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Picking and Choosing Franchises out of Bankruptcy Court (part 1)

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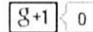

Buying assets out of bankruptcy court is time-consuming but usually easy. But if your target is a franchisee and you get choosy - meaning, for example, that you want to buy only 10 outlets in a bankrupt 20-outlet franchise restaurant chain - things get dicey. Why? Because it's hard to determine a fair 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.

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

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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.

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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.

Next time we'll look at a number of factors that, as a buyer, you can examine more deeply to determine what kind of deal you're looking at.

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