

Getting Past the Right of First Refusal to Complete a Sale Transaction

The ROFR can potentially complicate the problem of selling a business.

by Frank Buhler

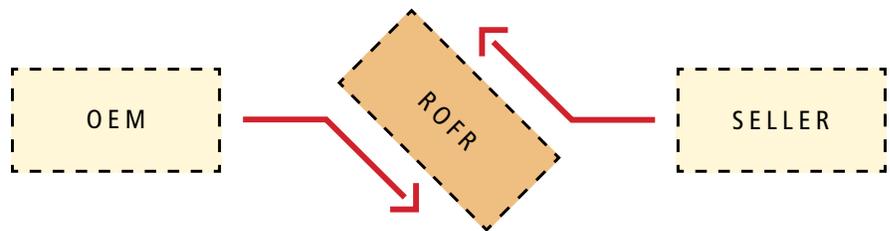
Original equipment manufacturers (“OEMs”) and franchisors sometimes employ a business model for distribution that embodies separately owned franchises or dealerships under the umbrella of the OEM’s or franchisor’s brand. To assure alignment of all parties around the preservation and optimization of the OEM’s brand, the OEM or franchisor grants the right to operate a franchise or dealership under a set of conditions, one of which may be to approve the next owner of the dealership or franchise. A technique used by many OEMs is to require the dealership or franchisee to enter into an agreement referred to as a right of first refusal (“ROFR”) that allows it the right to match any offer made by a third party to purchase the ownership interests in the business. The ROFR may additionally contain rules for selling the business, notices, and time frames for action. This presents a potentially complicated problem for the seller and his adviser that requires some tactical thinking prior to initiating a sale process.

COMPETITION IS REQUIRED

With any ownership sale transaction, the objective is to close a deal wherein the seller receives a market rate valuation and terms. In order to achieve this goal, competition is required, which is best accomplished by bringing simultaneously all logical and financially qualified buyers to the “table”. At this point, the interests of the seller and the OEM or franchisor may diverge. The party that is the most enthusiastic and values the business highest may not be the buyer most preferred by the franchisor or OEM. ROFRs get in the way of achieving the seller’s goals because a deal could be ready to close with all the parties having invested substantial money and time, but with the ultimate decision of whether the deal can close left to another party. The existence of a ROFR and the implied risk of not being able to close may impair the ultimate value to the seller and the number of interested parties.

REVIEW THE FRANCHISE AGREEMENT

The first step in designing a sale process is



With a ROFR, Incentives May Not Be Aligned Between the OEM/Franchisor and the Seller

to thoroughly review the franchise agreement and understand the transfer terms. We suggest the seller’s team consult with an experienced franchise attorney to understand all regulatory requirements and any industry or regional nuances. Not all franchise agreements are the same. Laws protecting the rights of franchisees

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also vary from state to state. We have found that, despite being designed by large OEMs with substantial resources, some agreements are ambiguous. Depending on the state, this could be for the benefit of the OEM or the dealer. The nature of the relationship and the clarity of the franchise agreement ultimately leads to a decision of whether to ask permission in advance or, at a later date, forgiveness. Each of these courses imply different tactics. For example, if the sole remedy for the OEM is a ROFR on the specific terms of the offer,

moving forward without permission might be the best course, whereas if the OEM has other rights than a ROFR (e.g., right to approve the buyer or right to transfer the franchise to an acceptable buyer), gaining alignment with the OEM in advance might be necessary. There is a lot of space in the middle.

In the case of the decision to involve the OEM in the process, we recommend several steps in gaining support prior to entering the market. Our overriding advice however would be to establish a concise paper trail that leaves no ambiguity between the seller and the OEM or franchisor. Running a successful competitive process only to learn at the end, after giving up other alternatives, that there was a misunderstanding with the OEM or franchisor on the terms of transfer could be very disappointing.

- Learn the concerns and criteria the OEM has for the next owners (business plan, capitalization, type of organization, ability to support the business long term, buyer longevity, private equity)
- Receive approval (in writing) of an acceptable list of next owners prior to entering the market, such that the ROFR process becomes moot
- Receive an express OEM waiver of the ROFR (in writing) if a transaction with a pre-approved party is consummated

If the decision and facts suggest that a pro-

cess can be initiated without pre-approval by the OEM, then make it easy for the buyers and reduce the cost of investigation by having all their work completed for them, such as having all diligence materials completed and available during the process. In order to induce prospective buyers to spend time and resources on the transaction, consider providing a breakup fee to the party that enters into a definitive agreement for the purchase of the company.

Depending on the specific description of the ROFR, it may be possible to structure the breakup fee such that the OEM may have to assume that obligation if the ROFR is exercised, thereby protecting the displaced party for out-of-pocket expenses and opportunity costs, while not

reducing the proceeds to the seller. The breakup fee should be expressed as a specific dollar amount plus out of pocket expenses, with the breakup fee size being a function of the size of the transaction. In a typical \$100 million enterprise value transaction, it would not be unreasonable for a breakup fee to be in the range of one to two percent of the enterprise value.

To make this course most effective, all material conditions to close should be satisfied such that the ROFR is the only obstacle in closing the transaction with no additional outs in the transaction for the OEM, should it exercise its ROFR rights.

WELL-THOUGHT OUT STRATEGY

The ownership transition process is often

times complicated by third party consents which may be partially out of the direct control of the selling and buying parties. This is especially complicated in an OEM or franchisor / franchisee relationship where the interest of the OEM may not be consistent with the interest of the seller. Prior to a sale, the seller and the OEM have a common interest in maximizing the market potential of the business resulting in success for each party, but when the seller decides to exit the business, the incentives are not aligned. As a result, a well-thought out strategy and competitive process will provide the seller a better outcome. **zs**



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ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions through three service lines: sell-side M&A, acquisition and investment advice, and direct investing. For more information on Zachary Scott, go to **ZacharyScott.com**.

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