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

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Body

T he difficult circumstances facing automakers have already led to the closure of many dealerships, and more will come in the wake of the Chrysler bankruptcy and the elimination of GM's Pontiac brand. Especially where the driving force behind a dealer's difficulties is the economy, rather than poor managerial or operational decisions made by the dealer, adversarial enforcement of dealership contracts is giving way to cooperative workouts.

Part One of this article explained the benefits of engaging a dealer early and discussing possible workout arrangements, and it outlined the impact that a dealer's bankruptcy filing can have on the process. In Part Two, we consider an automaker's options when termination, liquidation, or change in ownership of a dealership cannot be avoided.

Identifying financially distressed dealers before a bankruptcy filing is important because there are instances where termination and liquidation is the appropriate strategy. A valid pre-bankruptcy termination notice, so long as it does not provide an opportunity to cure, is not subject to an automatic stay, and thus, a bankruptcy filing does not stop the running of the notice period. Instead, in order to prevent the termination from becoming effective, the dealer should be required to seek and obtain a preliminary injunction on the basis that either the notice was not procedurally valid or that the manufacturer lacked good cause for termination. By putting that burden on the dealer, the pre-bankruptcy termination notice significantly strengthens the manufacturer's position.

Seeking to terminate a dealer post-petition requires both good cause to terminate the dealer agreement and good cause for relief from the automatic stay. The fact that the dealer has filed for bankruptcy or is experiencing financial difficulties is usually not enough. Rather, the manufacturer needs to establish not only a material default of the dealer agreement, but also that continued operations will harm the manufacturer and that reorganization is not likely. The manufacturer will need to develop historical information about sales, vehicle purchases, and the brand's performance in the marketplace, as well as issues affecting consumers, such as declining customer satisfaction, overdue liens on trade-in vehicles, or delays in warranty and other repair services. The manufacturer should consider conducting an audit of sales reports, incentive programs, and warranty claims because the existence of fraud or other mismanagement not only constitutes good cause to terminate but also affects whether the current dealer management should remain in place.

Manufacturers may also face a "lights on, nobody's home" scenario where the dealer has no floor plan, no inventory, and no staff to conduct any semblance of customary operations. Because a closure constitutes an incurable default precluding a sale, dealers often keep the doors open, arguing that they have not stopped operating. Simply keeping the lights on, however, is not enough. *See, e.g.,* *Chic Miller's Chevrolet, Inc. v. General Motors Corp., 352 F. Supp. 2d 251, 259-60 (D. Conn. 2005)* (one newspaper advertisement and one car sale "is insufficient to show the conduct of regular, customary sales and service operations"); *In re Downtown Automotive Group, LLC*, Case No. 06-10228 (Bankr. W.D. Wash. Mar. 28, 2006). This is important because a dealer's failure to conduct required normal operations constitutes a "historical fact" that cannot subsequently be cured, a prerequisite to assuming the dealer agreement under *365 of the Bankruptcy Code*, which is necessary for either a proposed reorganization or a sale. *See* *Worthington v. GMC (In re Claremont Acquisition Corporation, Inc.), 113 F.3d 1029, 1033 (9th Cir. 1997)*.

PROPOSED REORGANIZATION OR SALE

Other than liquidation, a bankrupt dealer really has two options: reorganize and stay in business; or sell the dealership as a going concern.

If the dealer is achieving sufficient post-petition sales to meet its ongoing obligations, and there are no other defaults justifying a termination, most bankruptcy courts will be inclined to give the dealer time to attempt reorganization or a going-concern sale. If, however, the debtor is not operating at a breakeven basis, the lender will likely seek to shut down the dealership and repossess its collateral.

When there is no creditors' committee, it is often helpful to engage the U.S. Trustee if the post-petition operations are deficient. If a dealer cannot meet its post-petition obligations, the U.S. Trustee's office will seek to protect existing creditors, dealership employees, and others. Depending on the timing, the 341 creditors' meeting also presents a good opportunity to examine the dealer under oath and to explore the cause of the financial distress, the sufficiency of the post-petition operations, and the prospects for a sale or reorganization.

The manufacturer also needs to analyze any proposed reorganization plan carefully, especially the proposed post-confirmation operations. Does the plan seek to alter the dealer's obligations under its dealer agreement or any affiliated agreements? Because dealer agreements are generally considered executory contracts, a proposed reorganization or sale first requires "assumption" of the dealer agreement pursuant to *365 of the Bankruptcy Code*. While there are other legal and strategic issues, some significant "assumption" considerations include that the dealer must: 1) cure existing defaults as administrative claims with "100-cent dollars"; 2) pay any pecuniary losses suffered by the manufacturer; 3) assume all terms of the applicable agreements; and 4) provide adequate assurance that it will be able to perform in the future, such as complying with working capital, floor-plan financing, and other similar operating standards.

If there is a sizeable past-due dealer-account balance or past-due lease obligations, the dealer's cure obligations may present a substantial hurdle. Manufacturers should anticipate a request for a compromise.

Also, there are market representation and dealer-network issues to consider. The proposed sale may be to a less-than-desirable buyer, it may involve the relocation to an undesirable location or facility, or it may call for the combination of operations with other vehicle lines.

Because many counsel and judges look at the sale of a dealership as a routine sale of assets, the proposed sale procedures often do not preserve the manufacturer's approval rights nor provide sufficient time for the normal application process. While many state statutes and dealer agreements provide a 60-day evaluation period, there will be incredible pressure to accelerate the approval process because 60 days is an eternity for a dealership losing money. Dealers often seek to impose an accelerated review process in these situations, but manufacturers must ensure that their approval rights are recognized. Offering some flexibility in the review process is usually sufficient to avoid contentious motion practice.

Further, because creditors will likely not recover their funds without a sale, virtually every constituency will be pressuring the manufacturer to approve a sale, regardless of the buyer's qualifications, the terms of the proposal, or the impact on the dealer network. Thus, at the beginning of the sale process, a manufacturer must establish the scope of review, the relevant considerations, and ensure that its decision is not subject to *de novo* bankruptcy court review. *See* *In re Van Ness Auto Plaza, Inc., 120 B.R. 545, 546 (Bankr. N.D. Cal. 1990)*, in which the court looks at whether the manufacturer's decision is "based on factors related to the proposed assignee's performance as a dealer and is supported by substantial objective evidence." Further, if the proposed transaction likely will not be approved (because, for example, there would be an unauthorized dual site with another brand or a relocation to an unacceptable facility), a prompt response is advisable. Waiting until the end to reject a sale invariably leads to claims of an insufficient review and a shutdown of the dealership.

If the manufacturer is going to approve the sale, the form of the approval is critical. At a minimum, it should be contingent upon: 1) the debtor curing all material defaults (paying for cars, parts, etc.); 2) the buyer assuming all obligations under the dealer agreement and any affiliated agreements (lease, site control, and right of first refusal); 3) the buyer agreeing to satisfy the conditions essential to future operations, such as sufficient working capital and floor-plan financing; and 4) the entry of a final order that cannot be appealed. Because there are usually grounds for the manufacturer to seek a termination and not even consider a sale, or there may be a compromise on the dealer's 365 cure obligations, there should also be an agreed-to termination of the prior dealer agreement with a release of claims, by both the dealer and its principals. A portion of the sale proceeds may need to be set aside so that all charges are paid from the sale proceeds. All of the above will be the subject of negotiation.

CHAPTER 7 LIQUIDATION

When a dealer files Chapter 7 liquidation or a Chapter 11 case is converted, it means that the dealership is required to cease operating. The manufacturer should immediately document the closure, since it constitutes an incurable event of default that should preclude a Chapter 7 trustee from seeking to auction the dealership rights later. The manufacturer should then seek relief from stay, so it can initiate or complete a state-law termination or, where appropriate, negotiate a voluntary termination. A voluntary termination can provide increased or expedited termination assistance for the dealer, accelerated liquidation of a lender's collateral (reducing guaranty liability), and, significantly, a release of claims in favor of the manufacturer.

Other important considerations in liquidation include the repurchase obligations under the dealer agreement and state-dealer laws, collections of any dealer-account balances, stoppage of any display of signs or trademarks, and cessation of operation of dealership Web sites. It is much easier to deal with these issues at the time of closure rather than six months later when the sign is still standing on a vacant lot, or the property has been sold.

LITIGATION

A dealership liquidation or closure likely means substantial losses for shareholders, investors, and creditors. The losses for shareholders are especially acute where there is significant guaranty exposure to the lender. For many failed dealerships, lost investments and potential guaranty liability mean litigation especially where dealers have recently established dealerships, built or upgraded facilities, relocated operations, have not been able to meet new operating standards or qualify for incentive programs, or have questioned the propriety of collection or other actions. In fact, dealers facing lender collection actions generally have little choice but to sue or assert counterclaims. Especially where the lender is an affiliated finance company, the manufacturer needs to anticipate being dragged into the fray.

Assessing the scope and likelihood of litigation is essential to determining a strategy for any financially distressed dealer, but especially one in bankruptcy. Litigation is expensive, even where dealer claims have little or no merit. Compromising on payment claims, offering additional termination assistance, agreeing to consider or facilitate a sale even after the dealership has been closed, and, for the affiliated lender, considering compromises on collection claims can be part of a workout strategy that provides a release not only from the dealer company but also from other constituencies such as the former operator or shareholders. While capitulation to dealer claims is not advisable and, in fact, can actually foster claims, taking steps to avoid or reduce litigation risk needs to be an important part of the manufacturer's overall business strategy.

CONCLUSION

The bottom line is that there are many issues and considerations involved with distressed auto dealerships. Some are straightforward, while others involve complex financial, operational, and network-related issues. In all situations, however, the manufacturer needs a business strategy that recognizes today's challenging economic environment.

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