

SYNOPSIS OF BANKRUPTCY LAW

APPLICABLE TO MOTOR VEHICLE MANUFACTURERS AND DEALERS

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In this time of economic distress in the automotive industry, many inquiries are coming up regarding bankruptcy. The following is a short synopsis of bankruptcy law as applied to manufacturer and dealer bankruptcies. This synopsis is intended only to provide general information about bankruptcy. It is not intended as legal advice and should not be relied on as such. Anyone having questions regarding his or her particular situation should consult his or her own legal advisers.

I. Summary of Bankruptcy Law and Procedures

Bankruptcy proceedings are governed by federal law and conducted in the federal courts. There are three types of bankruptcy cases that may affect dealers.

- A "Chapter 7" bankruptcy is one used by individuals and business entities to liquidate their nonexempt assets and distribute them to creditors. For a business entity, it means the end of its existence as a going concern.
- A "Chapter 11" bankruptcy is used to reorganize a business with the goal of continuing it as a going concern.
- A "Chapter 13" bankruptcy is used by individuals with a regular income to budget the individual's future earnings to pay some or all of their creditors' claims.

A bankruptcy may be commenced voluntarily by an insolvent debtor or involuntarily by its creditors. The filing of a bankruptcy petition creates an automatic stay against the enforcement

of pre-petition debts against the debtor. In a Chapter 7 bankruptcy, a trustee is appointed to liquidate the debtor's assets and otherwise administer the bankruptcy estate. In a Chapter 11 bankruptcy, the debtor normally stays in control of the business as a "debtor in possession." In Chapter 11 proceedings, one or more creditors' committees usually play a large role in the proceedings. If a Chapter 11 proceeding is successful, the debtor will emerge from bankruptcy as a going concern under a reorganization plan confirmed by its creditors, some or all of which may receive less than the full value of their respective claims against the debtor.

II. Manufacturer Bankruptcy

In the event a manufacturer files bankruptcy, its dealers' major concerns will include (1) what happens to the franchise agreement; (2) whether any prior payments received by the dealer from the manufacturer can be recovered by the manufacturer or bankruptcy trustee, (3) whether the dealer's unpaid claims against the manufacturer, which accrued before the bankruptcy, will get paid, (4) whether claims accruing after the bankruptcy petition is filed will get paid; (5) whether the manufacturer will continue to honor its customer warranties and, if not, whether the dealer will be obligated to do so.

A. Franchise Agreement

1. Chapter 7 Bankruptcy

If a manufacturer files for bankruptcy under Chapter 7, it will cease operations simultaneously with the filing of the petition and all of its franchise agreements will be effectively terminated. The dealers will have only unsecured claims for damages against the bankruptcy estate if the de facto termination of their franchise agreements violates its provisions or applicable state law.

2. Chapter 11 Bankruptcy

In a manufacturer's Chapter 11 bankruptcy, all franchise agreements will initially continue in effect after the petition is filed. However, the manufacturer will eventually decide whether to assume or reject each agreement, subject to the bankruptcy court's approval. If a franchise agreement is not formally assumed at some point during the proceedings, it will be deemed rejected. The manufacturer may decide to assume some franchise agreements and reject others.

The manufacturer's decision to reject a franchise agreement must be approved by the court. If the court approves rejection, the franchise agreement will be effectively terminated, notwithstanding state franchise laws prohibiting franchise terminations without good cause. Dealers may object to the rejections of their franchise agreements, in which case the bankruptcy court will decide, after a hearing, whether the rejected agreements are a burden to the bankruptcy estate and whether their rejection will increase the probability of a successful reorganization. If a franchise agreement is rejected, it is treated as a breach of the agreement by the manufacturer immediately prior to the bankruptcy proceeding. Accordingly, the rejection will give rise to the dealer having an unsecured claim against the bankruptcy estate for the damages caused by the rejection. Dealers may be able to contest the rejection of their franchise agreements in a manufacturer Chapter 11 bankruptcy by convincing the court that their continuation will not be burdensome to the bankruptcy estate and that the rejection's creation of a large number of breach of contract claims by the rejected dealers will impair payment of the claims of the manufacturer's general creditors overall.

Dealers should be aware that franchise agreements not formally assumed will be deemed rejected. Therefore, dealers should ask the court to set a deadline for the manufacturer to decide

whether to assume or reject franchise agreements, so they will have time to oppose the rejection and, if necessary, assert claims based on the rejection in the bankruptcy proceeding.

Because a manufacturer needs a distribution network to successfully operate during and after a Chapter 11 bankruptcy (and many state laws prohibit manufacturers from selling their vehicles directly to retail buyers), it is likely that most franchise agreements will be assumed by the manufacturer. If a franchise agreement is assumed, the manufacturer will be required to cure any existing default, compensate the dealer for any damages caused by the default and provide adequate assurances of performance in the future. A successful Chapter 11 bankruptcy by the manufacturer may have no long-term negative effect on dealers whose franchise agreements are assumed.

B. Prior Payments

A dealer can be required to give up payments it receives from a manufacturer before a bankruptcy petition is filed, if those payments constitute a "preference" under the bankruptcy law. A preference is a payment or other transfer of something of value made by the bankrupt debtor to a creditor for an "antecedent" debt while the debtor is insolvent and within 90 days before the bankruptcy petition was filed. Payments received by a dealer more than 90 days before the petition is filed cannot be recovered as "preferences." Neither can payments intended to be for present value and made substantially contemporaneous with the debtor's receipt of consideration for the payment or payments for debt incurred in the ordinary course of both the debtor's and recipient's business. Most payments that dealers receive from a manufacturer before a bankruptcy petition is filed will fall within these exclusions and not be recoverable as preferences. However, some payments, such as reimbursements for facility improvements or repurchases of vehicles, parts and special tools from a terminating dealer, may be regarded as

preferences if there is a significant delay between the time the dealer provides consideration for them and the time they are made by the manufacturer.

If a franchise agreement is assumed in a Chapter 11 bankruptcy, the dealer will be entitled to any pre-petition payments the manufacturer was contractually required to make, even if they would otherwise be regarded as preferences.

C. Pre-Petition Claims

The filing of a petition for bankruptcy results in an automatic stay against enforcement of pre-petition claims against the debtor. If the manufacturer assumes the franchise agreement in a Chapter 11 proceeding, it will be obligated to satisfy any pre-petition (and post-petition) claims of the dealer as a condition of the assumption. Otherwise, the dealer will need to assert an unsecured claim against the bankruptcy estate.

To the extent the dealer owes amounts to the manufacturer when the petition is filed, it may be able to achieve the benefit of its pre-petition claims by setting them off against its pre-petition obligations to the manufacturer. However, the dealer may not setoff its pre-petition claims against obligations to the manufacturer accruing after the petition is filed.

A bankruptcy petition does not extinguish a creditors' right under applicable state law to setoff claims against the amounts it owes the bankrupt debtor. However, the automatic stay prohibits setoffs without court permission and, therefore, a dealer must obtain relief from the stay before exercising its set off rights. An exception to this rule is the doctrine of recoupment. If the dealer's claims arise from the same identical transaction as its obligations to the manufacturer, it may setoff those claims against its obligations without seeking relief from the court.

Dealer warranty, holdback and incentive claims, as well as amounts dealers owe the manufacturer for parts and special tools and equipment purchases, are normally paid via the

dealer's open account with the manufacturer. Dealers may be able to successfully argue that the open account is a single transaction and, therefore, the amounts owed the dealer under the account may be recouped against the amount it owes the manufacturer under the same account. However, to the extent the dealer's open account has a positive balance when the petition was filed, the dealer will need to assert an unsecured claim for the amount of that balance.

Dealers might also attempt to argue that holdbacks and certain advertising fees held by the manufacturer when a bankruptcy petition is filed are the dealer's property and, therefore, not part of the bankruptcy estate. To make this argument, dealers will need to petition the court to exclude this property from the estate and order it paid to the dealers to who it belongs. However, the likelihood that dealers will prevail in arguing that holdback amounts are dealer property in the possession of the manufacturer is probably weak, even though dealers are ordinarily automatically entitled to be paid holdbacks.

To preserve pre-petition claims, a dealer should file a proof of that claim within the time set by the court. Once the proof of claim is filed, it is presumed to be valid unless objected to by the manufacturer, trustee or other interested person. If an objection is filed, the bankruptcy court will determine the validity and amount of the claim. Generally, the dealer will not be entitled to interest on its claim.

In some Chapter 11 cases, a large number of small claims will be classified as "administrative convenience" claims which will be paid in full at confirmation. This allows the debtor to avoid soliciting large numbers of acceptances from a creditor class whose total claims are relatively insignificant in amount. It is possible the manufacturer may elect to treat its dealers' pre-petition claims as "administrative convenience" claims.

C. Post-Petition Claims

In a Chapter 7 bankruptcy, dealers will not have post-petition claims because the manufacturer will cease doing business when the petition is filed.

In a Chapter 11 bankruptcy, the dealer will be expected to continue performing warranty and other services under the franchise agreement until it is assumed or rejected. If the franchise agreement is assumed by the manufacturer, all dealer claims arising after the assumption will be treated as priority administrative expenses. These expenses have priority over all other claims and must be paid prior to confirmation of the reorganization plan. Even if the franchise agreement is ultimately rejected, payment for the dealer's post-petition services under that agreement will probably be entitled to administrative priority if the court determines the services were beneficial to the estate.

Administrative expenses are not, however, always paid in accordance with the contract terms or applicable state law. The court may limit their payment by the amount judged to be the actual value received by the estate, rather than the cost incurred by the claimant. Also, administrative expenses may not be paid as they are incurred. Dealers may be required to wait up until the time the manufacturer's reorganization plan is about to be confirmed before receiving payment for their post-petition services.

A dealer may initiate legal action to recover claims against the manufacturer that arise after the petition is filed; however, the automatic stay prevents the dealer from seeking to enforce any judgment against the bankruptcy estate.

E. Manufacturer Warranty Obligations

In a Chapter 7 bankruptcy, customers with outstanding manufacturer warranties will undoubtedly continue to look to the manufacturer's dealers to provide services under those warranties. However, the filing of the bankruptcy petition will effectively terminate the

franchise agreement, and the dealer will no longer have any guarantee of receiving reimbursement from the manufacturer. It is possible that, even in a Chapter 7 bankruptcy, the purchaser of the assets from the bankruptcy estate will set up a fund to honor the manufacturer's warranties, as General Motors did when it purchased the assets in the Daewoo bankruptcy. However, absent such an arrangement, dealers will be faced with both the public relations and legal quandary of whether to perform services under the manufacturer's warranties, even though they will not be reimbursed by the manufacturer. Whether dealers are legally obligated to do so, will depend on the state law where the dealer is located.

In a Chapter 11 bankruptcy by a manufacturer, dealers will be obligated to perform warranty services under the franchise agreement until the agreement is either rejected or terminated by the dealer. Because of the automatic stay, the dealer cannot voluntarily terminate the agreement after the petition has been filed, without getting leave from the court to do so. However, the dealer's warranty services after the petition is filed will most likely be deemed beneficial to the estate and qualify as priority administrative expense claims that must be paid in full before the manufacturer's reorganization plan is confirmed.

III. Dealer Bankruptcy

Dealers may find it advantageous, in some instances, to use bankruptcy to go out of business with the least amount of continuing financial problems (Chapter 7 bankruptcy) or to recover from crippling debt while remaining in business (Chapter 11 bankruptcy).

A Chapter 7 bankruptcy has the advantage of resolving claims against the dealership and eliminates the stress of trying to continue to keep a financially troubled business afloat and continuing to incur debt. Technically, the claims against a dealership corporation are not discharged in a Chapter 7 case, as they are in a Chapter 11; however, once all of the dealership

corporation's assets have been liquidated and it has ceased operations, it has nothing left for the creditors to pursue.

On the other hand, a Chapter 7 bankruptcy means your dealership ceases to operate. While you are free to start another business, your ability to do so will be limited by the facts that all of your dealership's assets will have been liquidated to pay off the dealership's creditors and that the bankruptcy will impair your ability to obtain credit and new contracts with suppliers, including new franchise agreements. A business bankruptcy may also result in the IRS or other taxing authorities to audit the business more carefully than they otherwise would.

If you have personally guaranteed any debt of the dealership business, the holder of that debt will be able to pursue it against you, unless you also personally file for bankruptcy protection, in which case your non-exempt personal assets will also be liquidated. Also, if the dealership business is delinquent in payment of sales taxes or withholding for income taxes and you were active in managing that business, you may have personal liability for those debts that will not be discharged unless you personally file for bankruptcy. Once you have completed a Chapter 7 bankruptcy, you may not seek this protection for another 8 years.

The advantage of Chapter 11 over Chapter 7 is that it gives you an opportunity to keep the dealership operating while receiving "breathing room" from its creditors. After you file a Chapter 11 case, the creditors cannot take action to enforce their claims against you or to terminate essential supply arrangements. With the court's approval, you can assume or reject executory contracts, including franchise and floor plan agreements. You may potentially even assign a franchise agreement to another dealer for consideration, even though the agreement prohibits such assignment without the manufacturer's consent. Therefore, you may be able to

use a Chapter 11 bankruptcy to salvage the "blue sky" value of the dealership by giving you time to find the "right fit" buyer for it.

If the protection afforded by a Chapter 11 case doesn't ultimately permit you to reorganize the business in a way that will make it profitable or to sell it, you have the option of converting it to a Chapter 7 case.

On the other hand, a Chapter 11 case means that you continue to undergo the stress of trying to manage a financially troubled business, while also taking on the extra burden of trying to prepare a reorganization plan that the creditors of the business will confirm. A Chapter 11 case will cost more money for attorneys fees and other administrative expenses. Finally, even under a Chapter 11, the owners of the dealership will receive nothing for their equity interests unless all creditors will be paid in full.

If bankruptcy protection is needed, the choice of whether to file under Chapter 7 or Chapter 11 comes down to deciding whether the business can be salvaged and whether you and the other owners/managers want to continue trying to salvage a struggling business. While a Chapter 11 will give you "breathing room" from the dealership's creditors, possibly allow you to jettison burdensome leases and other contracts, and free up cash from servicing old debt, it will not create more business and revenues.

A Chapter 11 case will require more resources in terms of both your time and the dealership's money for payment of attorneys fees and other administrative expenses than a Chapter 7 case. However, if you would like to stay in the automobile dealer business, it may be worth it to choose Chapter 11, at least initially. Once your dealership has been liquidated in a Chapter 7 case, it will be very difficult for you to start a new dealership any time soon.

There are ways other than bankruptcy, such as receiverships and assignments for the benefit of creditors, where a financially troubled business may liquidate or seek "breathing room" from its creditors. These alternatives are beyond the scope of this paper. However, in choosing among alternatives with your attorneys and accountants, make sure that these alternatives are also considered.

If you are concerned that your manufacturer is about to terminate your dealer agreement, a Chapter 11 filing will initially prevent the termination notice from being served, because of the automatic stay. You can then ask the bankruptcy court to approve the assumption of the dealer agreement. However, in order to be eligible for assumption, you will need to show that you are able to cure any defaults under it and provide adequate assurances of future performance. The difference between an assumption proceeding in bankruptcy court and a termination proceeding under a state franchise law is that the bankruptcy filing may give you additional time to cure a default. However, even if the court approves assumption of the dealer agreement, the manufacturer may later attempt to terminate it, if it has grounds to do so under an applicable state termination statute.

Filing under Chapter 11 will prevent foreclosure on your existing new vehicle inventory by your floor plan lender, at least initially. Once you have filed, the lender would have to obtain relief from the stay before it could foreclose and take possession of your floor plan inventory. To obtain such relief, the lender would probably need to show that your retaining the inventory will not result in a successful reorganization. However, the lender would not be required to continue to extend financing for new vehicle purchases, and alternative financing arrangements would probably need to be made, with the court's approval. The bankruptcy court might require

you to provide "adequate protection" to the floor plan lender. Adequate protection can take various forms, including a monthly payment or a deposit.

While a manufacturer or floor plan lender may not, without first getting leave from the bankruptcy court, initiate termination of a franchise agreement or floor plan agreement with a dealership after a Chapter 11 petition has been filed, if a manufacturer or floor plan lender has issued a notice of termination prior to the petition being filed, the filing will not prevent the termination from taking effect under the terms of the contract. If the termination does take effect, the dealership will no longer have the right to assume the franchise or floor plan agreement. Accordingly, if a bankruptcy strategy is being pursued to prevent the termination of a franchise agreement or floor plan agreement, it is important that the petition be filed before a termination notice is served by the other party.

If your dealership's financial problems are being caused, in part, by a burdensome real estate or equipment lease or other executory contract, a Chapter 11 bankruptcy gives you the opportunity to reject it. However, the other party to the lease will then have a claim for damages as if you breached the contract on the date that the bankruptcy was filed. The damages that your landlord can recover from rejection of the dealership facility lease are capped at an amount that does not exceed the greater of (1) one year's rent or (2) 15 percent of the unpaid rent for the remaining term, not to exceed three years' rent. A bankruptcy court may limit the award of damages provided under other rejected contracts.

You would not be able to use rejection to relieve yourself of obligations under dealer-issued warranties or service contracts because these are not executory contract (the customer does not have a continuing obligation to perform). Customer could sue you to enforce post-

petition claims under warranties and service contracts without going through the bankruptcy court.

If you are a "small business debtor" (one with total, noncontingent, liquidated debts of no more than \$2 million), you will have only between four to ten months after a Chapter 11 petition is filed in which to file a reorganization plan. Even if you are not a "small business debtor," the maximum period of time you will have the exclusive right to file the reorganization plan, even with court-approved extension, will be 18 months from the petition filing date. Because the amount of work required to prepare a reorganization plan is significant, you may want to begin work on the plan even before the bankruptcy petition is filed. You may even want to work with the dealership's creditors on an agreement on a "pre-packaged" plan that can be filed when the bankruptcy is filed.