M&A ACADEMY: ISSUES IN RETAIL M&A TRANSACTIONS
David McManus and Christina Melendi
May 10, 2016
Agenda

• Introduction
  – Deal Structure and Considerations
  – Important Issues in a Retail Deal

• Key Diligence Areas
  – Real Estate
    – Leases and Owned Property
    – Environmental
  – Data Privacy
    – PCI Compliance
    – Website Terms
  – Gift Card/Loyalty Programs
  – Employment
    – Employee Misclassification
    – Unions
    – Immigration
    – ADA Compliance
  – Franchises
  – Brand/IP

• Purchase Price Adjustments
  – Working Capital
  – Inventory Count

• Liability Protection
  – R&W Insurance
  – Specific Indemnities
  – Quantify the Risk

• Postclosing Considerations and Integration
Deal Structure and Considerations

- Typical M&A Deal Structure
  - Asset Purchase: acquire only specific assets and liabilities but watch out for potential successor liability
    - may be difficult for large leased real estate footprint
  - Stock Purchase: best if target has few stockholders or is foreign
    - all assets transfer as a function of the deal structure – get the good and bad
  - Merger: state law mechanism; allows for cash-out of unwilling stockholders or large group of stockholders where inefficient to obtain signatures
    - all assets transfer as a function of deal structure – get the good and the bad

- Retail M&A can use any of the above structures – often tax driven
Key Issues in a Retail Transaction

- **Due Diligence** is of the utmost importance given the potentially large employee base, large store footprint for conventional “brick and mortar” retailers 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.
Real Estate Due Diligence/Contract Terms

• **Owned Property Due Diligence**
  – Confirm ownership (title/survey/liens)
  – Environmental issues? Recent reports?

• **Leased Property Due Diligence**
  – Assignment provisions – consent required for transaction
  – Carefully vet the provision in light of the proposed structure – assignment, change of control and indirect change of control
  – State law interpretations for mergers
  – Provisions construed against the landlord
  – Restrictions on use of the property/sublet
  – Net worth requirements for tenant – leverage may be considered
  – Radius restrictions – often found in strip mall-type leases
  – Years left on the lease – Are the terms favorable? – Will it be renegotiated by landlord?

• **Heavily Negotiated Contract Points**
  – Consents required for closing – Who pays? All or a percentage of store-level EBITDA?
Data Privacy and Gift Card/Loyalty Programs

• Data Privacy Laws
  – Data privacy laws exist in approximately 100 countries
  – 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

Morgan Lewis
Franchises

• Review Franchise Disclosure Documents
• Standard Franchise Agreement (multiple franchises on one agreement)
  – Frequent deviation from standard agreement?
• Development Area
  – Evaluate agreements for exclusive development awarded to any party for a region (How broad is it and for how long?)
  – Carefully consider whether there is any overlap between buyer and seller (and sometimes affiliates – additional risk when PE sponsor involved)
• Risk of Franchisee Litigation – evaluate relationships between franchisor and franchisee
• Joint Employer Liability
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
  - Can the brands be sold to competitors?
  - If a strategic buyer, do any of the target supply contracts conflict with supply contractions of buyer? If so, can either contract be terminated; are there termination payments?
Real-World Buyer “Employment Due Diligence”

- **Standard Stuff**
  - Employee lawsuits pending
  - Benefit plans and SPDs
  - Employment agreements
  - Employee handbooks
  - What unions and where?
  - Labor contracts

- **What you also really want (current and past)**
  - Charge/litigation history
  - Internal complaints/issues
  - Government audits, investigations, and citations
  - Exempt and nonexempt classifications/independent contractor
  - Benefit claim appeals
  - Workers comp claims and expenses
  - Workplace accidents and other OSHA information
  - ADA/Title III Compliance/Litigation (Internet and physical assets)
  - Employment applications, offer letters, turnover data, absenteeism, exit interview results, etc.
  - EEO-1 forms and affirmative action plans
  - Immigration I-9 forms for current employees
  - Prior handbooks, benefit plans, SPDs, etc.
  - Union organizing, strikes, and work stoppages (past and pending)
  - All union memos of understanding, side letters, ratification summaries, etc.
  - Grievance, arbitration, NLRB charge history, etc.
Large Exposure Issues

• The following have potential for large exposure for a **Buyer**:
  – Termination and CIC Obligations
  – Misclassification of Service Providers
  – Labor Organizations and Representation
  – OSHA

• **Sellers** should also pay attention to these issues:
  – Where seller can resolve or limit these issues prior to the transaction, seller may increase its bargaining power and limit the need for heavy negotiation over potential liability
Misclassification Liability

• Misclassification of service providers
  – A key area in nearly every transaction
  – Like each key area of liability, this impacts both buyer and seller – and has implications in integration

• Two main types of misclassification:
  – Misclassification of independent contractors
  – Misclassification of employees for overtime purposes
Misclassification: Independent Contractors

• The key focus is whether an 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 and penalties.
  – Unpaid overtime or other wage-based claims (if the employee should have been classified as nonexempt).
Diligence of Independent Contractors

- **Independent Contractor Classification Diligence:**
  - Buyer should request information such as lists of contractors with summaries of any services provided and service history.
  - Buyer should also request copies of individual contractor agreements and related statements of work.
  - As with overtime, consider requesting any self audits of classifications as well as any recent agency audits.
Misclassification: Overtime Exemptions

- The key focus is whether an employee was properly classified as exempt or nonexempt for overtime purposes (FLSA/state law)

- Potential repercussions for misclassification:
  - Potential liability for all unpaid overtime (may run back as far as three years in cases of willful violations)
  - Potential liability for withholding wages
  - Fines and penalties
  - Recordkeeping liability (e.g., where seller has failed to properly record employee hours worked)
Diligence of Overtime Exemptions

Overtime Exemption Classification Diligence:

- Request information on employee salaries, classifications, job titles, and classification policies, and similar documents

- Inquire as to target’s classification methods and practice

- Request internal and external self-audits of classifications as well as any recent DOL (or similar state agency) audits
Mile-High Summary of International Issues

- Assemble your team of knowledgeable lawyers in relevant jurisdictions
- Organize tasks and documents by country as well as by other aspects of the deal
- Press for diligence from relevant foreign entities
- Much more extensive government regulation of individual employment relationship in many countries
- Pay attention to timetables for pre- and postclosing tasks
- Much more extensive government approvals and union and works council approvals required in many countries
- Be aware of TUPE (Transfer of Undertakings (Protection of Employment))
Union Issues

• If employees are represented by a labor organization, buyer must understand scope of representation, including obligations under existing agreements

• Such agreements may include information and requirements relating to such areas as:
  – Employee benefits and compensation
  – Promotions and demotions
  – Hiring and separation from employment
  – Grievances and related matters
For sellers (and buyers in a stock deal)

- Labor contract obligations
  - WATCH: successors/assigns language
  - WATCH: limitations on sales, relocations, plant closings and layoffs
  - WATCH: maintenance-of-benefits clauses and required participation in multiemployer pension plans (withdrawal liability)
  - WATCH: neutrality or card-check provisions

- Bargaining obligations
  - Decision bargaining
  - Effects bargaining
  - Expiration of existing labor agreements

- Risks
  - Status quo injunctions
  - Buy it back, put it back plus $$$$
Union Issues (continued)

For buyer (in an assets deal)

- Union “successorship” – what seller obligations does buyer inherit?
  - “Workforce majority” is controlling in many cases
    - WATCH: measured against whom?
    - WATCH: discrimination in hiring is illegal
  - Business continuity component is also relevant
  - WATCH: “perfectly clear successor” loses ability to unilaterally set new initial terms and conditions
  - REMEMBER: different “successor” test for each type of potential obligation

- WATCH: protect against “material changes” with deal pending
  - Seller labor contracts being renegotiated (check contract termination dates)
  - Significant grievance arbitration cases, other union litigation, and settlements
  - Ad hoc “side agreements” or “memos of understanding”
  - Seller management “mixed loyalties” problem
Summary of Union Considerations:

- Realistically evaluate management leverage (but leverage works!)
- Consider pre-deal buyer “preliminary discussions”
- Importance of timing . . .
  - When seller notifies union
  - When and how buyer offers employment
  - When buyer engages union
  - When union demands recognition
- Buyer and Seller coordination almost always important (if possible)
- Not for amateurs (use “real” labor attorneys)
Immigration Issues

• Identify early on any foreign national workers impacted by the transaction, particularly senior-level management who may be on work visas
  – H-1B worker issues will need to be addressed prior to closing
  – L-1 and E visa workers may not be transferrable
  – TN and other free trade workers will require attention

• 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
Purchase Price Adjustments

- Retail transactions have unique cash flow considerations
- Inventory count – is it necessary?
  - Consider when the last inventory audit was performed
  - How much value is allocated to the existing inventory in the transaction?
- Cash in the registers
  - If purchase is on a cash/debt-free basis – is a minimum level of cash needed to open the stores on day one of ownership?
- Escheat liability
  - If liability identified for gift cards programs, escheat liability deduction from cash
- Working capital
  - Consider seasonality of business and inventory turnover
  - Consider any necessary adjustments to LTI average working net capital
  - Bonus payments for large employee basis – is it properly accrued?
Protection Against Identified Risk

• Indemnification
  – Strong representations/longer survival
  – Specific indemnity for identified risks
  – Special escrows to cover known risks

• R&W insurance
  – Can be obtained by either buyer or seller for all representations or a heightened risk
  – Insurers will not cover known liabilities or liabilities that are high risk such as environmental or wage/hour claims and pension underfunding

• Best protection is comprehensive due diligence
  – Buyer is able to identify and quantify the risk
  – Seller can identify risks and educate buyer about the exposure to reduce the risk of a lower purchase price or large escrow
Postclosing – Effectively Integrating the Businesses and Managing Identified Risks

- Manage risks identified in the diligence process postclosing
- There may be limitations on identified risks if seller agreed to pay for damages related to an identified liability – i.e., consent for settlement of a claim
- Develop a time line to fix issues identified during the diligence process
- Consider a postclose employment practices audit
- Combination of suppliers/vendors – develop an efficient time table to merge suppliers and outside vendors to eliminate inefficiencies, and consider potential termination costs
Employment Integration Issues: Initial Questions

- Buyer needs to consider how to integrate service providers into postsigning organization, including:

  - Will they become employees of buyer or a sub upon closing? If so, where in the organization?

  - If the acquired company continues to exist as a wholly owned sub of buyer, will they continue to be employed by the surviving entity?

  - Will buyer continue any of seller’s existing benefit plans?

  - How will buyer handle accrued but unused benefits (e.g., vacation)? Offer credit for any prior service with seller?
• Buyer should request information regarding seller’s current workforce, including:
  
  – Location of employees
  
  – Salary, benefits, and other compensation matters
  
  – Confirmation of all existing benefit plans and participants
  
  – Accrued but unused benefits (e.g., vacation/PTO)
  
  – Any collective bargaining agreements or other labor-related contracts or statutory obligations relating to workforce
Concluding Remarks

• The best protection for both buyer and seller is effective due diligence
  – Quantify risks to understand exposure and educate the other party
  – Key areas of risk in a retail deal include employment, real estate, privacy, franchises, and intellectual property
  – Realistically plan for and address issues
  – Don’t forget to fix the issues identified postclosing
David McManus
New York
T +1.212.309.6824
david.mcmanus@morganlewis.com

David A. McManus counsels employers in an array of industries in labor and employment matters, and regularly represents employers in litigation and in arbitration relating to both union and nonunion employees. He advises clients in planning and implementing the restructuring and redeployment of their US domestic and international workforces in connection with reductions in force, outsourcing transactions, facility shutdowns and relocations, mergers, sales, acquisitions, and joint ventures. David is practice group leader of the labor and employment practice in the firm’s New York office.

Christina Melendi
New York
T +1.212.309.6949
christina.melendi@morganlewis.com

Christina Melendi’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.
<table>
<thead>
<tr>
<th>Our Global Reach</th>
<th>Our Locations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa</td>
<td>Almaty</td>
</tr>
<tr>
<td>Asia Pacific</td>
<td>Astana</td>
</tr>
<tr>
<td>Europe</td>
<td>Beijing</td>
</tr>
<tr>
<td>Latin America</td>
<td>Boston</td>
</tr>
<tr>
<td>Middle East</td>
<td>Brussels</td>
</tr>
<tr>
<td>North America</td>
<td>Chicago</td>
</tr>
<tr>
<td></td>
<td>Dallas</td>
</tr>
<tr>
<td></td>
<td>Dubai</td>
</tr>
<tr>
<td></td>
<td>Frankfurt</td>
</tr>
<tr>
<td></td>
<td>Hartford</td>
</tr>
<tr>
<td></td>
<td>Houston</td>
</tr>
<tr>
<td></td>
<td>London</td>
</tr>
<tr>
<td></td>
<td>Los Angeles</td>
</tr>
<tr>
<td></td>
<td>Miami</td>
</tr>
<tr>
<td></td>
<td>Moscow</td>
</tr>
<tr>
<td></td>
<td>New York</td>
</tr>
<tr>
<td></td>
<td>Orange County</td>
</tr>
<tr>
<td></td>
<td>Paris</td>
</tr>
<tr>
<td></td>
<td>Philadelphia</td>
</tr>
<tr>
<td></td>
<td>Pittsburgh</td>
</tr>
<tr>
<td></td>
<td>Princeton</td>
</tr>
<tr>
<td></td>
<td>San Francisco</td>
</tr>
<tr>
<td></td>
<td>Santa Monica</td>
</tr>
<tr>
<td></td>
<td>Silicon Valley</td>
</tr>
<tr>
<td></td>
<td>Singapore</td>
</tr>
<tr>
<td></td>
<td>Tokyo</td>
</tr>
<tr>
<td></td>
<td>Washington, DC</td>
</tr>
<tr>
<td></td>
<td>Wilmington</td>
</tr>
</tbody>
</table>

*Morgan Lewis*