Issue to Consider in Negotiating Shareholders Agreements, Company Agreements and Partnership Agreements

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A Hypothetical "Deal" to Negotiate:

Donny Dealer, your long time client, owns a series of car dealerships and calls you about a new opportunity. Elon Musk has awarded Donny the first Tesla retail location in Texas. BUT, Elon Musk requires his flagship Texas outlet to be located in a specific area in Austin, since that is a progressive city. There are limited locations available for such a large dealership in Austin. Furthermore, Donny owns 5 other dealerships in the South Texas area and does not have the time to manage the new flagship location himself given his other obligations.

A Hypothetical “Deal” to Negotiate:

Donny has a solution. His best General Manager, Manny, from the Corpus Christi Ford dealership, shows incredible potential and drive. Donny trusts Manny’s abilities to make the venture a success. Manny is 41 years old, has three young children, and his family and wife’s family and their church and friends are all located in Corpus. He has little desire to leave his home, move his family, or his current very lucrative position at a dealership that he’s dedicated 15 years to—but he can be coaxed away.   He has little money to offer to the venture but has extensive management experience, is smart, trustworthy and is a hard work.

A Hypothetical "Deal" to Negotiate:

Donny knows trucks and knows Texas, but Elon insists Donny allow Eddie Electric, a San Francisco car dealer who owns several hybrid-car dealerships participate in the venture because of Eddie's extensive knowledge in the electric and hybrid automobile car industry and preexisting relationship with Elon. Texas is a big market, so this is an important event for the Tesla brand, and Elon Musk doesn't want to rely solely on someone that has owned and operated traditional dealerships. Elon wants Donny, Mickey and Eddie involved in the operations of the dealership, but understands Danny and Eddie have other dealerships to babysit as well.

A Hypothetical “Deal” to Negotiate:

Elon believes in the old addage of “location, location, location,” and has given a directive that the dealership must be located in the up-and-coming east side of Austin. The only viable location is a 15 acre tract owned by Peter Property, and is a former Saturn Dealership. Peter used to be in the auto business, but has not been for many years. Peter is clever and insists on a significant premium for the sale of the property, or alternatively an equity participation in the new dealership. Backed into a corner, Donny begrudgingly agrees to allow Peter to contribute the property to the venture in exchange for ownership. A benefit of this though is that Donny and Eddie have to come up with the funds to purchase any real property now and can invest those funds into operations and inventory instead.

A Hypothetical "Deal" to Negotiate:

So, here's their economic deal [Investments based on a valuation of $35MM]:

- Donny will contribute $15,000,000 towards the development of the real property, purchase of initial inventory, furniture, fixtures and equipment, and other start-up costs. In return, Donny will own a 43% interest in the dealership entity.

- Eddie will contribute $10,000,000 to be used for the same purposes as Donny. In return he will own a 29% interest in the entity. [Investment based on a valuation of $35MM]

- Peter contributes the 15 acres of real property which appraised at $5,000,000. In return he will own a 14% interest in the entity. [Investment based on a valuation of $35MM]

- Mickey doesn't have any money, but he has time, energy, potential and tremendous expertise. He also does not want to move his wife and children from their home town and leave the lucrative dealership he has spent the last 15 years developing with Donny. He will contribute $100,000—but to entice him to move to Austin he will receive credit disproportionate ownership in the entity equivalent to a 14% interest therein. In short, Mickey is "credited" with a $5,000,000 contribution. [Investment based on a valuation of $35MM]. It's a completely different lecture to go into the tax consequences for Mickey associated with being granted this equity, and the multitude of other ways his participation could be funded. There are lots of ways to skin this cat.

The BIG ISSUES:

- When considering governance matters in an operating entity, although there are almost unlimited issues, a reasonably comprehensive list of matters you should consider likely should include at least:
  - Contributions of Cash/Mandatory Cash Calls
  - Preferred Return
  - Distributions of Net Cash Flow
  - Management Authority, Continuity of Management, Terminating Events
  - Duties to the Company
  - Non-Compete and Non-Solicitation Obligations
  - Corporate Opportunity and Rights of First Refusal
  - "Bad Acts" of Members and Valuation upon Bad Acts
  - Voting Rights
  - Restrictions Against Transfer
  - Divorce and Death of a Spouse—Community Property Issues
  - Death of an Owner
  - Life Insurance
  - Disability of a Members
  - Valuating Interests
  - Push-Pull or other "Exit Strategies" or "Release Valves"
  - Drag-Along and Tag-Along Rights

- In this example, the dealership will have $25MM in cash from Donny and Eddie to develop the dealership, purchase inventory, furniture, fixture and equipment, and to staff up.
- The business will operate for a loss for almost 2 years. They believe the $25MM includes sufficient reserves for their business operations during that period.
- What happens if they are wrong though? What if there is a cash shortfall?
  - Consider whether your governance documents need to contemplate Mandatory Cash Calls
  - What voting threshold should be required?
  - How quickly might the business need the funds?
  - What is someone fails to timely contribute? Penalty?
    - Poured out?
    - Diluted proportionately forever?
    - Is it a loan?
    - Should there be a “Non-Consent” type penalty?

Contributions of Cash and Mandatory Cash Calls

Preferred Return

- Donny and Eddie have to deploy a LOT of cash to fund the capitalization of the dealership. If they didn't contribute those funds to the dealership they would have it in the market or purchase other investment products or have those funds invested in other opportunities.
- Should your governance documents contemplate some sort of minimum return, or risk hedge, on cash investment by certain owners?
- Should the preferred return have a priority over the distributions to the other owners who did not contribute any cash and have less at risk—Manny, for example?
- Should Peter receive a preferred return, when he contributed real estate, not cash?
- Depending on how speculative the investment is, or how desperate the business is for the cash investment, a preferred return may be anywhere from 6% to 12%.

Assume the dealership is now running profitably. How should net cash flow be distributed?

- Preferred Return will have a priority.
- Make arrangements for reasonable reserves.
- Should distributions or dividends be made based on percentage ownership?
- Disproportionate distributions or dividends
  - Should Manny participate proportionately immediately, or should he have the earn a “promote” or “carry”? He didn’t contribute any cash, so should he “pocket” 14% of the net proceeds derived from the business?
- What about mandatory tax distributions?

Distributions of Net Cash Flow

Management

- Who should be making the decisions as the board of directors, managers or at the general partner level, depending on what type of entity is used?
- Appointing officers (Manny)
- Limitations on Authority of Governing Persons (agreeing certain acts requires a super-majority or unanimous approval)
- Protective Provisions for Governing Persons
  - Limitation on number of governing persons
  - Voting agreement as to number of designees
  - Proxy
- Terminating Events of Governing Persons

Duties to the Company

- Duty of Loyalty and Duty of Care
- Time and Effort Commitment:
  - Different for Manny, Donny, Eddie and Peter.
  - COMPLETE EFFORTS: Full and complete dedication of professional efforts, in lieu of all other ventures. [Manny]
  - MIDDLE GROUND: Governing persons to dedicate reasonable time to the best interest and success of the Company, taking into account that they have other full time employment which may be prioritized over (but not attended to to the exclusion of) its obligation to dedicate reasonable time and effort to the success of the Business. [Donny and Eddie]
  - NO OBLIGATION: No obligation to dedicate time and effort to the Business. [Peter]. We probably don't want him involved anyway.

Duties to the Company

- Non-Compete Covenants
- Non-Solicitation Covenants
- Carve-out for current ventures
- Corporate Opportunity—should there be an obligation to offer participation to the other owners? Elon Musk requests Donny open another dealership in Dallas, for example.
- Confidentiality obligations

Bad Acts of Members

Consider, should the entity have the right to separate itself from an owner in the event of a “bad act,” which endangers the success or the business?

- The conviction of, or plea of nolo contendere to, a felony or of a misdemeanor involving material fraud, misappropriation, embezzlement or moral turpitude;
- The neglect of his or her duties to the business;
- Fraud or dishonesty in connection with the performance of their duties to the business;
- Bankruptcy;
- Engaging in any act in contravention of any franchise or license agreement with the automobile manufacturer with which the business has an agreement;
- Violating material loan covenants or guarantor covenants related to the company’s financing arrangements. Can’t jeopardize our financing!
- Any act which will have, or can be reasonably anticipated to have, a material detrimental effect on the business or operations of the business as a result of damage to the reputation of the Partnership;
- The breach of the non-compete, non-solicitation or confidentiality covenants under Sections 9.8 and 9.9 of this Agreement.

- Should the entity or other members have the right to buy out an owner upon a bad act?
- What should be the purchase price for the interests be? Shouldn't it be discounted?
- Should we be able to pay the withdrawn owner over time?

Consequences and Valuation upon "Bad Acts"

- Keep in mind, voting rights don't necessarily have to track equity ownership.
- For example, stock, membership interests or partnership interest can be "non-voting".
- Should Peter have the same kind of voting rights as Donny and Eddie? He doesn't know anything about the modern car dealership business.
- Should Manny have proportionate voting rights? He didn't contribute any cash.

Voting Rights

This is a “closely held” business in many ways. Do we want an owner to be able to “bring in” other owners without everyone agreeing?!

- Would Donny invest $15MM without knowing and trusting the other owners and governing persons?
- Would Elon Musk award the new Tesla location if the ownership could change at any time?
- What about estate planning type transfers (wholly owned businesses, children, trusts, affiliate businesses, etc.)
- What about a right of first refusal? Should there be some liquidity, so long as we offer any shares or interests contemplated for transfer to the other owners first?

Restrictions against Transfer

Divorce or Death of a Spouse

- What if Donny gets divorced and a court awards a "just and right division" of his ownership in the business to his ex-spouse?
- What if Eddie's spouse passes away and her will left her community property to her children from her first marriage?
- Right of first refusal and waterfall right to purchase.
- Valuation.

The dealership has been operating profitably for 7 years now and is valued at approximately $100MM.

- What if Peter dies?
- Rights of First Refusal and Waterfall.
- Valuation of Ownership – Appraisal, CPA Appraisal, Book Value, Formula based on multiple of EBITDA or other revenue.
- What if Manny dies two years into the venture? Shouldn't his valuation be different? He didn't contribute any funds!
- How can we afford to buy out Donny or Eddie? The value of their interests would be so high!
  - Pay out over time
  - Life Insurance
  - If I'm Manny, this is incredibly important.
  - If I'm Donny or Eddie, it incredibly important for me as well, for the best interest of my family.

Death of an Owner and Life Insurance

- What if Manny is in an accident and suffers a long term physical disability or loses mental capacity?
  - We need to recapture his equity so we can attract another talented general manager.
  - Is it an obligation for the Company to buy our Manny, or an election? If I'm Manny, I want the security for my family of an obligation upon the company to buy my ownership.
- What if Donny or Eddie suffer a physical disability, but is not mentally incapacitated? Should this be treated differently than if the same thing happened to Manny?

Disability of an Owner

- Call Rights (let's take out Pete at some point—he's a pest)
- Put Rights (Peter or Eddie may "want out" at some point)
- Push-Pull Provisions
  - After a number of years
  - Valuation and "money whipping" someone
  - Mandatory mediation first?

"Release Valves" and "Exit Strategies"

Events of Sale

- A Drag-Along provision provides protection for majority ownership in certain events of sale.

- A Tag-Along provision provides protection for minority ownership in certain events of sale.

Drag-Alongs and Tag-Alongs