

# MD JOHNSON INC.

*A Mergers and Acquisitions Financial Advisory Firm*



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## Site Control Option Agreements and YOUR Money

Unfortunately these are trying times for many domestic automobile dealers for a number of reasons. The depth of the problems has much to do with the brand, the market and the dealers' personal situation. For many, losses or a lack of profits is starting to take its toll not just on the bottom line but on the operators and their families, their relationship with the factory and their employees. I have some examples that, unless witnessed, can be hard to appreciate. Hopefully my description will shed light where it is needed, understanding where it must and empathy where it should.

Imagine working for years and years and reinvesting the balance of the 65% (35% tax) of the 2% (average net on sales) you earn while selling, servicing, painting, detailing, buying and wholesaling vehicles. Balance means the part you live on keeps you from investing it all. The sad part is most dealers love their business so much and believe in it so ardently, they would never think of investing in anything else, even if they did have the extra money. Extra money to a dealer means paying down or paying off the real estate or putting some extra in the CMA account to generate less of an interest payment. For the most part, most dealers just want to sell iron and make money doing it and to put money back in their business.

This article is not about the fabulously wealthy Toyota, Lexus, BMW, Mercedes, Honda dealer. This article is about the guy or the family hawking iron made by companies who keep the money they make (hopefully) in this country, not take it out and loan it back to us. Our country is built on the tenet that if it's legal, you can buy it and sell it and get rich doing it, as long as it is legal. I have no axe to grind with the imports, many are my clients. They simply don't face the same issues. It is also fair to say that at the end of the day, the majority of dealers could care less what they sell as long as they make money. To go one step further, most dealers could care less if a single car was built in this country as long as they were making money. That is also what our country is about; making money.

So, the domestic dealer has plowed money, time energy etc into their business over a period of years and has had the opportunity to pay down some debt, pay off some cap loans, own some used cars and generally have a healthy business with some degree of insulation from the ebb and flow of car sales. The problem probably starts when the ebb lasts a long time where a strong economy exists and interest rates and employment rates are good. Car guys see this picture and get a little nervous. A lot of "what if" scenarios start going through their minds. If I used to make x number of dollars and now I am not breaking even after breaking my behind in a relatively strong economy, what is the deal? This has to be the best kept secret that this is going on, widely, today.

That being said, a number of domestic guys are getting into different brands or getting out. Based on the pricing that is currently in the market, getting out seems to be the most likely. The decision to get out has been reached, now comes the "it's just another car deal mentality" as the dealer starts to think about what to do next. Here is a piece of advice "it's not another car deal". This few page observation is designed to illustrate the shortcomings of such a mentality. Many of the individuals getting out or are being taken out, are minorities. These minorities were financed by the factory, often in stores no one else wanted. The car companies kept these stores churning out cars by churning out operators. Some of the operators were good, some not so good. The nice thing about the factory was they were consistent in blaming the operators. We should take a count of how many Toyota dealer investment operators are going out of business. This article is not directed at minorities or minority programs but it sure is interesting how when things get tightened a notch, the minority dealers seem to be the first to get crushed?

Some of these operators were lucky enough to end up in some good stores. Maybe not great brands, but great areas and great locations within those cities or towns. Here comes the moral to this article. When many of these operators finally bought out and bought the real estate, the factory often placed a very restrictive agreement on the property itself. Often called option agreements or site control agreements, these minority acquired stores all seemed to have the same theme; a very one sided option agreement. A typical site control agreement gives the factory the option to purchase the real estate when offered for sale by the selling dealer or to keep the dealer, for some period of time, from selling

to a non brand user of the real estate. This was to protect the factory from not having a place for a dealership when, inevitably, the property value increased to the point where no dealership could afford to pay the rent.

In the case of these minority agreements, the factory set the price, some time as long as ten years, that they had the option to purchase the property from the dealer for the same amount they sold it to the dealer for, plus improvements. This would be like the bank saying if you sold your house for the next tens years, we get the increase in market value but you make the payments Toyota's dealer investment group does not pull this on its dealers by the way. So, if you were in one of these minority programs, you put up ten or fifteen percent of the operating capital and the value of the real estate, financed it with the factory and the captive finance company, paid the factory their share of the profit, just like a partner, paid the C corp. tax (dealer development deals are C Corps) and then redeemed stock. This would be like paying 24% interest. So now you buy out the factory's share of the dealership, which normally had the real estate in the corp. You now take it out and pay capital gains on the fair market pick up, put it into your own LLC and start paying yourself rent. You also get your mortgage from the very same captive finance arm of the ex factory partner you just paid off, because you may not qualify with a standard bank. I don't know why that would be, but that is what I hear.

You are now on your own-you think. During this flurry of paperwork when the factory was telling you what to sign, you dared not ask any questions about the forms, or they could decide to bestow their gift to someone else less inquisitive. Fast forward. Times are tough and you need to sell. Falling in and out of trust with the captive finance arm, low on operating capital, it is time to do something. This is where you "just make another car deal" and sell the store. **First problem.** The option or site control agreement has "triggers" which you may have inadvertently violated, such as being out of trust, insolvent etc. Five, six, seven years have gone by and now your property is worth double what you paid. More than likely, if you were to sell to anyone except another dealer of the brand vehicle you sell, the factory has the right to exercise their option on the real estate. Your deal, along with your equity, is gone forever. Millions of dollars gone.

**Second problem.** The highest bidder for your property is Walgreens. Sorry. You can't sell to Walgreens. If you do, we exercise for the original sales price. Read the previous paragraph. **Third problem.** You finally come to grips with the fact you can't cash in with Walgreens and decide to sell your franchise to the adjoining dealer so he can put your franchise on his property and you want to sell the property to the Toyota or Lexus dealer who is expanding. Sorry, you can only sell to someone who will operate your brands at your site. Safe to say, if you are in a domestic brand, this deal is going to cost you a few million dollars of lost opportunity. Domestic buyer versus import highline? Who can pay more for your real estate?

**Fourth problem.** You decide to just lease the property to the buyer and wait for the site control document to either revert to fair market value or expire. You do the deal and you sign the lease with the buyer. Your lawyer is getting ready for the closing and gets this call. “You want us to release our lien on the assets, no problem, just pay off the mortgage”. Oh. The mortgage document states that if you are no longer a dealer or don’t have a wholesale floor plan, you need to pay us off. You have to now go out and refinance your dealership as a non owner occupied investment so you can sell and hold a lease. I think this is why dealers say not have your eggs all in one basket. You now feel like you fell off a ladder and hit your head on every rung on the way down.

**Fifth problem.** That old dealer development C corp. you converted to an S corp. is not ten years old yet so your sale proceeds get taxed like a C corp. Check with your accountant and get the built in gains tax number from him.

Here is what you’re going to do.

1. Every document you exchange, every email you exchange related to the transaction concerns two buy sells. One for personal good will and one for corporate good will.
2. Hire a firm to do a personal goodwill appraisal. Moss Adams does a great job. Whatever they say your personal goodwill is goes in that document, the balance goes to the corporation and you owe C corp. tax on it if your S Corp. is not at least ten years old, doesn’t have adequate built in gains, etc. This is for you to talk about with your accountant.
3. Make sure you know what triggers any options that allow the factory to buy your land for the 5 year old price and don’t do any of those things. If you have, get with your lawyer and get it fixed, if possible. Get with them anyway to figure out what to do with the option document.
4. Most factories will amend the site control document to get a new dealer they like in place. The buyer’s lawyer will make this a condition precedent to the closing. The factory will use this to control which buyer you select. This is the one case where you don’t want to simply send them a buy sell. They don’t have any obligation to amend the site control agreement and conform to the condition precedent.
5. If you want to keep the property, get it refinanced prior to making a deal. If you can’t, then sell it and put your money in something else. Don’t lease the property and try to figure out how to refinance while you have a buy sell pending.

**Thoroughly review your mortgage documents, site control documents and option agreement documents with your lawyer before doing anything related selling your business and leasing or selling your property. Discuss with your accountant how he will calculate your post tax net for the purposes of your return. If you are a C Corp, discuss a personal goodwill and a corporate goodwill appraisal. Use professionals and have someone “manage” the transaction. It is not a car deal. Don’t spot deliver**

**yourself after signing 5 contracts and the finance guy telling you he will call you when he gets your deal bought.**

The bottom line here is that when considering an exit; get the help of people to who do such work. It is second nature to us to put deals together that take all of the issues into account and then build the best deal, that is the most like to be approved. Fail to plan or plan to fail. Something like that.