impact on value. The appraisal must determine to what degree this support might have contributed to the debtor's operations and, conversely, to what degree the absence of such support might damage the bidder's profits should the bidder operate independently.

• **Plant and equipment leases.** Equally important are the contractual terms of any leases of plant and equipment, whether involving the franchisor or other parties. What concessions might the bidder reasonably seek from the lessors, with what impact on profitability?

• **Efficiencies of scale.** Franchisees with more than a handful of outlets often enjoy certain efficiencies of scale in such factors as inventory, even in training costs. The appraisal and legal due diligence must assess to what degree the bidder might lose such advantages in operating the 10 good outlets.

• **Litigation and regulatory action.** Given the possible impact on value of any pending litigation or regulatory action, the legal due diligence must explore any such matters in detail.

Clearly, the legal due diligence and appraisal efforts are closely intertwined in any effort to buy business assets out of bankruptcy court. Indeed, a close coordination becomes crucial in assessing the data on the prices and terms of recent sales of comparable restaurant chains. In hard times some restaurants simply close down rather than sell, and many exchanges are distress sales involving operators generally profitable but caught up in a sudden credit squeeze. Only a coordinated effort can determine whether such operations were profitable but fell victim to cash flow problems, for example, or to changes in market conditions or other factors.

A great deal of financial data is available for public companies, and it can provide valuable benchmarks against which to measure the numbers illustrating the target business. But like the "comps," this information also requires careful analysis to identify conditions and trends affecting value.

Careful analysis is crucial to any successful bid to buy business assets out of bankruptcy, especially franchise business assets. So is speed. Bankruptcy is commonly a slow process, but the bidder who lingers can lose the opportunity to win a good business entangled in bankruptcy proceedings. Indeed, if the underlying business operations are sound, and if the bidder follows a disciplined, multi-pronged program to investigate the financial, legal and other factors in play, success can follow.

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