

**SURVIVAL IN TODAY'S AUTOMOTIVE INDUSTRY:
HOW TO MANAGE YOUR CONTRACTS WITH
FINANCIALLY DISTRESSED COMPANIES**

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SURVIVAL IN TODAY'S AUTOMOTIVE INDUSTRY:

Managing Contractual Relationships and Supply Chain Distress

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Foley & Lardner Overview

- Founded in 1842
- Today, more than 1,000 attorneys in U.S. and foreign offices (Brussels and Tokyo)
- Nearly 400 attorneys have been awarded Martindale-Hubbell's highest rating
- 15 practice groups recognized by *Chambers USA: America's Leading Business Lawyers*
- Recognized as #1 general practice IP firm
Technology savvy/CIO 100 honoree

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Foley's Automotive Industry and Restructuring Capabilities

- Foley's Automotive Industry Team (AIT) represents companies throughout the automotive supply chain, with an emphasis on representing Tier 1 suppliers
- More than 50 attorneys practice in Foley's Business Reorganizations Practice Group, including in New York, Delaware, Detroit and other jurisdictions
- Foley is the only national law firm with a Detroit Office and dedicated Automotive Industry Team, with deep knowledge of supply chain contracts and how to deal with troubled customers/suppliers

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Foley's Automotive Industry Chapter 11 Experience

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- Foley & Lardner attorneys have had significant involvement in the following automotive Chapter 11 cases:
 - Tower Automotive
 - Meridian Automotive Systems
 - BBi Enterprises
 - Collins & Aikman
 - Pilot Industries
 - Venture
 - Oxford Automotive
 - Intermet Corporation
 - Key Plastics
 - Amcast Industrial
 - Delphi
 - JL French
 - Dana Corporation
 - Dura Automotive

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Introduction

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- Automotive Industry Practices/Environment
- Key Contract Provisions
- Strategies and Implementation Issues Before Bankruptcy
- Strategies and Implementation Issues After Bankruptcy
- Proactive Contract Counseling Management
- Recognizing When a Company is Troubled

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Historical Automotive Contracting Practices

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- Yesteryear's Kings of the Hill: The (Really) Big Three
 - Contracting practices
 - Build-to-spec
- Evolution of Automotive Tiers
 - Implications
 - Contracting practices
 - Beyond build-to-spec

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Historical Automotive Contracting Practices (cont.)

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- Steel Price Increases Changed Everything
 - The steel price run up
 - Contract implications: yesteryear turned upside down
 - Other commodity issues
 - “Get me one of those injunctions”

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Current Industry Environment

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- Customer bankruptcies more likely – not “too big to fail”
- Contract unlike other industries with OEM power buyer, termination for convenience, and scheduled price-downs
- Prevalence of sole-source and PPAP requirements – unique goods

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Current Industry Environment (cont.)

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- JIT inventory management – stoppage of shipments cause plant shutdowns
- Reduced Big 3 production make contracts less profitable (or bigger losers)
- Consolidation of suppliers to OEMS and Tier Ones by 2/3

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Current Contracting Practices

- RFQs
- Quotations
- Purchase Orders
- “Battle of the Forms”

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Current Contracting Practices (cont.)

- What is the Contract?
 - T’s & C’s: conflicting terms and the “Battle of the Forms”
 - Termination date is important: fixed or indefinite?
 - Emails and course of dealing impacts what constitutes the “contract” (course of dealing and course of performance)
- Trends: Long Term Agreements?

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Key Contract Provisions for Survival in Today’s Automotive Industry

- Warranty
- Indemnity
- Intellectual Property
- Price Adjustment Mechanisms

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Key Contract Provisions for Survival in Today's Automotive Industry (cont.)

- Term and termination
- Provisions to deal with troubled supplier/troubled customer issues
- Overriding goal: Match commitments extracted on buy side with promises given on sell side

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Troubled Situations

- Nature of contract affects rights and remedies pre-bankruptcy
 - Stoppage of shipment
 - Termination of contract
 - Adequate assurance of performance
- Nature of contract affects rights and remedies
 - Ability to stop shipment
 - Assumption or rejection of contract
 - Affect on ultimate payment
 - Obligations and rights in the "Gap Period"

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Strategies and Implementation Before Bankruptcy

- 2-609
- Set-off/recoupment
 - Injunction issues
- Reclamation
- Accommodation and access agreement

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Demands for Adequate Assurance of Performance Under the UCC

- When reasonable insecurity exists concerning a contracting party's willingness or ability to perform a future obligation, the other party can issue a demand for adequate assurance of performance under Uniform Commercial Code Section 2-609
- Party receiving demand must give written assurances concerning its ability to perform these future obligations

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Demands for Adequate Assurance of Performance Under the UCC (cont.)

- Party issuing demand may suspend or modify performance (example – change credit terms) if appropriate assurances are not provided
- Good tool to force issues into negotiation (and perhaps litigation) before the actual breach occurs
- Way to shore up your position with a troubled customer before a bankruptcy filing

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Setoff and Recoupment

- Setoff
 - Allows parties with mutual claims to offset such claims against one another – even different transactions and possibly affiliates
 - Setoff permitted where:
 - Creditor and debtor hold pre-petition claims against each other
 - The claim and debt are mutual
 - Setoff rights can be defined by contract
 - Can modify general rule that claims must be liquidated and not contingent
 - Can apply to claims involving third parties
 - Rights specified in terms and conditions are critical

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Setoff and Recoupment (cont.)

- Recoupment
 - Recoupment is related to setoff and allows a creditor to avoid paying a debtor when the debtor also owes the creditor
 - Recoupment is an equitable principle
 - Only one requirement for recoupment:
 - The claim and the debt to be recouped must be from the “same transaction,” which is construed narrowly
 - Courts interpret this to mean “same contract”
 - Unlike setoff, the amount recouped is limited to the amount of the debt owed – there is no “overage” for which a claim remains

Reclamation

- Reclamation claims against insolvent customer should be pursued within 10 days of delivery unless misrepresentation of solvency made within 3 months
- Ability to go into court and take back goods shipped
- Lender’s lien can affect rights
- New Bankruptcy Act improves reclamation rights of suppliers – filing for reclamation must occur within 45 days of receipt by debtor or within 20 days of bankruptcy filing

Accommodation and Access Agreements

- Typically between customers, suppliers and secured lenders, these agreements are designed to provide continuity of supply and protection of the secured lenders’ collateral base
- The access agreement permits the customer, under limited circumstances, to access the supplier’s plant to produce parts pending transfer of the contract and/or facility to a healthier supplier
- The accommodation agreement provides accommodations that solidify the lenders’ collateral base through protections on inventory and receivables and commitments to continue sourcing of existing parts to the troubled supplier
- Often provide for waiver of the right of setoff as to consequential damages
- May provide for loans or financial accommodations

Strategies and Implementation Issues After Bankruptcy



Assumption of Rejection of Executory Contracts

- Generally speaking, an executory contract is a contract with unperformed obligations on both sides
- A debtor must assume or reject executory contracts for the sale of goods by no later than confirmation of the plan
- The debtor can be compelled to assume or reject an executory contract sooner, for “cause”
- In order to assume an executory contract, all monetary defaults must be promptly “cured” and adequate assurance of future performance must be given



Assumption of Rejection of Executory Contracts (cont.)

- Claims arising under an assumed contract or a subsequently rejected assumed contract are entitled to priority as an administrative expense
- Negotiation or court imposition of early assumption or rejection deadline by the debtor depends on leverage and contract terms
 - Long term vs. order by order
 - Product type
 - Contract termination date
- Rejection of an executory contract results in a pre-petition unsecured claim for damages



Setoff and Recoupment in Bankruptcy

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- Setoff
 - Common law rights are preserved
 - Creditor and debtor must hold pre-petition claims against each other
 - Debts must be mutual against the debtor and creditor, absent contract exception
 - Restrictions on the use of setoff in bankruptcy
 - No setoff where claim acquired after bankruptcy or for the purpose of gaining right of setoff
 - No setoff where claim acquired from one other than the debtor in the 90 days before bankruptcy while the debtor was insolvent
 - Preference concept is built into the statute. It permits recovery of “improvement in position”.

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Setoff and Recoupment in Bankruptcy (cont.)

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- No setoff of post-petition claims against pre-petition debts is permitted
- Creditor may setoff debtors from different transactions against each other
- Setoff is subject to the automatic stay – creditor needs court permission to setoff a claim
- While setoff is subject to the automatic stay, the United States Supreme Court has held that a creditor may place an ‘administrative hold’ or ‘freeze’ on a debtor’s assets in an attempt to protect a creditor’s state law setoff right without violating the automatic stay. *Citizens Bank of Maryland v. Strumpf*, 116 S.Ct. 286 (1995)

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Setoff and Recoupment in Bankruptcy (cont.)

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- Benefits of Setoff
 - A creditor that has valid setoff has a secured claim in a bankruptcy, up to the amount of the setoff
 - Thus, a creditor with a claim capable of setoff is in an improved position in the bankruptcy where general unsecured claims are being paid pennies on the dollar
 - Any amount due over the setoff amount is considered an unsecured debt

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Setoff and Recoupment in Bankruptcy (cont.)

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- Preference issue if setoff occurs in 90 days
 - Recover improvement in insufficiency (i.e. the amount by which a claim against the debtor exceeds the debtor owed by the debtor to the creditor)
 - Tested by the amount by which the insufficiency is less than the insufficiency on the later of (a) 90 days before filing, and (b) the first time, in such 90 days, on which an insufficiency exists

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Setoff and Recoupment in Bankruptcy (cont.)

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- Recoupment
 - Recoupment is not mentioned in the Bankruptcy Code, but courts routinely apply equitable principle
 - Benefits of recoupment in bankruptcy
 - Recoupment is not subject to the automatic stay, and thus no court permission is required to exercise the right to recoupment. See *In re Kasadnar*, 157 F.3d 1011 (5th Cir. 1998); *Malinowsky v. New York State Dep't of Labor*, 156 F.3d 131 (2d Cir. 1998)

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Setoff and Recoupment in Bankruptcy (cont.)

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- Post-petition claims may be recouped against pre-petition debtors arising out of the same transaction. See *Ashland Petroleum Co. v. Appel (In re B & L Oil Co.)*, 782 F.2d 155 (10th Cir. 1986)
- Does not literally constitute a secured claim. See *In re Photo Mechanical Servs., Inc.*, 179 B.R. 604 (Bankr. D. Minn. 1995)
- Not subject to preference improvement test. See *Reiter v. Cooper*, 507 U.S. 258 (1993)

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Essential or Critical Suppliers

- Cardinal principal of bankruptcy is that similarly situated creditors receive equal treatment
- Certain creditors (usually trade) can be deemed “critical” in bankruptcy proceeding if they are:
 - Irreplaceable;
 - Crucial to continued operation and successful reorganization; and
 - Can be used as means to obtain unsecured administrative credit.

Essential or Critical Suppliers (cont.)

- The Seventh Circuit Court of Appeals, in *In re Kmart Corp.*, No. 03-1956, 2004 U.S. App. LEXIS 3397 (7th Cir. Feb. 24, 2004), limited debtors’ ability to make critical vendor payments and expressly rejected arguments that such payments can be authorized pursuant to the bankruptcy court’s inherent equitable powers under section 105(a) of the Bankruptcy Code. The Seventh Circuit left open the possibility that payments may be authorized under section 363(b)(1) of the Bankruptcy Code, but required that a debtor make an evidentiary showing that a vendor will actually refuse to ship unless pre-petition debts are paid and that refusal to ship will harm unsecured creditors.

Essential or Critical Suppliers (cont.)

- Consequences for a supplier that is deemed “critical”:
 - Supplier can be paid in advance of and at higher percentages (usually in full) than others on account of its unsecured claim
 - Converts pre-petition claim into administrative claim
 - Typically requires credit terms and equal exposure
 - Similar result can be obtained by assumption
- Debtor/customer may argue that a supplier is a “critical vendor” if such supplier would either:
 - Stop doing business with the debtor because of the bankruptcy, or
 - If the supplier be forced into insolvency by the debtor’s unpaid claim

Essential or Critical Suppliers (cont.)

- Auto industry gives support to critical vendor arrangements
 - Customers may not have alternative markets for the goods they are purchasing
 - An inability to replace that supplier (owing to the high cost associated with moving tooling from one supplier to another and the attendant time delay)
 - Extremely thin profit margins (where the collapse of even one customer may mean economic ruin for many suppliers)
 - Tooling vendors often considered critical vendors
 - Lien issues (possessory and by filing)

Essential or Critical Suppliers (cont.)

- Critical vendor doctrine is unsettled, particularly in light of the Seventh Circuit Court of Appeals Kmart Decision
 - Comes from necessity doctrine
 - Different jurisdictions handle differently
 - In the United States Bankruptcy Court for the Eastern District of Michigan, local rules set forth a number of requirements for a "critical vendor" motion
 - Among other things, such a motion must include: (i) aggregate amount to be paid to all critical vendors, (ii) the individual vendors to be paid and the amount to be paid to such vendors and (iii) the reason each vendor is "critical"

Essential or Critical Suppliers (cont.)

- Section 503(b)(9) of the Bankruptcy Code – Administrative claim for goods sold to the debtor in the ordinary course of business in the 20 days preceding the bankruptcy
 - Section 503(b)(9) of the Bankruptcy Code provides that:
 - (b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including
 - ***
 - (9) the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business

Essential or Critical Suppliers (cont.)

- Expanded reclamation rights: Section 546(c)(1) of the Bankruptcy Code expands the right of reclamation to goods for which demand is sent not later than 45 days after receipt and not later than 20 days after the filing of the bankruptcy petition (if the 45 days expires post-petition)





Other Miscellaneous Strategies



Proactive Contract Counseling Management is Essential

- We recommend that automotive suppliers assess and manage their contracts, both with customers and lower tier suppliers
 - Create and maintain a chart showing critical terms of LTA's and PO's, including expiration and renewal dates
 - Know what contracts to which setoffs and recoupments pertain
 - Ensure that your contract obligations are appropriately addressed
 - Address volume and raw material issues, where possible



Proactive Contract Counseling Management is Essential (cont.)

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- Foley & Lardner conducts training sessions for both purchasing and sales organizations, with a focus on claim and cost avoidance
- Topics include:
 - Elements of a Contract
 - Basic Principles of Contract Law
 - Key Provisions of Uniform Commercial Code
 - Early Warning Signs of Problems

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Proactive Contract Counseling Management is Essential (cont.)

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- How to Proactively Manage Problems
- Dealing with Financially Distressed Suppliers and Financially Distressed Customers
- Litigation Avoidance/Mitigation Tactics
- Antitrust Law Issues
- Email and eCommerce Issues
- Discovery and Other Litigation Issues

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Recognizing When a Company is Troubled

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- Late and delayed payments
- Increasing receivables
- Decreasing market share
- Dun & Bradstreet reports
- Changes in key management positions
- Lengthening of credit terms
- Delays in payment of dividends or payments on funded debt



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Recognizing When a Company is Troubled (cont.)

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- Early warning signs of financial distress may include:
 - Supplier requests for price increases, early payments, accelerated payment terms, or customer financing
 - Late deliveries or negative changes in product quality
 - Failure to update information technology systems
 - Failure to effectuate cost reductions or to address volume reduction during economic downturns

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Recognizing When a Company is Troubled (cont.)

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*Cartoon by Robert Weber, as seen in "The New Yorker"

- Failure to effectuate cost reductions or to address volume reduction during economic downturns
- Delinquent taxes
- Deteriorating accounts receivable and accounts payable
- Employment of financial consultants
- Restatement of or delays in issuing audited financial statements, or a change in audit firms

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Thank You!

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NOTES



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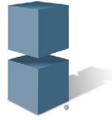
John R. Trentacosta is a partner with Foley & Lardner and co-chair of the Automotive Industry Team. He is a member of the Distribution & Franchise and Commercial Transactions & Business Counseling Practices, as well as the International Team.

Mr. Trentacosta is actively involved in drafting contracts commonly used in the automotive industry. He is also extensively involved in litigating disputes involving automotive concerns, particularly supplier-manufacturer disputes.

Mr. Trentacosta has over 20 years of commercial, contract and computer litigation experience. Having published two books in this area, he is recognized as one of Michigan's leading experts in Article Two of the Uniform Commercial Code involving commercial transactions. In addition, Mr. Trentacosta was named in the list of 2006 Michigan "Super Lawyers" by *Law & Politics Media, Inc.* for his work in business litigation. Mr. Trentacosta is also listed in the 2006 edition of *Chambers USA: America's Leading Lawyers for Business*.

A respected and widely published author, Mr. Trentacosta was editor and contributing author of *Michigan Contract Law* (Institute of Continuing Legal Education, 1998), co-author and general editor of *Michigan Legal Forms-Uniform Commercial Code* (Lawyers Cooperative Publishing, 1995). He twice co-authored the "Annual Survey of Michigan Law, Commercial Transactions and Contracts," published in *The Wayne Law Review*. He has also published numerous articles on UCC issues and commercial litigation appearing in *Michigan Bar Journal* and *The Michigan Business Law Journal*.

Mr. Trentacosta is a member of the State Bar of Michigan and has served as chairperson (1995-96) and council member (1990-95) of the Business Law Section. He has served as chairperson of the UCC Committee (1987-98)



and council member of the Computer Law Section since 1997. He is also a member of the American Bar Association, Business Law and Litigation Sections.

A 1980 graduate of Georgetown University Law Center, Mr. Trentacosta received his undergraduate degree in finance from Michigan State University with high honors in 1977.



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Judy A. O'Neill is a partner with Foley and is vice chair and leader of strategic development of the firm's national Business Reorganizations Practice.

Ms. O'Neill is experienced in bankruptcy, insolvency, reorganization, commercial transactions and corporate law and business transactions, specializing in issues arising under the Bankruptcy Code. Her experience has spanned a variety of industries including the automotive, retail and healthcare industries. She has represented clients in all aspects of debt restructurings, including representation of purchasers and sellers in acquisitions arising from receiverships and bankruptcy proceedings, and representation of troubled public and private companies in bankruptcy and out-of-court proceedings, unsecured creditors committees, and secured lenders in bankruptcy and out of court restructurings. Her representations of troubled companies has included Internet Corporation and its subsidiaries, Venture Holdings, LLC and its subsidiaries, The ½ Off Card Shop, Steinbach Stores, Inc., Pilot Industries and its subsidiaries and special counsel to Oxford Automotive, Inc. and its subsidiaries. Her representations of unsecured creditors has included The Unsecured Creditors Committee in Folds, Inc, the Unofficial Committee in Fort Wayne Foundry Inc, and The Official Unsecured Creditors Committee of River City Plastics. She has also had significant creditor representations in the Alleghany Health and Education Foundation, Mariner Healthcare and Sun Healthcare bankruptcy proceedings. She also represented several purchasers in the Michigan Healthcare Corporation bankruptcy.

Ms. O'Neill previously served as managing director of Dykema Gossett's Business Department and as assistant leader of the Bankruptcy and Creditor's Right/Reorganization Practice group. She is a facilitator for the Eastern District of Michigan Bankruptcy Court. Prior to practicing law, she was a mathematics teacher.



Ms. O'Neill received her law degree from University of Michigan Law School in 1980 with high honors, and her undergraduate degree from Michigan State University in 1976, *magna cum laude*.

Ms. O'Neill is a member of the Detroit Metropolitan Bar Association, the Michigan Bar Association, and the American Bar Association. She is a past regional membership director of the American Bankruptcy Institute and its Unsecured Trade Creditors Committee, advisory board member of the American Bankruptcy Institute Central States Conference, a past advisory committee member of the Eastern District of Michigan Bankruptcy Court, and a past Debtor/Creditor Committee chairperson of the Detroit Metropolitan Bar Association. She also is an American Board of Certification Bankruptcy and Creditor's Rights Certified Attorney.

Ms. O'Neill is a member of the American Board of Certification; was inducted into the American College of Bankruptcy Fellows in 2002; is a life member of the National Registry of *Who's Who*, 2001 edition; and has been listed in *The Best Lawyers in America*®, for more than the past decade. She is also listed in *Who's Who Legal USA: Insolvency & Restructuring 2006*, and *Who's Who in American Law*, 2000 edition. She was selected by *Crain's Detroit Business* as one of the "100 Most Influential Women in Michigan," March 2002. She is included in the *Guide to the World's Insolvency and Restructuring Lawyers*, 2003 and 2006. Ms. O'Neill is also recognized in the list of 2006 "Super Lawyers" by *Law & Politics Media, Inc.* for her work in bankruptcy, creditor and debtor rights, and will appear in the Top 50 Female Michigan "Super Lawyers" list.

Publications

- Co-author, American Bankruptcy Institute's Creditors' Committee Manual
- Co-author, "Franchisor Beware: Using the Bankruptcy Forum to Resolve Disputes with Franchisors," Michigan Business Law
- She is also a frequent speaker on the topics of bankruptcy and trial advocacy.