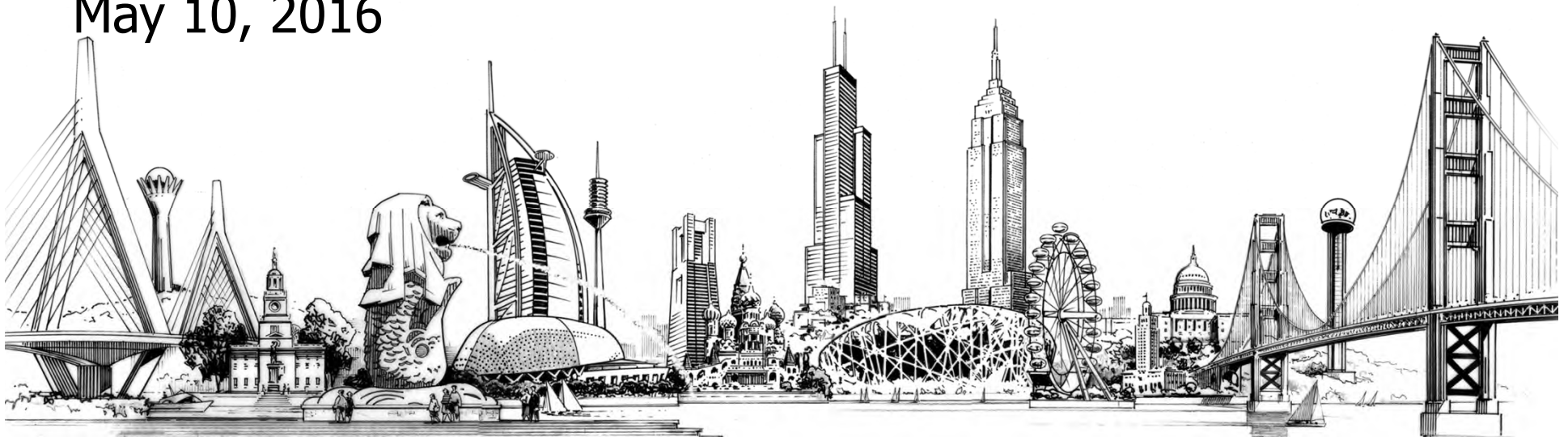


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**M&A ACADEMY:
ISSUES IN RETAIL
M&A TRANSACTIONS**

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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

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 contracts 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

Union Issues *(continued)*

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

Union Issues *(continued)*

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?

Integration Issues: Diligence (continued)

- 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

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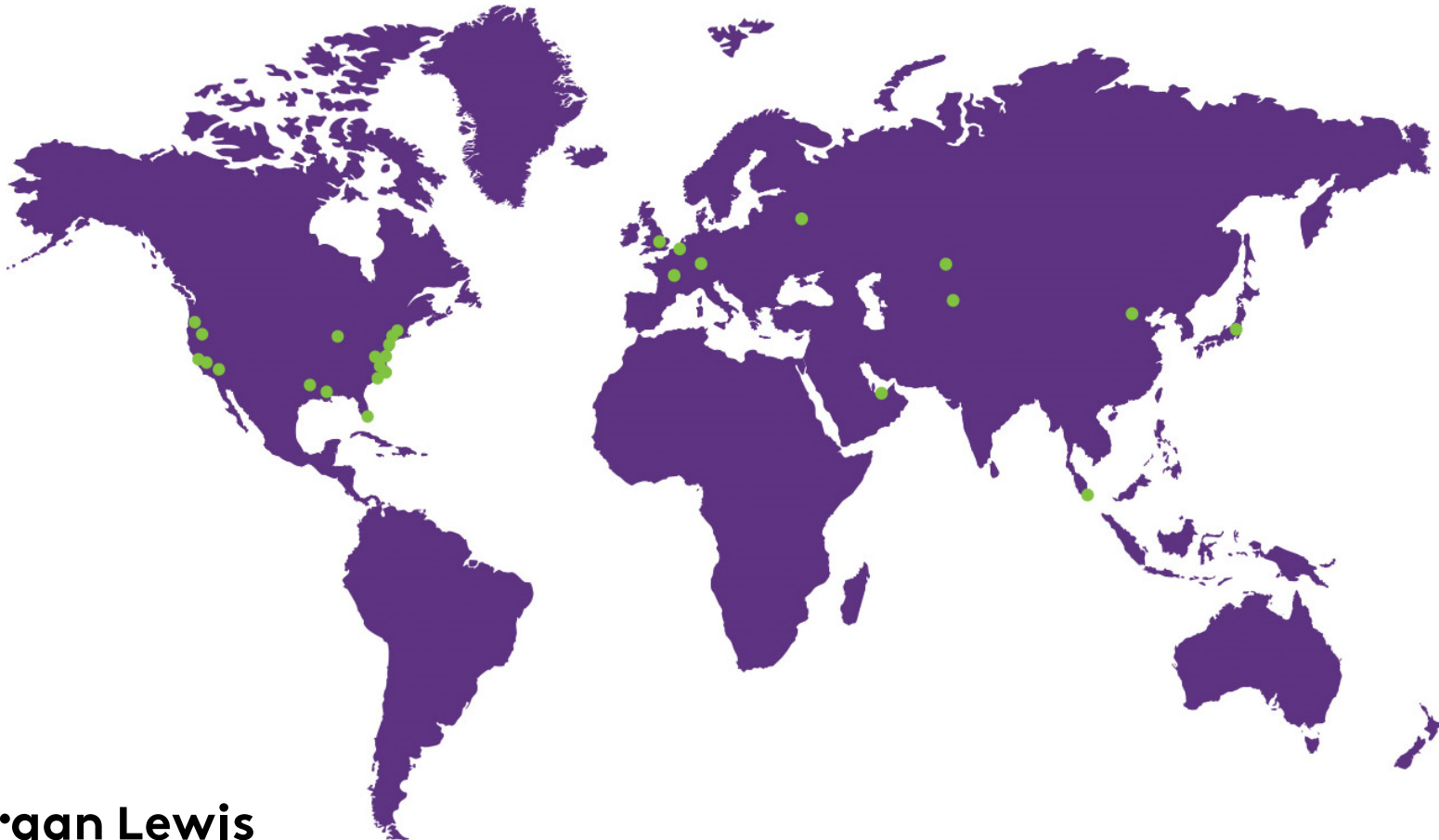
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