Strategies for Responding to the Financially Distressed Auto Dealership; Part One of a Two-Part Article

Franchising Business & Law Alert

May 1, 2009 Friday

Section: Pg. 1; Vol. 15; No. 8

Length: 2737 words

Byline: John R. Skelton

Body

I n the past, an automobile dealer filing for bankruptcy was likely the result of poor management, fraud, or declining sales because of a less-than-desirable facility or a depressed market area. Today, the current economic and credit crisis has changed the dynamic, and otherwise viable dealers in important markets are struggling.

Because the financial distress is network-wide, how manufacturers respond to the financially distressed dealership is more important than ever. Strict enforcement of operating standards, enforcing terminations, opposing proposed sales, terminating or suspending floor lines, repossessing inventory, and aggressively pursuing collection actions are established strategies. But today, the impact of those strategies on the larger dealer network and the brand need to be considered. For some dealerships, the appropriate strategy may be creative cooperation forbearance agreements, operating stipulations, and workouts not adversarial enforcement.

How automakers address dealer network issues in the next few years is likely to have relevance for all types of franchised operations struggling with adjustments in the economy. While in the case of auto dealerships, the dollar investments might be higher, the relationships longer tenured, and the relationships are governed by more-developed state laws, the basic questions of how and when to step into a difficult situation are very similar.

EARLY ENGAGEMENT

A dealership bankruptcy filing should not come as a surprise. Manufacturers and lenders need to be vigilant for the signs of financial distress: declining sales, deficient working capital, slow pay on parts and other purchases, increasing trade payables, and floor-plan irregularities. Monitoring the financial health of dealerships and identifying those in trouble before default is vital to protecting the overall network. Proactive steps such as increasing the frequency of audits, sending contractually required notices, reviewing cash management and lease issues, and assessing dealership operations for potential improvements are good business strategy.

While sometimes the circumstances call for a pre-bankruptcy termination, the circumstances may also suggest a forbearance or reservation-of-rights letter (with negotiated accommodations or extensions), assisting with a dealership sale, or even negotiating a voluntary termination agreement. Some dealerships in certain markets may be worth trying to save. The same holds true for the affiliated lender. Sometimes, protecting the brand's dealer network means that aggressive collection should give way to cooperative forbearance and restructuring. The manufacturer and lender need to be strategic and proactive.

While certain actions are prohibited by the automatic stay, interaction with the dealer should actually increase after a bankruptcy. Regular dealership contact regarding sales, warranty service and parts operations, floor plan audits, etc., is important because strategic decision-making requires up-todate operational information. Field personnel should continue to assess a dealership's operations and document deficiencies careful, of course, not to make commitments without proper approval or to make unauthorized demands.

Early contact also provides an opportunity to learn whether the debtor is seeking to reorganize, facilitate a sale, or simply file to stop adverse collection action. It also will reveal whether the dealer has a realistic turnaround strategy. Early communication regarding key operational issues and obligations also often avoids unnecessary disputes. Dealers do not want to spend limited resources litigating. Most want to negotiate a deal.

Even where the strategy is to provide the dealer time to try to reorganize, the manufacturer must monitor the proceeding closely. Motions to assume executory contracts, sell assets, establish sale procedures, establish bar dates, or dismiss the case or convert it to Chapter 7 demand immediate attention. Because bankruptcy courts are courts of equity and rarely does one party achieve all desired goals through litigation, manufacturers need to be involved and be prepared to negotiate.

BANKRUPTCY CHANGES THE RULES

Once a dealer files for bankruptcy, most of the issues will be resolved pursuant to laws and procedures designed to protect the debtor and to maximize creditor recovery not to protect the rights of a manufacturer, distributor, or lender. In other words, the rules have changed. Critical issues include:

- The automatic stay and its limitations on efforts to terminate the dealership agreement or to enforce operating standards, facility obligations, or affiliated agreements;
- The special rules governing a dealer's financial defaults and its post-petition financial transactions, including restrictions on the manufacturer's ability to reconcile or settle its dealer account on an ongoing basis;
- The ability of the dealer to operate post-petition, even though it is not fully compliant with its dealer-agreement obligations, including not having floor-plan financing to purchase and stock new vehicle inventory;
- The debtor's ability to assume or reject certain contracts and leases;
- A dealer's ability to continue operating or to sell the dealership over the manufacturer's objection; and

The potential appointment of a trustee to oversee and operate the dealership.

STANDARD BANKRUPTCY PROTOCOL

Because dealers often seek to blame others for their financial failure or the inability to reorganize, the manufacturer's actions should be consistent and include such actions as:

Immediately notifying all applicable departments that the dealer has filed for bankruptcy protection, including those responsible for financial transactions with the dealer, vehicle or parts sales, and enforcing operating standards;

Stopping any electronic funds transfer ("EFT") procedures, absent specific authorization, in writing, from the debtor and its counsel and, most often, court approval;

Analyzing the dealer's parts account to determine any monies due to or owing from the dealer, the scope and extent of the dealer's recurring monthly charges, and the existence of any assignments or pledges in favor of a lender;

If permitted, implementing COD, cash-in-advance, or similar procedures for parts purchases;

Notifying all divisions, affiliates, and vendors whose "charges" (sign lease, computer lease, etc.) are normally paid through charges to the dealer account;

Analyzing affiliated agreements, such as facility leases, renovations or relocation commitments, or site-control agreements to determine any continuing obligations by the dealer and the existence of any defaults;

Determining how to handle vehicle sales in the absence of a floor plan, including whether to sell vehicles for "cash" and, if so, under what terms; and

Establishing the process for implementing any contractual or statutory termination assistance in the event of a closure and liquidation.

ASSESS DEALER'S VIABILITY

The manufacturer should assess the viability of the dealership and its market at the outset of the bankruptcy proceeding, including whether the market area can be served effectively by other nearby dealers. Where a closure might leave an important marketplace dark for months, evaluating the dealer's proposed post-petition operations is not only important to ensure compliance with dealer-agreement obligations, but also to determine if a reorganization or sale is possible. Also, unless the dealer intends to liquidate, the dealer will seek authority to use its lender's "cash collateral," a process that requires the dealer to outline its proposed postpetition operations. If the dealer cannot operate profitably post-petition (with the benefit of the automatic stay and other significant bankruptcy protections), it likely means that a successful reorganization is not possible.

Because the cash-collateral budget reflects the contemplated operations, the manufacturer needs to assess whether those operations provide adequate representation in the marketplace. If the dealer wants to remain open, it needs to provide a minimally acceptable level of operations that protects customers and the brand's goodwill. Because "financing" essentially drives a case, the lender needs to consider collateral value and the dealer's cash flows and projections in order to understand the potential collateral for erosion, the need for appropriate economic controls (*e.g.*, adequate protection payments, budgetary controls, and cash-management systems), and non-economic protections (*e.g.*, monitoring and reporting requirements, tight bankruptcy timelines, defaults, and remedies). Unprofitable operations usually call for immediate termination, repossession, and liquidation.

CONSIDER A WORKOUT

Unless the dealer network strategy for a particular market is consolidation or reduction and assuming that the dealership can otherwise be viable there are times when a strategy of strict adversarial enforcement should give way to cooperative assistance. In important market areas, standing by while the dealership fails can cause not only significant short-term losses but also longterm competitive challenges.

Negotiating a forbearance agreement or an operating stipulation that provides a struggling dealership an opportunity to reorganize or sell can be a viable strategy. It gives the dealer an opportunity to continue operating and to work through its financial distress; it delays or avoids potential litigation; and it keeps the manufacturer represented in the marketplace with a dealer that is continuing to buy products and service customers. With the right protections, even the lender can minimize the risk of additional losses while continuing to provide credit.

There are several important considerations. First, the manufacturer needs to identify the market areas that are strategically important and determine if there is a reasonable prospect that the dealer can turn things around or effectuate a goingconcern sale. Second, the manufacturer needs to determine the scope and nature of the potential assistance or accommodations. Of course, understanding the underlying cause of the distress is essential. The manufacturer must then negotiate an agreement that documents both the terms of the proposed accommodations and the required operational changes, but also manages the risk if the dealer nonetheless fails. Agreement terms should include an acknowledgement that the dealer is in trouble and needs help; that the dealership might fail despite the workout or forbearance; and a release of any claims against the manufacturer or lender. (The dealer cannot expect to get assistance and then be able to sue afterward if it doesn't work out.) The agreement also needs to address the legal consequences if the dealership fails to achieve agreed-upon operational benchmarks; there needs to be an exit strategy.

While the scope of potential accommodations depends on the particular circumstances, there are several opportunities to assist a distressed dealer while still protecting the integrity of the manufacturer's network and operating standards. These include: 1) stipulations addressing the operation of the dealership's parts account to provide the dealer with ready access to operating revenue from sales incentives, warranty reimbursements, and other similar credits; 2) agreements that allow the dealer to buy new vehicle inventory for "cash" in the absence of floor-plan financing; 3) evaluations of the dealership's operations, with suggestions for improved operations; 4) agreements that delay the enforcement of required facility renovations, relocations, or exclusivity requirements; and 5) where the manufacturer is also the lessor, time extensions to assume or reject the lease, reduced rent, and other lease accommodations. The manufacturer must be mindful, however, of price discrimination laws that prohibit helping a distressed dealer in ways that give it a competitive price advantage over other area dealers.

Maybe the most significant consideration is the viability of the dealership opportunity and the potential for a turnaround. In this regard, the manufacturer should require the dealer to provide a *pro forma* business plan that outlines its current and projected sales operations, anticipated revenues and expenses, and how the dealer intends to achieve sustainable profitability. This plan should include benchmarks for measuring compliance, earning continuing support, and defining that support.

Even where a workout may not be advisable, a voluntary termination may be an option. With new credit almost non-existent, the prospects of going-concerns sales are dim, except for the most valuable brands in important markets. Sometimes, the underlying real estate is more valuable than the dealership operation itself, so some dealers will seek voluntary terminations. Voluntary termination agreements with expedited termination assistance, repurchase accommodations, and a release of claims allow the parties to agree upon the divorce terms and move on.

ADDRESS THE DEALER ACCOUNT IMMEDIATELY

Virtually all manufacturers have some form of dealer account for processing the regular financial transactions with dealers, such as parts purchases, computer charges, warranty reimbursements, and sales incentives. These accounts are reconciled weekly or monthly. Depending on whether there is a debit or a credit balance, there is a payment made to or owing from the dealer. Many accounts now operate through electronic funds transfers.

Because of special rules governing financial transactions, manufacturers must address the dealer account immediately upon a bankruptcy filing. Although the rules differ by jurisdiction, some courts recognize the manufacturer's ability to continue to reconcile the dealer account and, in doing so, apply post-petition credits to what the debtor will characterize as prepetition debt without violating the automatic stay. *See* *Bob Brest Buick, Inc. v. Nissan Motor Corp., 136 B.R. 322, 324 (Bankr. D. Mass 1991)* (upholding the recoupment defense). Because a party must normally obtain relief from the automatic stay before enforcing a contractual setoff right, however, addressing the dealer account with debtor's counsel is imperative. Also, focusing on the financial transactions at the first sign of financial distress is important because, if a dealer accrues a debit balance, subsequent payments create the risk that, in the absence of new value, the payments may be challenged as voidable preferences.

Addressing the dealer account early affects sales incentives and other "factory" payments, which represent significant revenue for dealers. Dealers will expect to be paid in the ordinary course, even though they may owe pre-petition debt and do not pay recurring postpetition charges. For some, a loss of this revenue will mean closure, and they will raise the claim that the manufacturer improperly withheld funds. In turn, the manufacturer must try to ensure that it will be paid for the regular charges as well as audits, chargebacks, etc. Oftentimes, the manufacturer should consider an administrative freeze of the dealer account to give it time to assess its rights and, if there is going to be significant post-petition operations, to negotiate a court-approved dealer account agreement. Such an agreement avoids disputes, allows for near-standard operation of the dealer account and, thus, cash flow to the dealer, while protecting the manufacturer's rights.

GET PAID FOR VEHICLES AND PARTS

Absent a court-approved stipulation, allowing a dealer to continue to purchase parts or other products and services through the dealer account, in effect, provides the dealer with an unsecured loan with significant risk of nonpayment. While treatment as an administrative expense pursuant to *11 U.S.C. 503* provides some protection (administrative claims are normally paid prior to any unsecured claims), the manufacturer may, and most likely should, as long as consistent with the applicable dealer agreement, place the dealer on cash-on-delivery or cash-in-advance procedures for parts and other purchases.

Next month's installment will discuss an automaker's or lender's options when termination, liquidation, or change in ownership of a dealership cannot be avoided.

John R. Skelton is a partner in the Distribution and Franchise Group at Bingham McCutchen LLP. He can be contacted at *john.skelton@bingham.com* or 617-951-8789.

Load-Date: April 17, 2011
