Ep #35: The Big MAC: Protect Your Restaurant Deal from Material Adverse Changes

Full Episode Transcript

With Your Hosts

Patrick Totah and Andy Mirabell

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Welcome to *Restaurant Deal Making EXPOSED!*, the only show that equips you with everything you need to know about restaurant transactions. In this show, we tell you all about how to make the sale or purchase of your restaurant not just possible, but successful. Now, here are your hosts, ex-restaurateurs, and seasoned brokers, Patrick Totah and Andy Mirabell.

Andy Mirabell: Welcome back to another episode of *Restaurant Deal Making EXPOSED!*. I'm Andy. I'm here with my co-host and partner, Patrick. Today, we're talking about the big MAC, and I don't mean McDonald's. I mean material adverse changes.

When acquiring a business or, in the case of Patrick and I, within our restaurant niche of commercial brokerage, each deal is unique and poses many moving parts and nuances from the time we get into contract until we close escrow. There are a handful of things that can derail a contract even after contingencies are removed. One of the most significant is a material adverse change, simply abbreviated as MAC.

A material adverse change is a change in circumstances that can or does significantly reduce the value of a company. The definition of material adverse change is unique to each contract. A contract to purchase a business often contains a term that allows the buyer to cancel the transaction if a material adverse change occurs. This MAC clause exists in nearly 100% of contracts Patrick and I deal with, and it's vital to protect buyers and sellers alike. Purchase agreements or contracts may provide that either party to the transaction can cancel if a material adverse change significantly reduces the value of the other party or of the business.

Many of our transactions require a long period of time between the signing of a contract and completion of the transaction. For example, time may be required to obtain approvals of the transaction by government agencies, lenders, or others. Until the transaction is completed, the companies involved go on about their daily business and are subject to risks. When a party to a contract claims that a material adverse change had occurred and refuses to complete the transaction on that ground, the other party may disagree, and litigation may ensue. In short, a material adverse change is no small matter; rather, it can be a big MAC. Haha. Okay, enough McDonald's references, Patrick, right?

Patrick Totah: Yeah, I like that McDonald's reference. That's pretty good.

Andy: Yes, we're going to have them on as an advertiser soon, so we can make some money.

Patrick: Yeah.

Andy: Well, let's dive into this. This is something that this is one of those dirty little secrets, right? We don't want a material adverse change to show up in any of our transactions. We don't want something significant to alter the course of a business, its operations, its value, but it can happen.

Patrick: It can. And I mean, we're talking about like the 99% of deals don't, you know, don't have this issue, but every now and then it pops up, right? And I think also just to clarify on a few things, when you say cancel an offer, I think logistically, as with a lot of things, in order to cancel an offer, even if there is a material change and you do have a leg to stand on, you still do need both buyer and seller to agree. And if that doesn't happen, you have to go to mediation, which is not great for anybody. So I think it's, you know, logistically, it's always important to talk to clients and let them know exactly how the contract actually performs. You can't unilaterally change or cancel a contract, right?

Andy: Yeah, absolutely. You're totally right. There has to be agreeance on it. And I would say in the event of a material adverse change or other changes to the business, oftentimes buyers and sellers don't see it the same way.

Patrick: Exactly. Yeah. I think the other two things that are really important as part of the big MAC is the continuity clause and then the seller's disclosure. I think whenever I go into a representation agreement, I stress to my sellers to really take time and complete the seller's disclosure with, you know, being as thoughtful as possible, putting anything and everything that they can think of, and not just going through there and putting a no on everything and then just signing it. You know, it's probably one of the more important parts of the total package of an offer.

Andy: Agreed. And let me ask you, how often because I do this occasionally and check in with my sellers, especially. These transactions, whether it takes 90 days, 6 months, 12 months, things change, things happen. So if something new has come up, a crime, I don't know, at the space, maybe a major piece of equipment broke, I can name a dozen others, but I won't. I've asked them to update their disclosures on the go, right? To keep it current. Keep it current.

Patrick: Yeah. Even if you send an email like, hey, if there's something really big that you think can affect the business. I do wonder if you're already in contract and you're in escrow, you know, if something major were to change there that happened that is out of your control, that's not at fault to the seller. Is that do you see it the same way?

Andy: I do see it the same way. This is where it gets sticky, right? What if it has a major impact on the business and the future performance of the business?

Patrick: Yeah, I mean that happened to me with the pandemic, for instance. I was in escrow, deep into escrow, like a few weeks from closing. And this person, actually it was way before March 14th, 2020, or whatever it was, his family were deep into the bank. They kind of had a jump start on what was happening, and he was the first person to really kind of like tell me like, no, we're not doing this transaction. A big pandemic is happening, and they started to want to cancel the transaction. And it was the first time in my career that I actually had to cancel a transaction so deep into it. And they had a really good reason. There was a pandemic, and it was going to be a material adverse change on the area.

Andy: I think that's the best and most simple example you could bring up because it's valid, but you know, again, I'm sure as a seller you weren't too excited about that, right?

Patrick: Yeah.

Andy: Another section, you know, like you said, this is all tied together. No material adverse changes in our, you know, CAB asset purchase agreement contracts and plenty of other contracts we use will have a, you know, the no adverse changes, continuity, and of course, we want everything to be related back to buyer representations, warranties, and disclosures that it all that all matches that everything's above board and being communicated. But I think we have a lot of good examples about continuity.

How many times have you had a business in escrow and the seller decides, you know, as we're getting closer to closing escrow, that maybe they're going to change the hours or maybe they're going to close down a couple of weeks to breathe and get some free time, go on vacation, whatever it may be?

Obviously, for a going concern, that's bad news. You're damaging goodwill. Your staff may be damaged because of that, the team in place because they're losing hours. Whatever it may be, it's more black and white with a going concern. But how about with an asset sale if the business is still operating? Is there any gray area there that you see? Because I still want my sellers to carry on to the last day, if that's what has been happening previously.

Patrick: Yeah, I think the misconception is that on an asset sale that you're not buying any goodwill. I beg to differ. And I've used this example a lot. I purchased a business when I was in the restaurant business myself that was doing, you know, close to a million dollars in revenue. And I was I had to change the name when I when I purchased the business within 30 days. That was part of the contract. And I would have been extremely angry if they would have closed down prior to the transaction because all that revenue is walking through that door, and although I'm going to change the name and change the menu, I didn't want to stop that traffic from walking through the door. And sure enough, you know, like I was able to take that million and turn it into more, close to 2 million.

So I think there is goodwill even when buying an asset sale and I would suggest unless the buyer plans to come in there and close down for 3 months and, you know, remodel and all that stuff, then maybe it's less of an issue, but if their plan is to come in there and not close down, then I would suggest that the seller should have to stay open.

Andy: 100%. And also, if the intent was to close down before escrow, it should be in your disclosure, it should be communicated, right?

Patrick: Yes.

Andy: Okay, good. I remember you previously patted me on the back for my term residual goodwill as related to asset sales, okay? So it's true. It's true. We don't want to just turn off the floodgates of people walking in the door if you're going to slap a new menu in there. You still want to be relevant and like you exist as a business, right? You want that.

Patrick: I had a pretty frustrating time when I was deep into escrow yet again, and the seller gave all of the employees a $5 plus an hour like raise, and then my buyer found out and was like, you know, extremely angry and frustrated. And so I spoke to the seller and, you know, and this is part of the thing where, like, you know, the buyer and seller see it differently. The seller said, you know, hey, I wanted to make sure that all the employees stayed on board afterwards, and I was doing the buyer a favor by giving them all a raise. I said, you can't do that. You have to disclose that is a material adverse change in itself because it's, you know, we're talking a 20% difference on payroll.

Andy: Yeah, no small thing.

Patrick: Yeah. So that was one of those examples that I'll never forget. And so now I go into every transaction and I say, hey, just want to make sure, you know, and I tell them my list of things that I talk about.

Andy: Yeah, absolutely. I think because you and I are in such a niche realm of commercial brokerage dealing with just restaurants and bars, for example, we oftentimes are a dual agent because we know how to navigate this, we know the bones of the restaurant, we know all the agencies to deal with, and so on. So we're quite proficient in it, and the majority of our deals, we are dual agents.

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How could a material adverse change really complicate our role? Or how would we best navigate that, do you think, if you were trying to help both sides of this? For me, I would want to bring in and encourage a professional third opinion, right? To observe and to help guide each party through this. I do not want to impose my own opinion on it.

Patrick: Yeah, you know, it's funny. I think that as a buyer, I can totally understand the perception of having one agent. But from a different perspective, you know, us, we're so intimately involved in the transaction, and having another agent step in a transaction like a business transaction, it's so different than like a house or a real estate, you know, commercial building. There's a whole can of worms with business transactions that they may not even know about.

And so what I tell buyers is if, you know, you let me handle the transaction and everything related to that. If you need an attorney to help you with the lease and, you know, other parts, then you hire an attorney because they're going to advise you with the things that you really need.

And then also, like you said, you know, you do all your, you know, inspections, you can hire a CASp inspector or any kind of inspector so that you're doing your due diligence, you know? And so that kind of takes it off of you a little bit so that you're just really the quarterback. You're managing both sides and making sure that everybody's happy and getting to the finish line and everybody's getting what they need.

Andy: Well said. We can be very surface-level on this one too, but you and I have worked transactions together where you're on the seller side, I'm on the buyer side, and we actually had a transaction that has had quote-unquote material adverse change, and each party has looked at it through their own lens. So it took a lot of, it added time to the transaction for each party to do further investigation into the situation.

In the end, we got to an agreement and both parties decided to move forward from there. So it definitely can complicate things, slow things, but I think if everyone doesn't go through a fire drill and panic, you really can dive in, dig, bring in the right parties to investigate or help you help assist on it. And um, I would hope that we could get to the finish line still, even with a big change.

Patrick: Yeah, yeah, no, it's true. It always goes back to that in the very beginning, I don't know if it was Steve who told me or somebody, but he made reference to how many times a deal, you know, dies before it actually goes through. And I can't tell you how many times that's actually come true. It's just like, you think that potentially this could be the thing that cancels the deal, but there's always, you know, as long as both sides stay reasonable and willing to make it work, there's a way to make the transaction happen. You know, but everybody, it takes dedication, and everybody being reasonable and calm about everything.

Andy: Yeah. And emotions come into play on this. There's a lot of emotions with selling your business and stuff, but I think if we give people time, it typically works out. So, yeah, we got through it. We're good guys, Patrick, we did it. So, let's go back a little bit. I think it's really important to kind of reiterate or conclude on the points of how to avoid, best avoid, you know, adverse changes or any non-disclosures that could alter or derail a deal. How can we best help our clients avoid these things?

Patrick: Yeah, I mean, it's all about really thorough disclosures. I have a recent example of someone who had a loan on the business, didn't disclose that, and as you know, in order for us to close escrow, you have to pay back any institutions in order to get the deal done, so you can clear the bulk sale publication. And they not only refused to do that but insisted that the buyer should sign an indemnification as if that was like a solution that the seller thought was okay for the buyer, because they were accepting responsibility, which is true.

But as I was telling my seller, I said, logistically that's true, but they still have to go through the process of spending money on an attorney and going potentially to court to protect themselves. Who wants to do that, right? And so not only did they not disclose that and assume that the buyer would just take the indemnification, and then when that became, you know, something that they were not able to pay back, you know, it derailed the deal. And they didn't disclose that, and the buyer was like, I want out of this transaction, and the seller did not want to cancel the deal. And it took some time and finagling and maneuvering to finally get that deal to cancel, unfortunately. I mean, obviously our we're always trying to get deals done, but you know, in the end, you have to do what's the right thing.

Andy: Not to the detriment of our clients, right?

Patrick: Yeah. They also were randomly closing down during the week because of employee issues and such like this. And so there was a whole material adverse change situation going on as well. So it was it was a hard deal. One of the more frustrating deals that I had, and it was really unfortunate.

Andy: Yeah. Is there any thing to be said for specific language in, I mean, obviously, we want specific and really direct language in any of the purchase agreements that we're assisting on, but is there any carve-out language that we could think of that may help navigate a change in the market, a sudden change in the market, a natural disaster comes to mind in certain areas, you know? We don't go that deep on a lot of our contracts, but I think in very specific situations, it would be appropriate. I have a business for sale on the riverside on a dock. That comes to mind. Things could change. It's in a flood zone, all those things.

Patrick: I mean, that would be something that I would recommend that the client, you know, be advised by an attorney. You know, that becomes like above my pay grade personally, but yeah, you know, depending on where you are and what your situation is, again, it goes back to the disclosures.

Like if you're in a flood area, if you're on the Russian River, for instance, I may say like every 5 years there's, you know, there's a chance that there's a flood. Some are small, some are big, just so that you've done everything. There's no such thing as over-disclosing. In fact, I think it's better to be that thorough because then it shows that you're being as thorough about it as possible and that you're not hiding anything.

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Andy: Got it, got it. Okay. I don't know, Patrick. I mean, I think that you and I survived one of these situations. We still love each other. We really want to just impress on people that it's really the disclosures in the beginning, and there's no over-disclosure. Over-disclosure is okay in our books. So it'll help avoid some of these things down the line.

Patrick: It seems like restaurant owners just want to like get through that document as quickly as possible. And I'm like, you know, like I won't even send it through DocuSign. I'm like, no, you have to like literally go through it and be as thoughtful about each and every one of those answers as possible. Like, please spend some time on this.

Andy: It's true. Take your time.

Patrick: So.

Andy: Good. All right. Well, we don't need to talk about Big MACs anymore for a while. And uh, you know, I'm more curious, it's summertime. We haven't recorded an episode in a while, and did you do any fun cooking experiences over the summer, Patrick? I know you're in San Francisco, so it's cold and foggy, but I'm curious to know if you had anything fun for the summertime.

Patrick: Yeah, I gosh, I don't even know. I mean, what did I do that was fun? I don't know. But I will mention that I did go to Thomas Keller's new burger spot, which is in Napa area. And I have to say, it's a pretty damn good burger.

Andy: Do they have something for people who don't eat meat?

Patrick: They have a lobster roll.

Andy: No way. Okay, I'm in. I'm in. Totally.

Patrick: And let me just say that the lobster roll was $29, okay? Which

Andy: That's a steal.

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Patrick: It's an absolute steal. And I was like, the burger was very inexpensive, and I'm like, there's a strategy going on here because most lobster rolls that I see on menus in San Francisco are like in the $40 range.

Andy: And they're like 2 and a half ounces of lobster.

Patrick: Yeah. So I don't mean to, you know, try and give Thomas Keller more business and everything, but like, it's a good burger. I assume their lobster roll is good as well, and it's inexpensive, which is fantastic.

Andy: I hope Dylan and Tyler from Woodhouse aren't listening to our podcast. No, I'm just kidding. I love those guys, and they have a good lobster roll.

Patrick: But let me ask you. I mean, you went to Outside Lands, given our last episode, what was your favorite meal? Let me put you on blast real quick.

Andy: I had two tween girls with me running around, so I was feeding them as much junk food as possible. Okay? For me, I think Kaiyō had an amazing poke bowl. It was so fresh and so bright, and that's so hard to do in a festival setting. I loved that. So that one really just stood out for me. I mean, there was caviar on corn dogs. You name it. It was it was pretty incredible. Yeah, absolutely. So, anyways, I might uh head to Thomas Keller's place this weekend. It's my birthday and I'm I'm not telling you guys numbers or decades, but I'm heading out to the Napa area for a quick getaway.

Patrick: And just a little-known fact, both my wife and Andy have the exact same birthday.

Andy: Exact same birthday. Yeah, she's much better looking than me and looks younger than her age, okay? So. All right, you guys. Well, until next time, we'll have an exciting topics for you guys to listen to and some new fun guests. So tune in to Restaurant Deal Making Exposed next time.

Thank you all for listening to this week's episode of *Restaurant Deal Making EXPOSED!* If you're considering selling your business and would like a free consultation, reach out to patrickAndAndy@therestaurantsalesbroker.com or visit TheRestaurantSalesBroker.com to learn more.