BUY-SELLS: BEYOND THE BASICS

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Handling a buy-sell transaction for a client can be a very rewarding experience to the dealer lawyer. However, the matter can also be frustrating, disappointing and embarrassing if not handled correctly. It is wrought with professional liability and exposure. Given the magnitude of the deals today in terms of substantial blue sky and real estate values, the risks can be significant and even beyond the insurance limits of a firm's malpractice policy(ies). As such, a full understanding of the nuances of a deal and the manner in which it should be drafted and handled are critical. Let the experience be both positive and rewarding.

This presentation will focus on the many key challenges of a buy-sell and related considerations. The goal is to establish a keen understanding of the many critical components of the deal and the ways in which you can employ this understanding in protecting the client and advancing his/her position in the deal.

I. PRELIMINARY MATTERS

A. Negotiations. As with all deals, whether automotive or non-automotive, negotiations is a significant aspect of the deal. While your client may present you with the major terms and, of course, the main price understandings, it is up to you to flush out the additional terms and conditions. The parties tend to overlook the fine details and get caught up in the notion that a deal was struck. It is our job to focus the parties on the many additional aspects of the transaction that must be addressed in the buy-sell agreement.

Having said this, it is important to keep in mind that this is your client's deal, not yours. It is your job to point out the additional terms to your client and recommend how these might be employed for his/her advantage. The client will be the ultimate decision maker.

You should also be careful about voicing an opinion on price. While the highly-experienced practitioner might comment on the price (indeed, in many cases, the client expects it), it is critical that you point out that this ultimate

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determination is made by the client without reliance on your opinion. Of course, you can recommend that your client seek input from some experts on value, such as their accountant or a valuation firm.

Your job is to protect the client within the confines of his/her business decisions. It is not to renegotiate the basic price and terms of the deal that have been established by the parties.

There is one additional note of caution. Email negotiations must be handled very carefully. There have been developing case law (e.g., New York) which holds that a binding contract can be established from such communications[2]. This result is easily avoided by including a clear disclaimer in your written communications that makes it clear that these are non-binding. The following is a typical disclaimer:

> *Please note that the transmittal of this Agreement should not be deemed as either an offer or an acceptance with respect to the proposed transaction. The latter can only be effectuated by the execution and delivery of a finally-approved Agreement of Sale. This transmittal is merely intended to continue the parties' negotiations so that a binding (written) Agreement may be entered into between the parties. Until then, nothing is binding.*

Your emails should never leave a doubt about the necessity of a formal, signed agreement to bind a deal.

B. **Letters of Intent**. The use of letters of intent in buy-sells is not uncommon. Typically, these are preferred by buyers (particularly the more formidable buyers, such as the publics). These are also employed by the brokers for obvious reasons. However, for the most part, the employment of a LOI is disfavored by the seller.

The reason for this is the typical inclusion of a no-shop clause in the LOI. This clause prohibits the seller from negotiating with other buyers, which can obviously be problematic for a seller. The LOI locks up a seller, but does very little to bound a buyer (other than a confidentiality restriction).

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[2] Naldi v. Grunberg, 80 AD3d 1,908 NYS2d 639 (1st Dept. 2010) and William v. Delsener, 59 A.D. 3d 291, 874 NYS2d 41 (1st Dept. 2009)

Great care must be given to whether the LOI is binding or non-binding. Obviously, this is another seller concern. The buyer is less concerned with a binding effect since the buyer has the right to walk from the deal if a contingency fails. Typically, the seller does not have that luxury.

It is also important to note that, if utilized, an LOI should be limited to the most basic terms of the deal. It should not be considered a substitute for the elaborate buy-sell agreement. I have seen many LOI's that contain far too many terms and conditions for its purpose. This can be an enormous waste of time and money, both of which make clients extremely unhappy.

A simple term sheet (typically 1 to 2 pages) can be a beneficial substitute. It can even include a limited no-shop clause, if the buyer is insistent.

C. **Drafting**. The threshold question is which party assumes the responsibility of drafting the acquisition agreement. In the case of large players (e.g., the publics), this is almost always their counsel. In all other cases, this is usually determined by the party with the stronger bargaining position and/or stronger counsel.

There is obviously an advantage to handling the drafting. This establishes a certain level of control for the drafter. Moreover, the key to a finely-drafted buy-sell is not what is in the document; rather, it is what is not in the document. The drafter has the advantage in this regard. An example of this aspect is a covenant not to compete or certain aspects of that provision - e.g., a general non-compete without protection of customers and/or employees.

The lawyers engaged in the drafting effort must bear in mind that it is not a contest of who is the better lawyer or how many representations or other provisions can be included or added. The drafting should be a fine balance of protecting the client and not disputing the deal. There is no worst label to obtain as a buy-sell lawyer than "deal killer".

II. BUY-SELL CHALLENGES

To be sure, each provision of a buy-sell agreement is important and must be drafted with the greatest level of care. However, there are certain areas of the agreement that deserve special scrutiny and can present significant challenges. These include the following:

A. Inclusion vs. Exclusion. What is included and what is not included in a deal is an important factor. There is no standard approach to this aspect. It is clearly a function of what the parties intend once a deal is struck. There is nothing more embarrassing for a buy-sell lawyer at a closing table than to learn that he/she either forgot to include an asset that his buyer-client expected to receive, or to include an item that his seller-client intended to exclude. Nothing increases the blood pressure more for the attorney as he/she leafs through the contract to check the relevant provision when such a dispute develops.

1. **Operating Assets**. The operating assets of a deal can be categorized very simply:

   - Tangible Assets - Prime examples of tangible assets include furniture, fixtures, shop equipment, and tools. This category customarily does not include inventory items, i.e., vehicles and parts, which are customarily addressed separately in the buy-sell agreement.

   - Intangible Assets - Prime examples of intangible assets include customer lists, tradenames, URL's and phone numbers.

   In the case of tangible assets, the drafting approach depends on what side of the table the lawyer sits. If drafting or reviewing the buy-sell for the seller, the approach is typically a specific enumeration of the assets to be included. The provision should state that what is not is excluded. Needless to say, the opposite is the case when representing the buyer, i.e., if not specifically excluded, the asset is included.

The following are some important examples:

- Company Vehicles; and

- Special Tools.

Should company vehicles be included in the deal without additional consideration? These assets typically include a parts van and maintenance vehicles. These assets customarily hold significant value and the seller may not desire to "throw" these assets in the deal without an additional price. Of course, the buyer will expect these items to be included.

The special tools carry an additional complication. It is incumbent upon the buyer's attorney to ensure that "all of the special tools required for the proper operation of the franchise" are included in the deal. This language will protect his/her client from the obligation to purchase missing tools discovered after the closing. Of course, when representing the seller, a general reference to "special tools on hand at closing" will be sufficient.

Finally, the exclusions must be carefully addressed, especially when representing the seller. It is not unusual for the seller to have many additional assets or parts balance sheet of the selling entity which are unrelated to the assets intended to be sold. An example of these includes personal furniture, art work, and collectibles. Classic cars are another example.

2. **Inventories.** The issue of what inventories are included in a deal is a complex area certainly worthy of a separate presentation. A related aspect of this area is how the price for inventory items is established in the buy-sell agreement. The following is an overview of this aspect:

   - Motor vehicles. The category of vehicles to be included in the deal his multi-faced and include the following:

     - Current model only or later models. As to the latter, what are the units and other limitations?

- Demos
  - Mileage limits
  - Unit limitations
- Loaners?

- Pre-Owned inventory

The pricing provisions for each of the above is an extensively negotiated aspect of the buy-sell agreement. For those unfamiliar with the variations of the pricing mechanisms, you are well advised to consult with the client, the client's CFO, the dealership's accountant, and, if necessary, special outside counsel. This is an aspect of the deal that can translate into tremendous savings for your client, if handled properly, or tremendous additional cost to your client, if not.

- Parts and Accessories. From the seller's perspective, all parts and accessories should be included in the deal, including factory (OEM) parts, both current and absolute, as well as outside vendor (non-OEM) parts and accessories. The buyer will assume a more conservative approach. Customarily, the buyer limits all even obsolete parts, non-OEM parts, and will limit current OEM parts to only those reflecting sales activity in the last 12 months prior to closing. Price is uncontroversial in this area and is typically based upon current catalog price.

B. **Contingencies**. The contingencies in the buy-sell agreement are the buyer's "back doors" to the deal. This is a critical aspect for both parties. The seller acknowledges the necessity of basic contingencies for the buyer's protection. However, the buyer's attorneys can go significantly overboard in drafting this aspect.

There is no question that the buy-sell must include contingencies for franchise approval and certain types of financing. Unless the deal involves a relocation of the franchise, the buyer must also have contingencies for environmental investigation and physical inspection. Where the negotiations and drafting become challenging is when the buyer introduces additional contingencies or an extended scope or troublesome language of the standard contingencies.

Financial due diligence can be a troublesome, additional contingency. While it is expected that the buyer will undertake financial due diligence, the preferable approach, especially from a seller's perspective, is to conclude financial due diligence before the buy-sell agreement is executed. In this regard, it is extremely dangerous to submit a buy-sell agreement with a financial due diligence contingency and the right of the buyer to walk from the deal at the end of that contingency and, worse, after the buy-sell has been submitted to the franchisor for approval. As a compromise to this approach, the parties can agree to withhold the buy-sell agreement from submission until the financial due diligence contingency is satisfied.

Franchise and financing contingency provisions that include multiple requirements and/or limitations or, worse, terms which must be "satisfactory" to the buyer, deserve particular scrutiny. Contingencies drafted in this manner could relegate the buy-sell agreement to a mere option to purchase the dealership for the buyer without any binding obligation.

- **Buy-Sell Parties**. It is axiomatic that the dealership entity is the seller in a buy-sell transaction. The establishment of the buyer or buying entity is not so clear and can be a troublesome aspect. The optimum approach for the buyer is to form a new entity and interpose it as the buyer. This can be problematic for the seller. Is the buyer a mere shell and uncollectible in the event of a contract default? Who are the real owners of the purchasing entity? These concerns must be carefully considered by seller's counsel.

In many instances, the buyer might insist that the principals of the selling entity sign the buy-sell agreement personally. There are a few reasons for this request:

- The personal signatures will further secure the seller's performance, especially with regard to a post-closing indemnification obligation.

- The selling principals must be personally committed to the post-closing covenants against competition.

The assignability provision of the buy-sell agreement is also an important aspect in this context. The buyer may request the right to assign to a new or an affiliate entity. This is

customarily acceptable to a seller. However, when representing the seller, caution should be given to ensure that the original contract buyer remains jointly and severally liable, together with the assignee entity, under the buy-sell agreement after the assignment.

C. **Post-Closing Escrows.** Examples of these include the following:

- An indemnification escrow that secures the seller's post-closing indemnification obligation. When this aspect is included in the buy-sell agreement, the amount is typically a percentage of the base purchase price (excluding the price to be paid for inventories) that ranges from 5 to 10 percent. It customarily runs for a period of one to two years.

- Environmental escrow to secure the seller's post-closing remediation of the dealership property should an environmental problem be discovered.

- A tax escrow in the event the relevant state tax law requires a bulk sale notification of the transaction and imposes transferee liability on the buyer in the event of non-compliance.

Needless to say, the foregoing are important components in protecting the buyer.

Of course, the seller prefers to avoid post-closing escrows to the largest extent possible. The ultimate resolution of any disputes surrounding this aspect mandates that both parties be reasonable and realistic.

D. **Covenants Not To Compete.** A seller has no great desire to include covenants against competition in a buy-sell agreement. However, the total omission of these covenants can be disruptive to a deal. The fair resolution are covenants that are reasonable in both scope and duration.

The following are the most salient components and issues that arise in this context:

- Should the non-compete restriction be limited to the line make in questions or extend to other franchises? Customarily, it is the former, not the latter.

- A typical covenant provision includes a non-compete restriction for a specified geographical area. This is generally phrased in terms of a mileage radius from the dealership location. The mileage is based upon what is custom in the particular market. Obviously, the geographical range in an urban market will likely be shorter than that contained in a deal involving the sale of a dealership in a rural or secondary market.

- Customer protection is a key component in the covenant provision. This aspect is inextricably intertwined with the protection of customer lists.

- Protection of the dealership's employees is another important aspect. This is typically couched in the form of a prohibition against the seller's post-closing soliciting of the dealership's employees. A higher level of protection is to prohibit hiring at all, whether the seller solicits or not.

- Finally, the proprietary information (e.g. customer lists) must be protected. Unlike the other components of the covenant provision, this aspect is typically not limited by duration. If the buyer purchased the customer lists from the seller, the seller should never be permitted to use those again.

E. **Tax Considerations.** The allocation of the purchase price in a buy-sell agreement cannot be overlooked. The seller's goal is to convert as much of the price to capital gains (i.e., a lower tax rate) as possible. The buyer's goal is to achieve the most aggressive write-off schedule as possible. In many instances, there is a clash between these two goals. In the end, there must be a reasonable compromise for a deal to surpass this hurdle. Needless to say, the parties' respective accountants will play a significant role in this aspect.

A related aspect revolves around a state's particular sales tax law. In several states, the buyer is obligated to pay a sales tax on the amount of the price allocated to tangible assets (excluding inventories). This creates a conflict between the higher amount that is likely to be sought for income tax (or write-off) purposes versus the lower amount to lessen the state's sales tax. Buy-sell counsel is advised to defer to the dealership's accountant regarding this aspect as well.

There is one additional noteworthy point. Until the recent tax change, the seller had the possibility of engaging in a tax-free exchange (a so-called 1031 exchange) in a buy-sell scenario. However, the exchanges of automotive franchises on a tax-free basis is no longer permitted.

F. **ROFR Challenges**[3]**.** Generally speaking, the exercise of a right of first refusal ("ROFR") by the manufacturer in a buy-sell transaction creates little concern for a seller. Whether the seller receives a check for his/her deal from the original contract buyer, from the manufacturer, or from the ROFR buyer makes very little difference in most instances. However, there are cases where the seller is adverse to a ROFR exercise, especially where it has a special relationship with the contract buyer.

From the buyer's perspective, the avoidance of the ROFR exercise is a crucial aspect. The buying attorney should employ as many features in the buy-sell agreement as possible to thwart or impair the ROFR. A typical example of this aspect is to include the seller in an equity position in the buying entity. This is not a feature that the manufacturer can match in a ROFR exercise.

The representation of a ROFR buyer in these scenarios is a very challenging task. This is primarily because the ROFR buyer is obligated to step into the shoes of the contract buyer at a much later stage in the deal. Such an "opportunity" must be carefully examined and planned before the ROFR buyer decides to assume the role as the new buyer in the transaction. One important example of this concern is insufficient time to conduct independent due diligence on an acquisition, such as an environmental investigation

G. **Dispute Resolution.** A critical, but often overlooked, component of a buy-sell agreement is the dispute resolution provision. Needless to say, one of the most crucial aspects of a buy-sell transaction from a seller's perspective is confidentiality. One cannot think of a more disastrous scenario than where the deal falls apart and the dispute ends up in a public proceeding in the very county in which the dealership is operating. It is for this reason that mandatory arbitration is the preferred approach. For the most part, such a proceeding will keep the dispute and the knowledge

[3] Navigating the ROFR Minefield, by Joseph S. Aboyoun, Esq., Defender, March 2017.

that a dealership was under contract for sale out of the public eye.

On a corollary matter, mandatory mediation is also advisable. This process can be very effective in resolving a contract dispute before a formal proceeding is instituted.