The Partnered Acquisition: Special Challenges

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The acquisition of a dealership is a challenge in its own right. To couple such a deal with a partnership can be even more challenging. If not properly planned and structured, it can be a formula for disaster from both a deal and an equity perspective. Let's explore the issues that arise in such a transaction and the manner in which these might be effectively addressed.

<u>The "Chicken or the Egg"</u>

A threshold issue in an acquisition involving equity partners[1] is whether the deal or the equity understandings should be established first. To be sure, the optimum approach would establish complete equity understandings among the equity partners before seeking out various dealership targets. But in the real world, the most effective approach is to do a little bit of both.

Unfortunately, the pace of a deal, especially in today's competitive market, sometimes does not lend itself to this approach. Indeed, it may be the surprise availability of a deal that sparks the effort to seek out partners, especially if the target dealership(s) is (are) priced beyond the reach of the prospective buyer, or involves enormous working capital or facility upgrade requirements.

By the same token, the dedication of significant time and money on equity understandings and the necessary legal documentation (e.g., formation of an entity and the preparation of a formal equity agreement(s)) may prove to be ill-advised unless there is a real acquisition in play. The two aspects are inextricably intertwined. How they are handled will be a judgment call.

The Equity Deal

No matter how the acquisition arises, the establishment of the basic terms of the equity relationship is critical. Too many acquisitions have faltered because of misunderstandings on the equity side. For example, there may be confusion over the amount of capital to be contributed by each partner, a dispute over owner/ management compensation, or even an uncertainty over the precise percentage of ownership to be allocated to each partner.

These misunderstandings can be avoided by early and comprehensive discussions of these and related equity issues. This process does not necessarily require significant legal costs. The understandings can be embodied in a preliminary agreement or letter of intent. The more comprehensive agreement(s) can be deferred to the due diligence stage of the acquisition.

In my experience, dealers do not think twice about negotiating the basic terms of an acquisition and embodying these in a basic letter of intent at the early stage of a deal, with the obvious understanding that a comprehensive acquisition agreement (buy/sell) will be finalized and executed down the line. Yet, this common sense concept is in many cases, lost in the equity understandings. Costly and disruptive disagreement can be avoided by taking the same approach with the equity aspect.

The Equity Terms

With some important exceptions, the terms governing an equity relationship in an automotive acquisition are not unlike those in any other business contract. These include the following:

- Ownership percentages;
- Voting rights;

- Capital contribution, including subsequent capital calls;
- Buy-out triggering events, such as death, disability and retirement;
- Management aspects; and
- Owner-Management compensation or pay plans.

These understandings are typically embodied in a comprehensive agreement known as an Operating Agreement (or Membership Agreement, in the case of a limited liability company) and a Stockholders' Agreement in the case of a corporation.

In the automotive arena, there are a few special equity issues which must be addressed. The primary concern~~s~~ is who will service as the "point man" with the manufacturer and be designated as such in the franchise application. This position is traditionally referred to as the dealer-operator. This aspect sometimes creates friction between the equity participants, especially if more than one would qualify for the position. It is an aspect that must be addressed and resolved very early in the deal.

Another aspect concerns the ability of the non-automotive partner to participate in day-to-day operations. This is an especially sensitive area from the manufacturer's point of view, especially in deals involving equity funds.

To properly address the franchisor's concern, the equity agreement must clearly delineate operational (day-to-day) control, which must be in the hands of the experienced automobile people, and control over majority matters, such as the sale of the dealership or the acquisition of a new facility. Most manufacturers understand the importance of vesting control over the latter matters with the majority equity holders.

Franchise Approval Aspects

One of the most significant considerations in identifying equity participants in an acquisition is to ascertain whether he or she will present obstacles to franchise approval. Of course, the obvious examples of these are whether the participant has issues such as a criminal record, severe credit problems or a history of regulatory issues such as consumer fraud.

There are, however, less obvious concerns. For example, if your partner had under-performance or customer satisfaction issues at a current or prior dealership, the franchisor may use this aspect as a hook in denying a deal or prompting it to exercise its right of first refusal. To help prevent that from happening, the entire background of each equity participant must be fully explored before committing to the relationship.

Financing Aspects

The same concept applies in the financing context. One is cautioned from including partners who may create obstacles in procuring necessary credit for the deal (e.g., floor plan and, if applicable, a working capital and/or mortgage loan). It is important to see financial statements of all participants. It is also advisable to ask for references and permission to run a credit report.

If there is any reservation about a particular investor, the better approach may be to exclude that participant rather than risk the potential problems that may arise. Partnership arrangements are difficult enough with pre-existing relationships and parties that you may have known for years. The problems and exposure arise exponentially when dealing with a new player.

There are obvious benefits for including investors in a deal. This allows you to reduce your exposure and to acquire target dealerships or groups that may be beyond your individual reach or budget. However, such deals involve a myriad of concerns as enumerated above. It is critical that these concerns be properly addressed and documented if a partnered acquisition is to be successful.

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[1] The term "partnership" is used generically in this context. In most cases, the acquisition company will be a limited liability company, in which case the owners are referred to as members. If a corporation is utilized, the owners are shareholders and, if it's a partnership (either a general or limited partnership), the correct term is, of course, partner.