TIA panel to freight brokerages: Limit risk as buyers flow into market

Attorney says 3PLs often enter risky transportation contracts to help secure business

John Kingston   Friday, April 8, 2022   5 minutes read

Panelists meet members of the audience after the session: Davis Looney, Tenney Group (back to the camera); Peter Stefanovich, Left Lane Associates, standing; Rob Kemp, DRT Transportation, sitting. Far rioght, Eric Zalud, Benesch law firm. Megan Johnson not visible.

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SAN DIEGO — Reducing risk at a brokerage is important, even more so now that so much private equity and so many asset-heavy carriers are hot for the space.

That message came through at a panel at the Transportation Intermediaries Association annual meeting, the first in three years. The panel's relatively bland title was "Key legal issues between brokers and motor carriers," but it was more like two panels in one.

The first part did discuss ways to mitigate risks, both legal and those a buyer might see if it looks to acquire a 3PL. The second was about the growing interest in buying brokerage houses. That interest is coming not just from private equity, but also from trucking companies that are trying to diversify their business by adding or expanding brokerage capabilities.

Moderator Eric Zalud, a partner in the transportation practice of Benesch law firm, noted the frustrations that attorneys encounter with brokerage clients who put themselves in potential future jeopardy.

The "fundamental threshold of the law is that brokers are rarely liable for losses," Zalud conceded. Even when a broker is pulled into a lawsuit, "they usually can get out with a few exceptions."

However, transportation contracts drawn up between brokers and carriers increasingly have the 3PL taking on liability, he said, "and they are doing it to provide seamless service, which has some risks also."

A decade ago, such contracts barely existed. "Today, they're all over the place," Zalud added.

"We tell our broker clients, 'Here is what your risk is,' and a lot of clients say, 'Excellent advice,'" the attorney said, "but we're going to do it anyway" because it is seen as making it easier to secure the business in the contract.

Marketing is another area where 3PLs encourage liability. Zalud joked about "amazing puffery," which he described as a brokerage with no tractors putting a picture on its website of a truck and the 3PL's name prominently displayed on the tractor.

Zalud said many brokers don't want to call themselves that: the B word. So he recommended they use the A word: arranger, as in a company that arranges transport.

"The very worst pronoun is 'we,'" he added. That term raises the prospect that any sort of legal conflict between shipper and carrier will drag in the 3PL. That's why brokers should rely on the word "arranger."

One other notable recommendation at the panel: Be careful about the types of interaction between the 3PL and the driver of the freight. In an era when everyone praises the value of communication. Megan Johnson, general counsel of Axle Logistics, said technology enables a reduction in regular, frequent communication between broker and driver. "It can help as a risk mitigation tool in terms of how much a broker has to integrate with the driver," said Johnson, formerly a colleague of Zalud at Benesch, which sponsored the forum. Zalud added that court decisions have gone against brokerage companies based on the level of interaction between brokers and drivers.

The discussion of risk segued into the prospect of merger and acquisition activity in the space, whether it's carriers acquiring brokerage assets or 3PLs buying truck capacity. Rob Kemp,the president adn founder of DRT Transportation, and a panelist, recently did that by acquiring rolling stock.

"We needed to add trucks to support our customers," Kempt said However, he said to mitigate the types of risk factors discussed during the panel, Kemp said the two organizations are structured to be completely separate.

"Control" is a key legal consideration in the issue of independent contractor status. And in order to ensure that the brokerage was not controlling the heavy assets, which might challenge the legal separation of the tdwo arms, Kemp said "we follow all the rules to keep them separate."

Davis Looney, a strategic adviser with M&A specialist The Tenney Group, said he is advising a few brokerage companies that are being acquired by carriers.

Major carriers have long had their own brokerage divisions, but it isn't universal among fleets. Looney said some carriers have tried to create their own brokerage operations, "but being able to acquire a broker that has systems and processes in place, and knows how to grow and take on excess freight, is seen as more and more important."

If a brokerage is going to find itself in play, Looney said, "as much as you can show them," decreasing risk is important to help maximize the value in a sale. It isn't just legal risk; he cited a theoretical brokerage company that had 90% of its business with one customer, or one that is headed by an owner who, as soon as the transaction is complete, "is going to be hitting the beach and carry a lot of customer relationships with him."

Private equity interest in brokerage assets picked up significantly early in the pandemic, Looney said, right after many PE companies went "pencils down" on all other activity. But they soon noticed that transportation had barely slowed and turned their attention to that field.

That did not necessarily change valuations. Looney said he has always been cautious in describing the average multiples received in sales of brokerages, because “every time we say something in a range, everybody hears the high end.”

The actual multiples are more “nuanced,” depending on the areas brokerages specialized in. But for companies with earnings before interest, taxes, depreciation and amortization of less than $10 million that don’t carry any particular speciality, Looney said multiples have been in the 5X to 7X range.

Peter Stefanovich, presdient of Left Lane Associates, told FreightWaves after the TIA session that preparation for a possible sale could involve taking several steps. “Decreasing customer and carrier concentration and focusing on a niche service offerings will position your 3PL/broker business at the higher end of the multiple range,” he said.

He also provided FreightWaves with a prepared slide on supply chain M&A trends, spelling out some of the risks and benefits in the sale of brokerages.

If a brokerage has an asset-based component — like Kemp’s company became — it could result in a different deal structure — “less upfront cash, inclusion of seller note, earn-out or other deferred methods of consideration,” the slide said. It also might mean that the buyer needs to be larger with greater access to capital.

If a broker is acquired by an asset-based carrier, the benefits are what has always been touted as the strength of an in-house brokerage: “ability to pass overflow freight to broker to find capacity and create additional revenue rather than passing on the load entirely,” according to the slide. It also benefits the broker to be able to cross-sell to the carrier’s base and that some shippers prefer brokers that have carrier capabilities.