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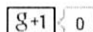
Deal or No Deal?: Due Diligence Key to Buying Bankrupt Franchises

By: Barry Kurtz And Nevin Sanli



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?
- Requ[...]oyee 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

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- **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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