

UPDATE: Dealers failing to maintain proper documentation regarding loans.

Much of our recent work has involved the sale and acquisition of dealerships in some form of distress, I think that it is appropriate to send along some information that many auto dealers, dealership lawyers and CPAs should be aware of just as a housekeeping item for your clients, or if you are a dealer, this is directed at you.

Our average workout engagement starts with a dealer who typically has done everything possible to avoid shutting down, including going through all of their cash, renegotiating debt, borrowing from multiple sources, etc. This article is important because most dealers are not following proper housekeeping regarding clear treatment and documentation of lending arrangements (many that involved related parties), including but not limited to having security agreements and filing appropriate UCC-1s, and maintaining minutes in corporate (or LLC) minute books along with clear and executed corporate (or LLC) resolutions regarding the details of cash contributions and cash borrowed from non banking sources.

The issues we are running across are related to a dealer who is selling his or her dealership and does not have sufficient funds to pay off all of the unsecured creditors, but will have some proceeds at closing. The inevitable question comes or statement is made “what about the money I put in the dealership” or “when can I pay my brother back the money he loaned me”. The first questions we ask are in regards to the existence of corporate (or LLC) minutes allowing and properly documenting the loan and whether payment of interest and the filing of a security agreement have occurred. In effect, have you treated the loan arrangement as a real arm’s length deal?

We are discovering that these housekeeping items are rarely if ever being performed. Auto dealers “selling short” typically take the position that they should be able to simply write themselves a check, or cash a check they have and then leave the unsecured creditors holding the bag. Without a clear, documented and valid debt obligation, which should have been documented at the time of inception not at the time when the dealer realized there might be a problem, a dealer cannot simply pay themselves the proceeds of the sale and not pay other unsecured creditors. We have seen such impermissible payments treated as preferences and unlawful distributions, but in either case, the dealer does not get to keep the proceeds he paid to himself.

Secured creditors, whether holding a validly filed deed of trust or security agreement and filed UCC-1, are required to be paid in a typical sale because they won’t release their liens/security interests/encumbrances on the assets; therefore, the transaction won’t close until the secured creditors release their interests in the dealership assets. Generally, secured creditors are paid and have rights based on the order (date) that they filed their security instruments; then, once the secured debts are paid, come the unsecured creditors. Dealers who have loaned money to their stores or who borrow money from the family and then put it in the business are generally unsecured creditors, unable to pay themselves ahead of other creditors when the sale occurs.

Treat these related party loans just like a regular third-party loan: document the loan amount, both in a note and on the company’s books; enter into a security agreement and file the necessary UCC-1 financing agreement to perfect the security interest; look to your lawyer and accountant for assistance and guidance; make sure the corporate (or LLC) minutes accurately reflect the loan and follow the

payment schedule. Again, if you do not treat these related party loans like actual arm's length deals, and then you sell your dealership, taking a disbursement of proceeds while not paying secured and/or unsecured creditors, you will likely find yourself in a situation of having to put the money back in the company or having to directly (and personally) pay certain creditors. Review and document all dealership loans, contact your lawyer for assistance and guidance and then act accordingly. Even if you are not planning the sale of your dealership, accurate and detailed documentation is a good idea. As we have all learned, we cannot necessarily predict the economy and its effects on dealerships.

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