

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

- 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

- 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
- Understanding and Avoiding Preferential Transfer Liability



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Historical Automotive Contracting Practices

- 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.)

- 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”



Current Industry Environment

- 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



Current Industry Environment (cont.)

- 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



Current Contracting Practices

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



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?



Key Contract Provisions for Survival in Today's Automotive Industry

- Warranty
- Indemnity
- Intellectual Property
- Price Adjustment Mechanisms



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

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"

Strategies and Implementation Before Bankruptcy

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



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



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



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



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



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Strategies and Implementation Issues After Bankruptcy

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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



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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



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Setoff and Recoupment in Bankruptcy

- 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”.



Setoff and Recoupment in Bankruptcy (cont.)

- 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)



Setoff and Recoupment in Bankruptcy (cont.)

- 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.)

- 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.)

- 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)

Setoff and Recoupment in Bankruptcy (cont.)

- 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)

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)



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Other Miscellaneous Strategies

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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



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Proactive Contract Counseling Management is Essential (cont.)

- 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.)

- 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

- 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



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



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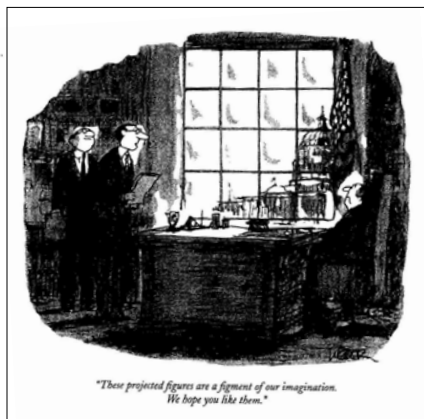
Recognizing When a Company is Troubled (cont.)

- 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.)



"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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Understanding and Avoiding Preferential Transfer Liability

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Understanding and Avoiding Preferential Transfer Liability (cont.)

Preference Statistics

- In 2003, nearly 60,000 preference lawsuits were filed around the country. This represented an increase of nearly 300% since 1999. *Source: Administrative Office of U.S. Courts.*
- Bethlehem Steel bankruptcy alone spawned more than 3,000 lawsuits, plus 1,300 letters demanding repayments.
- Thousands more suits from mega cases like Enron, WorldCom, and United Air Lines
- Small cases add up: 2,000 cases at an average of \$5,000 per case equals \$10 million
- Will the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) change this trend?

Source: David Henry, "The Long Arm of Failure," BusinessWeek, November 15, 2004.



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Understanding and Avoiding Preferential Transfer Liability (cont.)

A Primer on Preferences

- 11 U.S.C. § 547(b) (2007): “Except as provided in [certain subsections], the trustee may avoid any transfer of an interest of the debtor in property—
 - (1) to or for the benefit of a creditor;
 - (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
 - (3) made while the debtor was insolvent;
 - (4) made—
 - (A) on or within 90 days before the date of the filing of the petition; or
 - (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and



Understanding and Avoiding Preferential Transfer Liability (cont.)

- (5) that enables such creditor to receive more than such creditor would receive if—
 - (A) the case were a case under chapter 7 of this title;
 - (B) the transfer had not been made; and
 - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.
- 11 U.S.C. § 550 permits the trustee to recover any preferences that have been avoided.



Understanding and Avoiding Preferential Transfer Liability (cont.)

Practical Considerations

- Burden of proof on trustee for § 547(b) and creditor for asserted defenses under § 547(c)
- Relatively easy for trustee or debtor to prove all elements of *prima facie* case
- 11 U.S.C. § 547(f) provides for presumption of insolvency during 90 day period
- Most cases are decided not on § 547(b), but on defenses asserted by creditors
- Many times defendants admit all, or almost all, elements of *prima facie* case
- Cost for plaintiff to establish *prima facie* case is low
- Cost for defendants to prove defenses often higher



Understanding and Avoiding Preferential Transfer Liability (cont.)

Train Wreck: When Adequate Assurance Collides With Preference Liability

BACKGROUND:

- Debtor/Automotive Supplier (“Debtor”) contracts with scrap steel supplier (“Supplier” or “Creditor”) for large shipments of scrap steel.
- Open Purchase Order issued by Debtor to Creditor for term of one year. Quantities established by Releases issued periodically. (Alternative scenarios: Purchase Order sets quantity for entire year, or provides that Debtor will buy all of its “requirements” from Creditor)



Understanding and Avoiding Preferential Transfer Liability (cont.)

PROCEDURE:

- (1) release issued to Creditor;
- (2) Creditor loads scrap steel onto rail cars for delivery;
- (3) delivery often takes up to one week;
- (4) Creditor issues invoice to Debtor on net 45 terms;
- (5) scrap steel arrives at local rail yards;
- (6) Debtor coordinates deliveries to plant with local rail yards;
- (7) Debtor pays by check, typically within 45 to 60 days after invoice.



Understanding and Avoiding Preferential Transfer Liability (cont.)

ON THE BRINK OF BANKRUPTCY:

- Approximately 14 days before bankruptcy filing, Debtor provides notice of debt covenant violations.
- Creditor immediately suspends all rail shipments to Debtor at point of shipment or local rail yards.
- Creditor demands immediate payment for all rail shipments before delivery will be made.
- Debtor is a “just-in-time” manufacturer.
- In response, Debtor immediately pays for rail shipments on a rolling basis by wire transfer.



Understanding and Avoiding Preferential Transfer Liability (cont.)

BANKRUPTCY FILED:

- Debtor demands repayment of, among other things, wire transfers paid within two weeks before bankruptcy.
- Creditor asserts multiple defenses, including:
 - (1) No antecedent debt and/or contemporaneous exchange defense
 - (2) Subsequent New Value
 - (3) Ordinary Course of Business



Understanding and Avoiding Preferential Transfer Liability (cont.)

CREDITOR'S ARGUMENTS:

- A. NO ANTECEDENT DEBT AND/OR CONTEMPORANEOUS EXCHANGE
 - No antecedent debt when wire transfers made.
 - 11 U.S.C. § 547(c)(1) (2007): "The trustee may not avoid under this section a transfer—
 - (1) to the extent that such transfer was—
 - (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
 - (B) in fact a substantially contemporaneous exchange.
 - Analysis: Antecedent debt? Intent?



Understanding and Avoiding Preferential Transfer Liability (cont.)

B. SUBSEQUENT NEW VALUE

- If “new value” not contemporaneous, it must be subsequent.
- 11U.S.C. § 547(c)(4): “The trustee may not avoid under this section a transfer—
 - (4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—
 - (A) not secured by an otherwise unavoidable security interest; and
 - (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.



Understanding and Avoiding Preferential Transfer Liability (cont.)

- Encourages creditors to continue doing business with financially stressed debtors.
- Analysis: Does it fit the statutory definition? Was it “new value”?



Understanding and Avoiding Preferential Transfer Liability (cont.)

C. ORDINARY COURSE OF BUSINESS

- 11 U.S.C. § 547(c)(2) (2007): “The trustee may not avoid under this section a transfer—
 - (2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—
 - (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
 - (B) made according to ordinary business terms.
- Note significant change made by BAPCPA. May reduce number of lawsuits because defense easier to prove.
- What does it take to prove that a transfer was “ordinary” between the parties? In the industry?
- Analysis



Understanding and Avoiding Preferential Transfer Liability (cont.)

RESULT:

- Significant settlement payment from Creditor, which was already the Debtor’s largest creditor.
- Adequate assurance of payment remedy collides with preferential transfer statute
- Is result consistent with policy of the statute?



Understanding and Avoiding Preferential Transfer Liability (cont.)

LESSONS TO BE LEARNED:

- Know and understand your contracts:
 - When was a contract formed?
 - When was a debt created?
- Understand your UCC remedies, but consider effects they will have on preferential transfer liability
- Potential ways to avoid this problem:
 - Cancel old Release and issue new Release
 - Cancel old Purchase Order and issue new Purchase Order



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Understanding and Avoiding Preferential Transfer Liability (cont.)

- GENERAL TIPS:
 - 🎵 🎵 “Go on, take the money and run” 🎵 🎵
 - Pre-payments help with the new debt, not the old
 - Exercise collection efforts early and often
 - Monitor debtor’s financial position
 - Know your debtor



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Thank You!

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