

SURVIVAL IN TODAY'S AUTOMOTIVE INDUSTRY:

**HOW TO MANAGE RELATIONSHIPS WITH
FINANCIALLY DISTRESSED COMPANIES**

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With the financial difficulties confronting the automotive industry today, it is vitally important for automotive suppliers and other companies in the automotive supply chain to understand and address financial stress, its associated legal issues, and the variety of sophisticated strategies that can help mitigate business harm. This article is intended to summarize ways in which companies in the automotive supply chain can recognize critical issues and develop strategies for addressing them.

RECOGNIZING TROUBLED COMPANIES

Managing Supply Chain

In the case of troubled suppliers, financial stress in the supply chain often can be identified by closely monitoring their shipping performance, billings, and payments. In the case of troubled customers, stress often is identified by late and delayed payments, increasing receivables, and decreasing market share. Although the direct payment relationship with the purchaser will be revealing, well-known public sources such as Dun & Bradstreet reports also can shed light on the financial health of companies and often can provide early warning signals of potential supply interruptions or failures due to impending financial stress. These sources can reveal changes in key management positions, delays in payments of dividends or payments on funded debt, and lengthening of credit terms.

The best planning for financial distress, however, occurs well before such stress can be recognized. When properly written, supply contracts should, for example, allow flexible termination in distress situations so that no contractual requirement to continue a supply relationship exists in a troubled situation. Legal counsel often assist in reviewing and suggesting modifications to supply contracts to help provide ultimate flexibility and remedies in the event of a troubled supplier situation.

Identifying Financial Distress

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 reductions during economic downturns
- Delinquent taxes
- Deteriorating accounts receivable and accounts payable
- Employment of financial consultants
- Deteriorating market position
- Restatement of or delays in issuing audited financial statements or a change in audit firms
- Changes in key management positions

Reviewing Contract Terms

The key contractual provisions that legal counsel should analyze are those that define the circumstances under which a supply contract can be terminated. A variety of such provisions exist that extend varying degrees of freedom and flexibility. The greater the freedom to terminate, the greater the chance of mitigating damage that could result from a supplier's financial distress. Counsel also should review insurance and other strategies for protecting against supplier distress and failure.

Providing Adequate Assurance of Future Performance

Where signs of financial distress are apparent, a supplier may be able to demand adequate assurance of future performance from the customer under Uniform Commercial Code (UCC) Section 2-609 as adopted in

most states. The adequate assurance of future performance may take the form of a change in payment terms, security, letter of credit, or other financial protections. If the customer cannot provide such adequate assurance, the supplier may have remedies such as ceasing to perform under the supply contract.

Ensuring Continued Supply

Due to just-in-time delivery requirements between suppliers and their customers, if a supplier stops shipping, the customer's production lines may shut down in a matter of minutes, hours, or days, resulting in huge potential damages to the customer. Threats to stop shipping are common in the industry, both in and out of bankruptcy, and are used as leverage by the supplier. All customers in the automotive industry should have action plans to address these threats, including court pleadings that can be modified at a moment's notice to seek court approval to ensure continued supply.

Effecting Workouts

It is often the case that, after the early warning signs of financial stress appear, but before failure (or reorganization in bankruptcy), a company will attempt to negotiate an out-of-court restructuring — commonly referred to as a workout — of its debt and capital structure. The workout process usually is led by bankruptcy lawyers, financial advisors, and representatives of the affected companies.

A workout may include a sale of the troubled company. The troubled company, its significant customers, and its secured lenders may negotiate a variety of agreements to solidify the commitments of each party to keep the company operating while the workout is progressing. Such agreements may include accommodation and access agreements, forbearance agreements, and subordinated participation agreements.

A business connected to a troubled company — whether a customer or a supplier — must determine at the outset what leverage it may have during negotiations. That leverage will depend upon a number of factors, including the ability to resource quickly, capacity in the industry, ability to terminate contracts, and availability of financing sources. Descriptions of the more typical agreements are presented below:

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.

Common Accommodations

- Customer — Forbearance from resourcing certain existing business, limitations on setoffs, change of payment terms, and/or customer financing
- Lender — Working capital financing, ability for customers to participate in the lender's loan, and customer access to tangible assets for the purpose of continued production in the event of a threat to production
- Supplier — Continuity of existing production, continuing cash flow, and accelerated payment terms on product and/or tooling

Common Financing Operations

Often the lender will agree to forbear from foreclosing on collateral. In return for various accommodations described above, the lender — alone or with customers — will provide the troubled supplier continued funding through a subordinated participation agreement while the supplier is reorganized or until the supply can be resourced.

Filing Bankruptcy

If an out-of-court accommodation cannot be reached and a company files for bankruptcy protection pursuant to Chapter 11 of the U.S. Bankruptcy Code (Bankruptcy Code), its customers and suppliers must be vigilant about their legal rights and protections, and they must be prepared to act promptly to enforce them. Some of the key rights, protections, and expected legal developments in Chapter 11 include:

Executory Contracts

Supply contracts can be assumed or rejected by a debtor in bankruptcy. Time limits apply to such decisions, and leverage should be analyzed to determine the best timing for such a decision. Even discrete purchase orders may be executory contracts that must be assumed or rejected in a Chapter 11 case.

If the executory contract is assumed, the debtor immediately is obligated to cure pre-petition defaults (meaning that any unpaid debt must be paid in full). These assumption/rejection decisions often are subject to negotiation. The debtor may be willing to assume the contract if the terms are adjusted in a favorable manner. The nondebtor party may be interested in accommodating such an adjustment depending upon its own leverage, including the debtor's sales or purchase alternatives.

Filing Claims

Deadlines are set for creditors to file claims for pre-petition damages, including unpaid debts. Unless a seller has obtained collateral or its equivalent from the debtor-purchaser, or unless the claim arises under an assumed executory contract, the seller's claim for unpaid amounts likely will be an unsecured claim that will be worth a fraction of its actual dollar value.

Reclamation, Setoff, and Recoupment

Pre-petition sellers to debtors often have limited rights to reclaim goods sold to debtors prior to bankruptcy (or to obtain the economic equivalent). Sellers also may have setoff and recoupment rights that could give them priority over other unsecured creditors.

Financing

In some instances a lender in a troubled supplier's bankruptcy proceeding will refuse to continue lending. In such cases, the debtor's significant customers may be forced to increase prices or otherwise provide a means of financing the debtor's continuing operations pending the customer's ability to resource to another supplier. The customer must analyze the various means of providing that financing and the ways to recover the costs of providing such financing.

Preference Exposure

The debtor's suppliers (who are not insiders) are at risk of having to pay back to the debtor's estate amounts paid to it during the 90 days prior to a bankruptcy filing on account of old debt. This period is extended to one year prior to a bankruptcy filing if the creditor is an insider as defined by the Bankruptcy Code. Counsel can assist in the evaluation of the various defenses to a preference claim.

One way to mitigate the risk of preference exposure with a financially troubled company is to take cash on delivery (COD) or cash in advance (CIA) terms at the first sign of financial distress.

Selling the Troubled Businesses

Production supply lines sometimes can be preserved through a sale of the troubled business. The sale can occur in the pre-bankruptcy workout phase or during bankruptcy. Sellers to and purchasers from the troubled company often play an integral role in that process as they must ensure that production is maintained pending the sale, and that the purchaser is an acceptable successor operator of the business with minimal disruption. Because most of the customer's contracts permit termination of the contract "for convenience," a buyer should obtain customer approval as a means of assuring that the value of the business will be transferred in the sale.

In bankruptcy, contracts associated with the existing business may be assumed and assigned without nondebtor party consent. Because such contracts often contain termination rights, customer approval is still essential.

Either inside or outside of bankruptcy, the nondebtor party should retain experienced bankruptcy counsel with automotive experience to ensure that value associated with contracts is preserved in a sale.

Providing Special Supplier Protections in Bankruptcy

Once a customer files for bankruptcy protection, a supplier must analyze its options to determine how to minimize loss based upon any amounts the customer owed to the supplier at the time of filing. Some issues that may arise in Chapter 11 bankruptcy include:

Critical Vendors

The supplier may be considered a critical vendor in the customer's bankruptcy, and a mechanism may be in place to permit the supplier to obtain payment of some or all of its pre-petition debt in order to continue producing parts for the customer.

Committee Issues

The supplier may be asked to sit on the committee of unsecured creditors in the bankruptcy proceeding. The supplier must understand the duties and commitments involved in serving on a committee, and how those duties will impact its own interests, to determine whether the supplier wants to sit on the creditors' committee.

Claims Issues

Claims buyers may approach the supplier with an offer to purchase the supplier's claims. The supplier must assess whether sale of the claims is the most advantageous way to maximize recoveries.

Executory Contracts and Assumption

The contract between the supplier and the customer may be an executory contract subject to assumption. Because assumption of the supplier's contract results in payment in full of pre-petition indebtedness, the supplier should explore avenues to have its contracts assumed.

HIRING FINANCIAL ADVISORS

Financial advisors play a critical role in workouts both in and out of bankruptcy. In bankruptcy, financial advisors typically are employed by the creditors' committee and the debtor-in-possession. The critical customers also seek to retain financial advisors. Outside of bankruptcy, in a workout or liquidation scenario, the debtor will typically have a financial advisor.

Customers often hire financial advisors as well. When retained, the financial advisor's role may be smaller or larger depending on the strength of the debtor's financial advisor. Such an advisor may assist with negotiations, review and evaluate financial data, monitor production, and assist with other matters as appropriate. If the customer does engage a financial advisor, the customer should document and obtain legal review of the engagement letter.

GLOSSARY OF BANKRUPTCY TERMS

Adequate Assurance of Future Performance — Under the UCC, a party to contract for the sale of goods must provide the other party (counter-party) with adequate assurance of its future performance. If assurance is not given, the counter-party may suspend its performance and, under certain circumstances, terminate the contract.

Administrative Expense Claim — A cost or expense of estate administration allowed under § 503(b) of the Bankruptcy Code. Post-petition goods and services provided to the debtor are entitled to administrative status. Administrative expense claims often are paid in full and are senior in priority to other unsecured claims.

Chapter 11 Reorganization — A proceeding in the U. S. Bankruptcy Court in which the debtor, as a fiduciary to its creditors, may continue to operate its business while it restructures its debts. A confirmed Chapter 11 plan provides for the manner in which creditor claims will be paid in whole or in part by the debtor.

Claim — Any right to payment as well as any right to an equitable remedy for breach of performance if that breach also gives right to payment.

Creditors' Committee — A committee comprised of representatives of the creditors in a Chapter 11 proceeding formed to, among other things, assist in the negotiation of the debtor's reorganization plan.

Critical Vendor — A supplier of goods or services to a debtor that cannot be replaced and is crucial to the debtor's continued operation and successful reorganization. A critical vendor's pre-petition claim often is paid in full in return for a promise to continue providing goods or services during bankruptcy.

Debtor — A person or entity in bankruptcy.

Executory Contract — A contract or lease under which both parties have duties remaining to be performed. If a contract or lease is executory, a debtor may assume or reject it.

Preference — A transfer to a creditor in payment of an existing debt made within 90 days (generally) before the commencement of the case or within one year of the commencement of the case if the creditor is an insider. Preferences may be recovered for the benefit of all creditors of the estate.

Proof of Claim — A document filed by a creditor in a bankruptcy proceeding that substantiates its claim. It indicates the nature, amount, and priority of the creditor's claims against the debtor.

Recoupment — Related to setoff, recoupment allows a creditor to avoid paying a debtor when the debtor also owes the creditor, where the claims are not mutual.

Setoff — Allows parties with mutual claims to offset such claims against one another. The claims may arise from different transactions and, in some instances, setoff may be allowed amongst affiliates. A creditor that has a valid setoff right has a secured claim in a bankruptcy, up to the amount of the setoff.

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As the automotive industry rolls into the 21st century, its road map continues to change. Today, innovation and competition are among the driving forces as automotive-related businesses try to keep pace in the new global marketplace. The Automotive Industry Team of Foley & Lardner LLP addresses these ever-evolving challenges for clients across the globe. Working with manufacturers, suppliers, and dealers on a wide range of legal matters, from intellectual property issues and sophisticated financial and corporate matters, to complex litigation and financial restructurings, our attorneys are fluent in the language of the industry. And we can proudly say we're the only major law firm with a dedicated team of attorneys focused on serving auto-related clients.

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