MICHIGAN LAWYERS WEEKLY
www.milawyersweekly.com
Vol. 23, No. 41
August 24, 2009
DOLAN MEDIA COMPANY

No free ride for suppliers

Critical vendor status in recent automotive bankruptcies

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The wave of bankruptcies washing over the automotive industry presents new challenges for suppliers working to maintain their commercial relationships with their troubled customers while still attempting to mitigate their financial exposure.

As thousands of suppliers to Chrysler and General Motors recently learned, a Chapter 11 debtor will assert its leverage over suppliers, who must be prepared to withstand such tactics in order to best position themselves for future business.

So while most suppliers view critical vendor treatment as a good thing, debtors are holding out the promise of critical vendor treatment in order to rewrite commercial contracts in their favor.

Perhaps no industry has been hit as hard in the current recession as the automotive supply industry. Production volumes have decreased dramatically in the past two years, and particularly in the six months that preceded the Chrysler and GM chapter 11 filings.

In 2008, the annual December shutdown, which typically lasts two weeks, was extended by Chrysler and GM for at least two additional weeks at almost all facilities, and many plants were idled for even longer periods. Suppliers whose profit margins had already been squeezed were thus hit with extended shutdowns during which production either stopped or dramatically fell off.

As production and, therefore, receivables dwindled, it became even more critical for suppliers to collect what they were owed. Because many suppliers finance their business by borrowing against their accounts receivable, a reduction in accounts receivable means less money in the borrowing base available to finance the supplier's business.

Prior to Chrysler and GM's bankruptcy filings, the Treasury Department's Supplier Support Program (SSP) provided some short-term relief to some suppliers by advancing payments on accounts receivable. But even

the SSP came at a cost, with fees and terms required for participation that made it cost-prohibitive for some suppliers.

As it became clear that Chrysler and GM would file for bankruptcy, suppliers became increasingly concerned regarding payment of their outstanding accounts receivable. One of the greatest risks a supplier faces when its customer files a petition for Chapter 11 is that the supplier's prepetition accounts receivable will go unpaid and thus be relegated to the status of a prepetition general unsecured claim.

In bankruptcy speak, it is said that these claims are often ultimately paid — if at all — with tiny bankruptcy dollars, as opposed to 100-cent dollars.

The Bankruptcy Code generally prohibits the payment of prepetition accounts receivables outside of a chapter 11 plan of reorganization (except for the payment of claims for goods shipped to the debtor within the 20 days preceding the bankruptcy filing).

Payment strategies

There are strategies that a supplier may employ to reduce its accounts receivable prior to a filing by its troubled customer. Suppliers who recognize this and take advantage of their contract leverage usually are better positioned for a bankruptcy filing by one of their customers.

Most of these strategies are based on the effective exercise of rights and remedies under the existing contracts and the Uniform Commercial Code to shore up contracts prior to a filing, for example, by shortening payment terms or requiring cash in advance for prepetition shipments.

In cases where a supplier still has substantial accounts receivable that are unpaid at the time the bankruptcy petition is filed, its best chance for early payment of the prepetition accounts receivable may hinge on treatment as a "critical" or "essential" vendor of the debtor.

The Bankruptcy Code itself does not contain a section specifically authorizing payments to critical vendors. Instead, the doctrine arises under the broad exercise of the Bankruptcy Court's equitable jurisdiction and has been developed by case law.

Indeed, the critical vendor doctrine receives more favorable treatment in certain jurisdictions, including the Southern District of New York where both Chrysler and GM filed.

In many chapter 11 cases, debtors rely on "critical vendor" motions, often filed the first day of the case, for authority to pay some or all of the prepetition claims of certain suppliers whose ongoing support is deemed critical to the policy of successful reorganization contemplated by the Bankruptcy Code.

The first day motions in both the Chrysler and GM bankruptcies included an essential vendor motion with extraordinarily and uniquely broad coverage. Both Chrysler and GM announced their intentions to pay essentially all of their suppliers' prepetition accounts receivable pursuant to essential vendor orders in each case.

Trade agreement 'twist'

However, in the Chrysler and GM cases there was no established "list" of critical vendors per se. Rather, Chrysler and GM advised essentially all of their suppliers that in order to receive essential vendor treatment, they were required to execute a new "trade agreement" which would control the contract between the debtor and the supplier going forward.

In both cases, Chrysler and GM would assume these contracts under section 365 of the Bankruptcy Code and assign them to "new" Chrysler and "new" GM.

The result is that the trade agreement would effect an amendment to the supplier's contract with its customer — both during the bankruptcy and for future business with new Chrysler and new GM.

Among the commercial terms demanded by Chrysler and GM for treatment as an essential supplier were provisions concerning lien rights and possession of tooling that would make it easier for the customer to "resource" a supplier, in effect pulling business from one supplier and awarding it to another.

In addition, suppliers were asked to commit to continue to supply not only Chrysler and GM (as is sometimes required under the Bankruptcy Code), but also their domestic and foreign non-debtor affiliates, which could deprive the supplier of possible future leverage in dealing with those entities.

Finally, and in some cases most importantly, the trade agreements as proposed would strip away any contract terms agreed to between the debtor and the supplier within a certain period of time preceding the bankruptcy case that were more favorable to the supplier, including credit limits and payment terms.

Chrysler and GM's suppliers were thus faced with the choice of executing the trade agreement and modifying their existing contracts in favor of Chrysler or GM in order to be quickly paid their prepetition accounts receivable, versus holding out for more favorable terms.

Well-counseled suppliers who had established some degree of contract leverage over Chrysler or GM, and who could afford to withstand a delay in payment of their prepetition accounts receivable, had available to them the option of rejecting the proposed trade terms and perhaps negotiating a better deal for themselves.

In sum, while it is true that Chrysler and GM each proposed to essentially make all of their suppliers whole in terms of amounts owed — and, in many cases, this was the result — some of these payments came at great cost to the suppliers by forcing amendment of the commercial terms of their contracts with Chrysler and GM.

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