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Factory approval: The buyer's concerns when drafting a buy sell agreement

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The single most important factor in a dealership acquisition is franchise approval. Needless to say, without the manufacturer's approval, the deal cannot proceed. Every automotive acquisition agreement (buy sell) must include a contingency for this factor. It is essential that each party understand what the contingency must accomplish from their side of the table.

The meaning of franchise approval from the seller's perspective is clear and simple. From the seller's viewpoint, the contingency should provide for approval without mention of the details or conditions of such approval.

That means that when the provision is drafted in favor of the seller it is in very general terms and the primary focus shifts from what constitutes franchise approval to what the buyer must do to procure it. For example, there are deadlines for the completion and submission of the application and supporting materials, and there are requirements about the buyer's obligation to proceed with good faith and due diligence, and to comply with all requirements of the franchise to obtain the approval.

The concept of approval from the buyer's perspective has a significantly different focus. The careful and sophisticated buyer is not just looking for franchise approval. He/she must ensure that it is an approval with terms that are both reasonable and commensurate with the investment.

For example, if the buyer is paying top dollar for the store, he/she is less inclined to absorb any significant conditions or requirements from the franchisor. Of course, the most significant of these is the ever-present facility upgrade requirement. The investment (price) may make no sense at all if the buyer must spend millions on a facility/image requirement as a condition to approval.

The contingency provision for the buyer must be carefully drafted to protect against unreasonable and/or unacceptable conditions. Specifically, it should expressly exclude any objectionable components so that there are no misunderstandings between the buyer and seller regarding this aspect, and so that the manufacturer understands the buyer's position from the outset of the approval process. The following are some of the important components:

1. No facility upgrade;

2. If there is a contemplated upgrade, then the buy-sell should contain a dollar limitation on the investment;

3. No unreasonable performance requirements, e.*g.*, minimum sales or CSI levels; and

4. No increase in the current working capital requirements.

These components are designed to ensure that the buyer ends up with the investment that was contemplated when the price negotiations concluded. If the approval contains objectionable components that significantly alter the investment, the buyer must have the right to walk from the deal.

Separately, the provision must include a requirement that the buyer receive a *standard* dealer (franchise) agreement. The buyer is well-advised to avoid a so-called *term* agreement. An example is a 2-year franchise agreement which requires the satisfaction of specified conditions (*e.g.*, facility upgrade or CSI improvement) before a permanent (standard) agreement will be issued.

A term agreement containing such conditions can be a formula for disaster. Where it cannot be avoided, the buyer must ensure that it is properly and fairly drafted so that the terms are attainable. The properly-drafted term agreement should also include reasonable extensions. Of course, the contingency provision must address this aspect comprehensively if the buyer is to be protected.

The contingency provision should be supplemented by franchise-related representations from the seller. These typically include the following:

1. That the franchise agreement is standard (non-term) and is in full force and effect;

2. That the seller has not received any notices of default or deficiency from the manufacturer; and

3. That the seller is unaware of any contemplated changes in the franchise, including facility upgrade, requested relocation or increases in sales, CSI or working capital levels.

The seller's response to a request for such representations can go a long way toward understanding what the manufacturer can be expected to require in the approval process. It will also assist in the drafting of the contingency provision.

For example, if the seller's response to representation number 2 is that it has received a facility deficiency notice from the manufacturer, then the franchise contingency provision must address the deficiency so that the buyer is assured that a resolution has been reached with the manufacturer on the deficiency in his/her ultimate approval.

Fortunately, the franchise statutes provide certain levels of protection regarding franchise approval. For example, most of these statutes require a level of reasonableness on the part of the franchisor when addressing a franchise application and ultimately issuing its approval. It is important that you understand the protection afforded under your particular state franchise statute.

Without a comprehensively drafted contingency provision, disastrous consequences could follow for one or both parties. There is no reason why the provision cannot be crafted in a manner that protects both buyer and seller. This is best accomplished by a full vetting of this aspect in the negotiations and with competent drafting to capture the ultimate understandings.

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