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Due Diligence In Acquiring A Pro Sports Team

Law360, New York (February 17, 2011) -- In any acquisition, the general objectives of a buyer's due diligence investigation of the target company tend to be the same, regardless of the industry involved. First, the buyer will identify liabilities, risks and impediments to the acquisition. Second, the buyer will look to identify additional value for which the buyer had not previously accounted. Third, in light of such liabilities, risks, impediments and additional value, the buyer will structure the terms of the deal accordingly.

In addition to the general objectives, the due diligence process for buying a professional sports team has a number of common features with buying a company in other industries. For example, the buyer will request many of the same documents from the seller (e.g., organizational documents, financial statements and employee benefits plans).

In addition, when reviewing documents during due diligence, the buyer will identify many of the same issues as it would for a target company in other industries. For example, the buyer will identify contracts that are expiring, actions required shortly before or after closing (e.g., a renewal notice), breaches of contracts, restrictions on assignment or change of control, renewal terms and rights of first refusal, restrictive covenants (e.g., confidentiality, noncompetition and nonsolicitation covenants) and potential future contingent liabilities (e.g., as a result of environmental conditions).

Despite the similarities between the due diligence investigations of a professional sports team and a company in another industry, there are also a number of due diligence items that tend to be unique to professional sports teams. In addition, even for those issues that may commonly arise during due diligence in any industry, the context in which such issues arise for a professional sports team may be different.

Acquisitions of Professional Sports Teams

Although, ultimately, every acquisition — including for a professional sports team — is unique, the following provides an overview of items and issues that tend to apply to the due diligence for a professional sports team acquisition.

Sports Facility and Other Real Estate

The sports facility (e.g., stadium or arena) where a professional sports team plays is likely the most valuable asset of the team. Accordingly, the buyer's due diligence investigation of the sports facility is critical. The buyer should determine whether the sports facility is owned or leased by the team. If it is leased, then the buyer should review the terms of the lease. Whether it is owned or leased, the buyer will want a title insurance policy to insure against any encumbrances on the real property.

The buyer should conduct a physical inspection of the facility, including an inspection by an engineering firm, to determine the condition and structural integrity of the facility. The inspection may also identify projected maintenance costs, which might impact the value of the team.

The buyer may also include an Americans with Disabilities Act compliance review as part of the inspection. With recent changes to the ADA regulations, many sports facilities will need to be brought into compliance, and the buyer will need to account for those compliance costs.

Although sports facilities may not raise the same level of environmental concerns as, for example, a traditional manufacturer, the buyer will still want to conduct an environmental investigation of the property. Particularly with respect to older facilities, an environmental investigation may also include a mold and asbestos survey. A consultant should also assess the health and cleanliness of the concession areas in the facility.

The buyer should also assess the sports facility from an operations standpoint. For example, the buyer should determine the number of committed luxury suites and the applicable terms (e.g., annual license fees and term of the commitments). In addition, parking can provide an important revenue stream for professional sports teams, including parking for non-game-day events at the venue, so determining the ownership and terms of the surrounding parking is critical.

The team may also own or lease other properties, including practice facilities, pre-season facilities, administrative offices, and other commercial properties (e.g., a restaurant or fan shop). Depending on the value and importance of the other real property, the buyer may conduct many of the same due diligence investigations as it does for the primary sports facility.

Players

Next to the sports facility, a professional sports team's players are its most valuable asset. As a result, the buyer should review the terms of the player contracts, including term and price. Knowing how much money is guaranteed to be paid by the team is important.

For some professional sports leagues — like the National Basketball Association and Major League Baseball — a player's salary for the entire term is guaranteed, while in other leagues — like the National Football League — little to no money may be guaranteed. The buyer will want to know if the team will be hampered by ballooning long-term player contracts, particularly if those contracts have no-trade clauses or other restrictions on the team's ability to unload them.

If the applicable league has a salary cap or luxury tax, then the buyer should assess the total committed player contracts from that perspective as well. The buyer should determine if the team has any deferred compensation obligations with respect to past or present players.

For example, because of large deferred compensation obligations, the single largest unsecured creditor of the former owner of the Texas Rangers was New York Yankees third baseman Alex Rodriguez. Knowing the years of service of the players on the team's roster is also important, because the applicable collective bargaining agreement will likely have different rules for different levels of seniority.

As the future owner of the team, the buyer wants to ensure that the team's players continue to be available to play. In that respect, the buyer should determine whether any players are subject to suspension by the team or the league. In addition, although it can be tricky due to health and privacy laws, the buyer will want as much information as possible regarding the health of the players.

Major Types of Contracts

Professional sports teams are parties to contracts that may not appear in other industries. For example, a team will likely have sponsorship agreements and naming rights agreements, which allow third-party sponsors to associate themselves with the team or the facility in which the team plays. Important issues to note include any category exclusivities — which may restrict the ability of the buyer to sign future sponsors — and any restrictions on advertising for nonsporting events held at the facility.

Local media contracts (e.g., television and radio broadcast agreements) also represent an important source of revenue for many professional sports teams. One of the key terms the buyer should understand is the scope of the rights covered, including the applicable medium (e.g., cable television, over-the-air television, internet, smartphones, etc.), the language of the broadcasts and the territory.

The buyer should also determine how rights for technologies not yet developed are treated. The buyer wants maximum flexibility and does not want to be locked in with the same broadcaster without being able to test the market for future technology rights. The applicable league may also impose restrictions on the team's ability to grant current and future technology rights.

It is also important to understand the consideration paid to the team for its media rights (e.g., fixed rights fee, variable rights fee based on a percentage of advertising revenues, bonuses for broadcast ratings targets, advertising inventory for the team to sell, etc.).

Lastly, if there is a right of first refusal for a broadcaster upon expiration of a media contract, then the team might be constrained from starting its own regional sports network (RSN), which could diminish its value. For leagues other than the NFL, which has all national television contracts, RSNs can offer significant value to teams.

Other common types of contracts that the buyer may encounter in its due diligence include airplane/charter agreements, joint venture agreements (e.g., real estate developments), concessions contracts, co-licensing agreements (e.g., team branding on a credit card), stadium/arena service agreements and agreements with ticket service providers.

Specific issues that may arise in any number of contracts include restrictions on relocation of the team and impediments to new signage or naming rights at the sports facility. The buyer should also identify any arrangements with seller-related parties to ensure that revenues of the team are not being either diverted to entities that are not part of the deal or artificially inflated to increase the purchase price. These issues may be more prevalent with teams that have convoluted ownership structures.

League Information

Because professional sports teams are members of professional sports leagues, it is important for the buyer to understand information regarding the league. The buyer should review the league constitution and other governing documents, because those documents will generally override contrary terms in any team contract.

League documents may include restrictions on teams. For example, in the acquisition of an MLB team, the buyer's financial advisers should understand the MLB's "Debt Service Rule," which restricts the amount of a team's indebtedness. This could significantly impact the buyer's ability to finance the deal within the applicable league limitations.

Knowing when the league's collective bargaining agreement with its players association expires is also important. Potential labor unrest can create a great deal of uncertainty regarding the operations of a team and negatively impact its value. In addition, lenders may require the buyer to establish an interest reserve account to mitigate the effects of a potential strike or lockout on the buyer's ability to repay its loans.

The buyer should also know what league rulings, approvals and reports apply to the team. For example, a baseball team may have an open revenue sharing liability to MLB.

Finally, to understand the full value of a team, the buyer should review the leaguewide media contracts.

Financial Information

To assess the value of a team, it is important for the buyer to test the underlying assumptions of the seller's financial projections (e.g., whether the projections of increased ticket prices and attendance are realistic and sustainable). To do this, the buyer may need to bring in an industry insider as a consultant, especially if the buyer is new to the sports industry.
The financial information should be presented not only in accordance with generally accepted accounting principles (GAAP) but also according to whatever format and accounting principles are required by the league for its rules and reporting requirements.

Taxes

The buyer should review the player contracts and other team assets to determine the optimal tax treatment for the buyer. The buyer should also analyze various tax issues that result from the team playing in different cities, states and, if applicable, countries. The buyer's financial models for the team should also account for any other special taxes that may apply to the team (e.g., an amusement tax).

Governmental Restrictions

The acquisition of a professional sports team may require certain governmental consents (e.g., Hart-Scott-Rodino antitrust filing or consent of the governmental or quasi-governmental entity that owns the sports facility). In connection with public financing, there may be additional developmental, design, and operational restrictions and covenants (e.g., minimum game-day parking requirements) for the sports facility and surrounding real estate.

Other Subject Matters

The buyer's due diligence investigation of a team will also cover subject matters such as intellectual property (e.g., the terms of any league centralization of intellectual property and clearance of any music played at games or in team-related productions), insurance (e.g., for team travel or on a high-priced player) and employee benefits (e.g., nonplayer employees who are not necessarily covered by collective bargaining agreements or leaguewide benefit programs).

Conclusion

In addition to due diligence issues common to every sports deal, a buyer should always be mindful of the particular circumstances, structure and concerns of its deal and tailor its due diligence investigation accordingly. In addition, the buyer should remember how vested the community and fans are in the team and how they view the team as theirs. There will generally be disproportionately greater media scrutiny for sports deals. Therefore, the buyer should always be sensitive to how decisions and deal terms will operate in that environment.

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