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M&A ACADEMY

Retail & Ecommerce Considerations in M&A Transactions

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The background features a dynamic, abstract composition of light trails. A dense field of red lines radiates from the top right towards the bottom left, creating a sense of motion and energy. Overlaid on this are several prominent, parallel blue lines that also trend from the top right towards the bottom left, but with a more pronounced perspective, suggesting a deep, tunnel-like structure or a high-speed path. The overall color palette is dominated by deep reds and blues, with some lighter blue highlights where the lines intersect or are more concentrated.

~CURRENT TRENDS

~KEY ECONOMIC TERMS

~DILIGENCE MATTERS

The background features a dynamic, abstract composition of light trails. The top half is dominated by numerous thin, parallel lines in shades of red and orange, creating a sense of motion and energy. These lines curve and converge towards the right side of the frame. Below this, a series of thicker, more prominent lines in various shades of blue and white sweep across the lower half, also moving towards the right. The overall effect is one of high-speed movement and modern technology.

CURRENT TRENDS IN RETAIL M&A

Market Trends in Retail and Ecommerce

- Shift from traditional retail model to ecommerce
- Omnichannel shopping experience
- Disruption of supply chains
- Increased focus on well-being and fitness
- Sustainability as a business strategy

The background features a dynamic, abstract composition of light trails. On the left, numerous thin, parallel red lines radiate from the top-left towards the right, creating a sense of motion and energy. On the right, a series of thicker, parallel blue lines curve downwards and to the right, suggesting a path or trajectory. The overall color palette is dominated by deep reds and blues, with a dark, almost black, background that makes the light trails stand out prominently.

KEY ECONOMIC TERMS IN RETAIL M&A

Questions on Value

- COVID-19 Bump vs. COVID-19 Hit – What's next
- Working Capital
 - LTM period
 - Pre-LTM period
 - COVID adjustments - Delays in AR and AP; supply pricing; inventory
 - Inventory counts
 - Accounting principles
 - Collars
 - Escrows vs. Seller recourse

Debt-like Items

- Deferrals under CARES Act
- Deferred rent or other vendor payments, prior earn-outs
- PPP Loans
 - Diligence
 - Options for PPP Treatment
 - As a general matter in a stock/merger transaction, the parties should also consider whether to obtain SBA and PPP lender consent
 - *Generally, if parties (i) have applied for forgiveness and (ii) have put aside the loan amount into escrow with the PPP lender, your PPP lender can consent without SBA approval (otherwise, SBA consent is hard to receive).*

Purchase Price Mechanisms

- Holdbacks and Earn-Outs
- Advantages of using an Earn-out
 - Buyer and Seller cannot agree on valuation of target given uncertainty on prospects of the business – apportions risk
 - Defer payment of purchase price for a period after closing
 - Potentially higher purchase price for Seller (and offset for indemnification claims)
- Disadvantages of using an Earn-out
 - High potential for disputes
 - Negotiating terms can be difficult
 - May place constraints on business for Buyer post-closing

Earn-outs

- Earn-Out Targets
 - Financial Targets - Revenue, Net Income, EBITDA, etc.
 - Non-Financial Targets – development of products, store openings, increase in customers, contracts, etc.
- Earn-Out Period
 - Typically, one to three years (but depends on target)
 - Consider timing as it relates to restraints on business and exposure to credit risk of Buyer
- Dispute Resolution
 - Provisions needed to determine when earn-out targets are achieved and independent evaluation if a dispute occurs
- Operational Constraints on Post-Closing Business
 - Seller wants assurance that Buyer operates business in a manner that maximizes the earn-out (and also, ordinary course)
 - Buyer wants discretion over operation of business post-closing

The background features a dynamic, abstract composition of light trails. The upper portion is dominated by numerous thin, parallel lines in shades of red and orange, creating a sense of motion and energy. These lines curve and converge towards the right side of the frame. Below the red trails, there are several prominent, thick, diagonal streaks in various shades of blue, ranging from light cyan to deep navy. The overall effect is one of speed and modernity, with a dark blue gradient background that provides a high-contrast setting for the light trails.

KEY DILIGENCE ISSUES

Importance of Thorough Due Diligence

- **Due Diligence** is of utmost importance given potentially large employee base, large store footprint for conventional “brick and mortar” retailer, privacy issues with e-commerce retailer and increased risk from constant interaction with consumers.
- Allocation of identified risks through due diligence with appropriate representations and indemnity
- Third Party consents – who bears the risk of loss of contracts (key suppliers and retail leases)
- Purchase Price Adjustments – Inventory, Register Cash, Working Capital seasonality, Escheat Liability.

Employment Due Diligence Requests

- Standard items
 - Employee lawsuits/agency charges pending
 - Comprehensive employee census
 - Employment agreements
 - Bonus, incentive, commission plans
 - Confidentiality, noncompetes, nonsolicitations
 - Arbitration Agreements
 - Exempt/nonexempt classifications
 - Independent contractor classifications
 - Unions
 - Employee handbooks
 - Benefit plans and programs
 - **New: #metoo**
 - **New: COVID-19**
- What you also really want (current and past)
 - Internal complaints/issues
 - Government audits, investigations, and citations
 - Workers' comp claims and expenses
 - Workplace accidents; OSHA audits/investigations
 - Employment applications, offer letters, turnover data, absenteeism, exit interview results
 - Separation or severance agreements or plans
 - I-9 forms for current employees and visa overview
 - Union-organizing attempts (past and pending)
 - All union memos of understanding, side letters, etc.
 - Grievances, arbitrations, NLRB charge history
 - Strike, lockout, and work stoppage history
 - Leased employees and contracts with staffing agencies (Co-employer liabilities)
 - Government contracts - EEO-1 forms and affirmative action plans

Certain Employment-Related Exposure Issues

- Key diligence topics for **buyer**:
 - Misclassification of Employees
 - Overtime Pay
 - Misclassification of Contractors
 - Unions
 - COVID-19 & OSHA
 - Immigration
 - Sexual Harassment & Misconduct Liabilities in the #MeToo Era
- **Sellers** should also pay attention to these issues:
 - Resolving or limiting these issues prior to the transaction can increase sellers' bargaining power and limit the need for heavy negotiation over potential liability
- State laws matter
- Assemble team of knowledgeable employment lawyers in relevant jurisdictions

Misclassification: Overtime Exemptions

- The key focus is whether employee was properly classified as exempt or non-exempt for overtime purposes (FLSA/state law)
 - Potential repercussions for misclassification:
 - Potential liability for all unpaid overtime – could go back as far as 3 – 4 years for willful violations; may depend on state
 - Potential liability for withholding wages
 - Labor Code Violations - Some states have more significant penalties than others (i.e., PAGA claims in CA)
 - Pay frequency laws
 - Wage Statement laws
 - Meal and rest period premiums
 - Fines & penalties
 - Provides recovery of attorney fees for employees' attorneys
 - Record keeping liability (i.e., failure to properly record employee hours worked)

Diligence of Overtime Exemptions

- Request information on employees:
 - FLSA classifications – exempt v. nonexempt from overtime
 - Salaries/hourly rate
 - Job titles/position
 - Job descriptions
 - Locations
- Inquire as to classification methods and practices
 - How did company make classification decision
 - Review any classification policies
- Request internal and external classification audits
 - Recent DOL (or similar state agency) audits
 - Attorney classification audit
- Claims
 - Class or collective actions
 - Past claims or demand letters
 - Audit letters

Overtime - General

- Under the FLSA, the employer must pay the employee one and one-half times the employee's regular rate of pay for all hours worked in excess of 40 in a week
- Buyers should conduct diligence on target's overtime and pay practices
 - Review overtime policies and pay practices
 - Review sample time records
 - Review and ask about unique pay
 - Piece rate
 - Day rate
 - Commissions
 - Salaried nonexempt
- When calculating overtime, employee must be paid their "regular rate"

Overtime - Regular Rate of Pay

- Regular Rate of Pay is employee's actual rate of pay, including all hourly earnings, plus other compensation
- Regular Rate of Pay – Calculation
 - Generally, for hourly employees, the regular rate of pay is calculated by totaling all compensation earned in the workweek and dividing that sum by the total hours worked:
- Ask about:
 - Bonuses for accuracy of work, quality of work, productivity, incentives, safety, good attendance, etc.
 - Retention bonus
 - Commissions
 - Referral bonuses
 - On-call/call-back payments
 - Shift differentials
 - Other hourly earnings
 - The value of meals and lodgings
 - Any compensation or payment not specifically excluded by statute
- Looking for any bonus or payment or perk provided to non-exempt/hourly employees that is not completely and totally discretionary.

Misclassification: Independent Contractors

- The key focus is whether the individual was properly classified as a contractor, consultant, or advisor, rather than an employee
- Potential repercussions for contractor misclassification:
 - Misclassified contractors could be entitled to retroactive participation in employee benefits
 - Payment of employment taxes and amounts that should have been withheld, including interest & penalties
 - Unpaid overtime or other wage-based claims - if the employee should have been classified as non-exempt
- State laws matter
- Different agencies apply different tests

Diligence of Independent Contractors

- Buyer should request:
 - Lists of contractors with summaries of any services provided and service history
 - Copies of individual contractor agreements and related statements of work
 - Method for classifying contractors
 - Self audits or attorney of classifications
 - Agency audits
 - Claims History
 - Class or collective actions
 - Past claims or demand letters
 - Audit letters

Union Issues

- If employees are represented by a labor organization, buyers must understand scope of representation, including obligations under existing agreements
- Possible impact of unions on transaction:
 - Successors/assigns language
 - Treatment of employee benefits and compensation, promotions/demotions, hiring/firing employee grievances/claims
 - Maintenance-of-benefits clauses and required participation in multi-employer pension plan (withdrawal liability)
 - Limitations on sales, relocations, plant closings and layoffs
 - Can union contract be renegotiated
 - Notice to union of transaction/timing of notice
 - When/how buyer offers employment
 - What is bargaining unit

Diligence of Union Issues

- Buyers should request:
 - Collective bargaining and similar labor agreements
 - History of union organizing efforts or activities
 - History of work stoppages, strikes, lockouts
 - History of grievances and unfair labor practice claims
 - History of arbitrations
 - History of proceedings before the National Labor Relations Board
 - Ad hoc “side agreements” or “memos of understanding”
- Asset v. Stock deal will matter
- Buyer and Seller coordination almost always important (if possible)
- Not for amateurs - use “real” labor attorneys

CLE Code

We will now announce the CLE code. Please save this number; you will be asked to provide this code in a survey immediately following the presentation today, which will generate once you exit the WebEx application. Please be sure to take the survey and apply the code where necessary in order to receive credit.

Please email Erik Scott at **erik.scott@morganlewis.com** if you have any questions.

COVID-19 Considerations

- COVID-19 has created significant liability for employers
- Diligence should cover:
 - Reductions in force, furloughs, office and facility closures, material changes to schedules, material changes to pay, turn over
 - WARN Act compliance
 - Participation in various COVID-19 government programs (e.g., PPP loans, Treasury loans, Families First Coronavirus Response Act (FFCRA)/tax credits, ARPA/tax credits, etc.)
 - Compliance with local, state, and federal sick leave obligations and COVID-19 supplemental sick leave laws
 - OSHA audits, complaints, and citations
 - Workers' compensation claims relating to COVID-19 exposure
 - Return to Work/Reopening Plans – screening measures, mandatory testing, mandatory vaccines, social distancing, face masks, reconfiguration of workplace, remote work policies

The Rise of Employment Claims Related to COVID-19

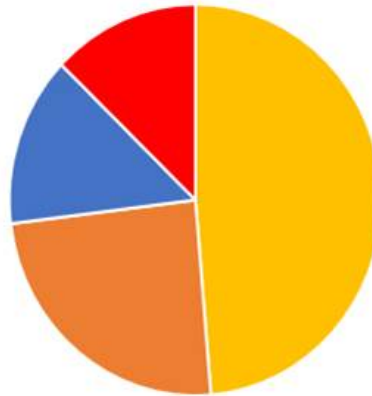
- As of 4/16/2021, over 1920 cases have been filed in court relating to COVID-19.
 - This does not include agency filings or union grievances

Type of Claim



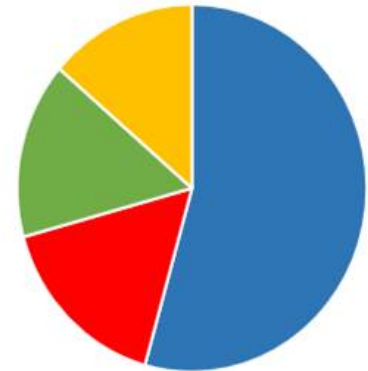
■ Wrongful Termination (620) ■ Workplace Conditions (331)
■ Discrimination (655) ■ Leaves of Absence (193)

State Claim Filed In



■ California (497) ■ New Jersey (249)
■ Florida (144) ■ New York (131)

Industry



■ Healthcare (388) ■ Manufacturing (117)
■ Hospitality (111) ■ Essential Retail (98)

Immigration Issues

- Retail's decentralized footprint often creates Form I-9 issues
 - Assess target's I-9 compliance and determine a strategy for how to handle I-9 forms of acquired or impacted employees
 - Review comprehensive sample of completed I-9s
 - Accept I-9s or require new ones
 - Violations can be mitigated but not completely cured
 - Require Seller to "fix" I-9 violations
 - Require Seller to keep I-9 liabilities
- Is I-9 process centralized by knowledgeable employee
- Does Seller use E-Verify
- History of I-9 audits by Immigration and Customs Enforcement (ICE)
- Identify workers, particularly senior-level management, who may be on work visas
 - H-1B worker issues will need to be addressed prior to closing
 - Acquiring company will have need to retain existing Public Access Files
 - L-1 and E visa workers may not be transferrable
 - TN and other free trade workers will require attention
 - Green Card Process – Acquiring company must file amended I-140 Petitions as a successor in interest.

#MeToo Diligence

- Buyer should ensure it is not inheriting undiscovered sexual harassment claims
- Diligence should include extensive review of HR processes and complaint records:
 - Is there HR department?
 - Investigations – external and internal
 - Focus on upper management
 - Search and review publicly-filed actions
 - Review all historical agency filings and claims (EEOC, etc.)
 - Review audit letters
 - Ask about demand letters
 - Consider background check on key players
- Sellers should not attempt to withhold existence of known or potential sexual harassment claims or allegations

Upshot of Employment Diligence

- Both sellers and buyers should evaluate liability associated with target workforce and plan accordingly
- Be prepared for R&W cross-examination
 - Underwriting relies on quality of the parties' due diligence
- Take appropriate action in deal if necessary
 - Escrow
 - Indemnification - uncovering the problematic issues in diligence will allow you to draft specific indemnity
 - Reduction in purchase price
 - Abandon deal
- Plan for post-closing items that will need to be addressed, changed or cured
 - Exiting or transitioning out high-level executives
 - Managing public relations
 - What changes to policies or classifications need to be made

Data Privacy

- Data Privacy Laws
 - Evaluate the type of customer information obtained
 - Review policies relating to safeguarding customer information
 - Enforcement is increasing and sanctions are expensive
- PCI Compliance and DSS Credit Card Rules
 - Different standards depending on size of the company
 - Has target ever had a breach and, if so, what did it do?
 - Big reputational risk for release of information
- Gift Cards/Loyalty Programs
 - Expiration Dates
 - State law considerations and escheat risk
 - Could be substantial liability for Buyer if not appropriately addressed in transaction agreement

How Important is the Brand?

- Consider the value placed on the brand/name recognition of the retailer
 - Comprehensive trademark/IP searches
 - Evaluate infringement history both by and against target
- Are there any third-party brands exclusively sold by the target retailer?
- Review the enforceability of the exclusivity provisions for any third-party brands sold in the stores or online
 - Can the brands be sold to competitors?
 - If a strategic buyer – do any of the target supply contracts conflict with supply contracts of Buyer – if so can either contract be terminated; are there termination payments?

Other Key Diligence

- Modification to Contract Terms post-COVID
 - Focus on deferred of obligations
 - Breaches or defaults under material contracts

Key Takeaways

- Retail M&A has been greatly affected by COVID-19 in both positive and negative ways
- Valuation methodologies and certain purchase price adjustment inputs have changed as a result of COVID-19 effects on the retail industry
- Key areas to think about when considering retail M&A diligence are employment, real estate, privacy, franchise and intellectual property matters

Biography



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Christina's corporate and securities practice focuses on representing public and private corporations and private equity sponsors and their portfolio companies in mergers and acquisitions, asset purchases, joint ventures, private and public equity and debt financings, securities offerings, and other general corporate matters. Christina also assists companies to raise capital in the public markets, including initial public offerings and secondary offerings. Christina counsels clients on SEC reporting and securities law disclosure, annual meeting and proxy related issues, corporate governance matters, and stock exchange listing requirements. Additionally, she currently serves as Morgan Lewis's firmwide hiring partner and co-leader of the firm's retail and eCommerce industry initiative.



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Biography



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Jackie counsels employers in connection with all aspects of employment issues, including employee discipline and termination, compliance and policy matters, workplace restructuring, compensation arrangements, hiring and termination documentation, and agency investigations and audits. Jackie also spends a significant amount of time providing employment experience in connection with corporate mergers and acquisitions, including analyzing due diligence and assessing risk, drafting executive compensation arrangements, restrictive covenants and employment-related provisions in the operative deal documents, and implementing workplace reorganization.

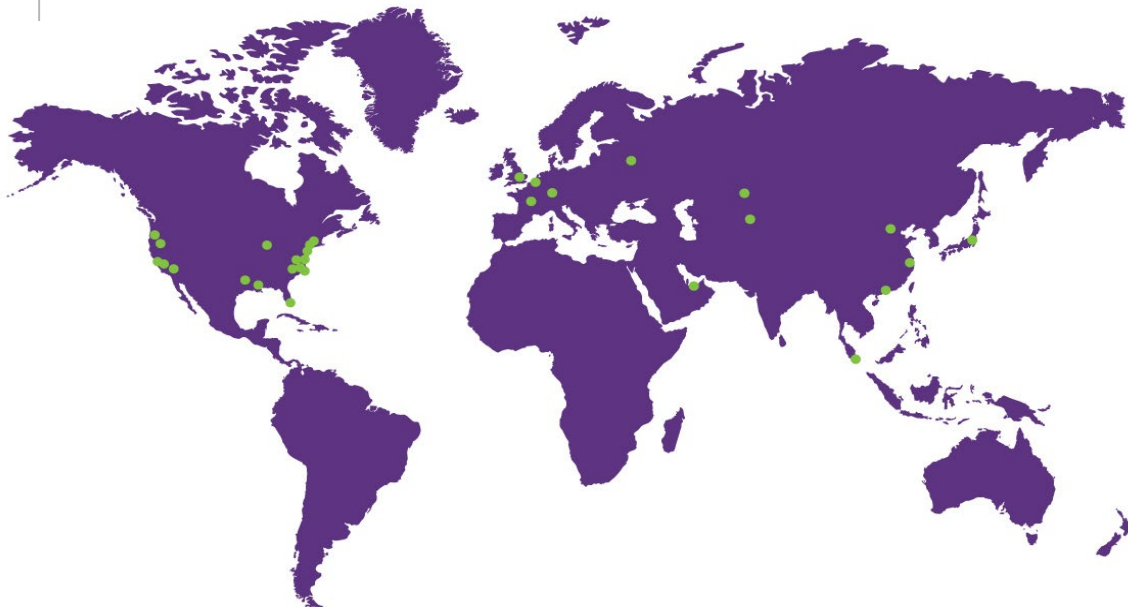


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