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Feature

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Check Engine: Rules of the Road to Navigate Upcoming Auto Distress



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Many restructuring professionals may recall that there was a time when automotive distress — rather than retail and oil and gas bankruptcies — grabbed ABI headlines. In 2009, U.S. light vehicle sales hit their low point of 10.4 million units,¹ resulting in hundreds of automotive suppliers being restructured in and out of court from 2008-10. Sales have since marched steadily upward, reaching 17.5 million units in 2016.² Light vehicle production in North America, the strongest driver of activity for domestic-based suppliers, similarly saw increases from 8.6 million units in 2009 to 17.7 million units in 2016.³ Profits have been plentiful for both original equipment manufacturers (OEMs) and suppliers alike.

Recently, Bank of America/Merrill Lynch flashed a yellow caution signal when it slashed its forecast for North American light vehicle production to just 13 million units in 2021.⁴ In addition, the future of the North American Free Trade Agreement is uncertain, raising prospects that suppliers who have invested significant capital in Mexico will now be forced to move production back to the U.S. in order to avoid heavy tariffs and remain competitive. Longer term, the industry faces an overhaul like nothing it has ever experienced, based on the speed with which ride-sharing, electrification and autonomous vehicles are being adopted.

These short- and long-term challenges will likely result in a number of suppliers having to be restructured. Successfully restructuring an automotive supplier requires a keen understanding of the industry and expertise in navigating agreements that have become the backbone of automotive

workouts to ensure that value is maximized, while also giving the supplier the best chance of survival as an ongoing business.

The Automotive Supply Chain

The automotive industry is one of the most complex industries in the nation, historically accounting for approximately 3-3.5 percent of the nation's gross domestic product,⁵ with more than seven million jobs depending on the industry.⁶ The industry operates with a tiered-network of suppliers, where tier-three suppliers provide component parts and services to tier-two suppliers, and so on up the chain until reaching the OEMs, where final vehicle assembly occurs.

To drive costs out of the supply chain, OEMs tend to "sole source" their needs for a particular component part from one supplier rather than multiple suppliers, and use just-in-time inventory practices, where only a few days of inventory might exist within the supply chain at any time. Contracts are usually awarded multiple years in advance of when vehicle production begins. Some component parts, such as those related to vehicle safety, might require retesting by governmental agencies, like the National Highway Traffic Safety Administration, if a supplier of a component part is changed.

Because many of the parts used in constructing a vehicle have characteristics unique to a particular OEM, they are built by suppliers using specialized tools and equipment located at the supplier's plant. As a result, each OEM desires to maintain ownership of these items, which are generally referred to as "tooling." Standard OEM contractual terms and conditions state that tooling is owned by the

1 Bureau of Economic Analysis.

2 *Id.*

3 "Are We There Yet?... Yes, and Heading Into the Summer of Our Discontent," Bank of America Merrill Lynch, June 2017.

4 *Id.*

5 "Automotive Spotlight: The Automotive Industry in the United States," SelectUSA/International Trade Administration.

6 Driving American Jobs Coalition, Press Release, Oct. 24, 2017.

OEM.⁷ The tooling is often deemed to be owned by the OEM even before the OEM pays the supplier for it,⁸ and in any dispute involving ownership of the tooling, there is a rebuttable presumption that the OEM owns the tooling.⁹ Further enforcing this presumption is the requirement that the supplier mark the tooling as being owned by the OEM.¹⁰ This facilitates court-ordered removal of the tooling to an alternate supplier in the event of litigation. In addition, OEMs attempt to control the secondary equipment that uses the tooling to produce their part by including an option to purchase these items in their terms and conditions.¹¹

Even in good times, suppliers can become financially distressed based on the industry's historically slim profit margins, which make it difficult to absorb unfavorable variances to a plan. For example, a number of suppliers are currently struggling with the dramatic shift in consumer preference away from sedans to crossovers and sport utility vehicles. In 2016, Fiat Chrysler Automobiles (FCA) announced that it would no longer produce passenger cars in the U.S.¹² Suppliers that invested heavily to support production of the Chrysler 200 or Dodge Dart, for example, might not recoup their investments and might experience liquidity challenges. When industry challenges are broad-based, similar to what occurred from 2008-10, distressed suppliers can threaten the entire automotive supply chain, putting even healthy suppliers at risk.

An OEM may lose millions of dollars per hour if one of its assembly lines goes down. The nature of the automotive supply chain leaves little room for error in the event that a supplier becomes distressed, as production of parts typically cannot be timely shifted to an alternative source. Because of this, OEMs spend substantial amounts of time and money qualifying suppliers and monitoring the health of their supply base in order to reduce the risk of a disruption in supply. Some OEMs even maintain troubled supplier groups, similar to a workout group at a bank, to address issues with distressed suppliers.

Accommodation and Access Agreements

Because of the unique nature of the automotive industry and the frequency of distress in its supply base, practitioners developed two common agreements in the 1990s to facilitate successful automotive workouts: (1) the accom-

modation agreement and (2) the access and security agreement. The main goal of these agreements is to maintain an uninterrupted supply of parts for the OEMs while providing incentives to the other integral parties (*e.g.*, lenders) to accomplish that goal.

Accommodation Agreement

The accommodation agreement provides a framework in which the OEM and supplier will work to maintain a supply of parts for the OEM. Because there are other constituents being impacted, the agreement is usually expanded to include secured lenders and sometimes other OEMs. Common issues addressed in accommodation agreements are setoffs, OEM financial support, re-sourcing/bank builds, the purchase of inventory and process milestones.

The pace and extent of change impacting the auto industry is unprecedented, and increased turmoil in the supply chain is highly likely in coming years.

Setoffs

Setoffs are a common law right that allows one party to deduct (or "set off") amounts that the other party owes to it from the amounts that it owes to that party. OEMs have expanded these common law rights under their standard terms and conditions to provide that mutuality exists between a supplier and its affiliates and subsidiaries on the one hand, and the OEM and its affiliates and subsidiaries on the other.¹³ This expanded notion of setoff, combined with broad damages provisions and the OEM's typical ability to recoup professional fees and expenses in insolvency situations,¹⁴ means that it is critical for a supplier — and any secured lender loaning against the supplier's receivables — to ensure that the OEM limits its setoff rights. Limitations often include the types of permitted setoffs and a maximum setoff percentage per invoice.

OEM Financial Support

A distressed supplier's lender might not be able or willing to provide sufficient funding in order for the supplier to continue operating. To fill this need, OEMs will sometimes expedite the payment of amounts they owe the supplier.¹⁵ More troubled situations might require that the OEM make a loan to the supplier or increase prices on the parts that the supplier makes for the OEM. Loans might be made directly

7 "10. PROPERTY AND TOOLING. (a) Property and Tooling. (i) Tangible property of every description including without limitation all tools, equipment, material, drawings, manufacturing aides, dies, test and assembly fixtures, jigs, gauges, patterns, casting patterns, cavities, molds and documentation, including engineering specifications, PPAP books, and test reports together with any accessions, attachments, parts, accessories, substitutions, replacements, and appurtenances thereto that is necessary for the manufacture of component and service parts for FCA US ("Tooling") ... is owned by, is property of, and is being held by [the supplier] as a bailee at will for FCA US." FCA US Production and MOPAR Purchasing General Terms and Conditions (January 2017).

8 "34.08 Ownership of Tooling. [Ford] becomes the sole owner of all Tooling as soon as it is fabricated or acquired by the Supplier. [Ford] takes title to the Tooling even if the Supplier has not yet been paid for the Tooling. Ownership by [Ford] will not relieve [Ford] of its obligation to pay for the Tooling nor affect any claim of the Supplier for payment under a Production Tool Order." Ford Motor Co. and Its Subsidiaries Production Purchasing Global Terms and Conditions (Jan. 1, 2004).

9 "34.14 Presumption of Buyer Ownership. In any dispute involving ownership of the Tooling, there is a rebuttable presumption that [Ford] is the sole owner of the Tooling." *Id.*

10 "34.02 Production Tool Order.... The Tooling may not contain or be marked in any manner with the name of any person or entity other than [Ford]." *Id.*

11 "21. Seller's Property.... [The supplier] grants [General Motors (GM)] an irrevocable option to take possession of and title to [the supplier's] Property that is used exclusively for the production of the goods upon payment to [the supplier] of its net book value less any amounts that [GM] has previously paid to [the supplier] for the cost of such items, but less any amounts otherwise owing to [GM] by [the supplier]." General Motors LLC General Terms and Conditions (February 2014).

12 Brent Snaveley, "Fiat Chrysler Ending Car Production in U.S.," *Detroit Free Press*, July 28, 2016, available at <http://freep.com/story/money/cars/2016/07/28/fiat-chrysler-ending-car-production-us/87649136> (last visited Nov. 20, 2017).

13 "In addition to any right of setoff or recoupment provided by law, all amounts due to [the supplier] will be considered net of indebtedness of [the supplier] and its affiliates/subsidiaries to [GM] and its affiliates/subsidiaries; and [GM] will have the right to setoff against or to recoup from any amounts due to [the supplier] and its affiliates/subsidiaries from [GM] and its affiliates/subsidiaries." General Motors LLC General Terms and Conditions (February 2014).

14 "26.04 Insolvency. [Ford] may terminate a Purchase Order, in whole or in part, upon Written Notice to the Supplier, if the Supplier: (a) becomes insolvent; (b) files a voluntary petition in bankruptcy; (c) has an involuntary petition in bankruptcy filed against it; (d) has a receiver, administrator, custodian or trustee appointed over the Supplier or its assets; or (e) executes an assignment for the benefit of its creditors. In each case, the Supplier is liable for all actual costs incurred by [Ford], including those for attorneys, experts, consultants and other professionals." Ford Motor Co. and Its Subsidiaries Production Purchasing Global Terms and Conditions (Jan. 1, 2004).

15 A typical payment period for a customer can range from 60-90 days. Examples of expedited payment terms include "net 10" days and "net immediate" as the most expedited.

to the supplier or through participations in the credit facility provided by the supplier's lender.

An OEM might require that a supplier file for bankruptcy protection and consent to a chief restructuring officer as a condition to providing financial and other accommodations. Bankruptcy is most often required when a sale of the supplier is anticipated.

When a distressed supplier has more than one customer, customers may join in an accommodation agreement to support the supplier. The support each provides is typically based on the customer's percentage of the supplier's sales. An OEM providing accommodations might insist that all other customers of the distressed supplier representing more than 5-10 percent of the supplier's revenue provide similar accommodations, or the supplier cannot use its liquidity to produce parts for those other customers.

Re-Sourcing/Bank Builds

The accommodation agreement may also contain a covenant by the OEM to not re-source the supply of the component parts produced by the supplier — absent a default — for a defined period of time. A “no re-sourcing” provision enables the supplier and its customers to more accurately forecast the supplier's budgetary needs and preserve the value that might exist in the supplier's contracts with its customers. To protect the OEM in these scenarios, the supplier will normally be required to build a bank of finished parts inventory to be used in case of an unforeseen interruption in supply.

Inventory Purchase

In the event that an OEM does re-source its production from the distressed supplier, accommodation agreements normally require the OEM to purchase raw materials, work-in-process and components that the supplier uses to produce the component parts to protect both the supplier and its lender.

Process Milestones

Finally, OEMs entering into an accommodation agreement with a distressed supplier want to ensure the accommodations will not continue for an unlimited period of time. In addition to having a defined duration of the accommodation agreement, OEMs will often insist on incorporating milestones into the agreement for events, such as obtaining new financing or running a sale process. Failure to meet milestones is typically an event of default and gives the OEM significant control over the supplier's future.

Access and Security Agreement

An OEM providing accommodations to a distressed supplier will typically require the supplier to also provide it with the right to access the supplier's premises and operate the supplier's facility for the purpose of producing the OEM's component parts. This right is rarely exercised and normally only in the event of an imminent interruption to the OEM's assembly operations, but it provides peace of mind to the OEM supply risk manager. The right of access will include a security interest in the supplier's operating assets in an effort

by the OEM to avoid rejection of the contract as executory in a supplier bankruptcy.¹⁶ If the supplier does not own the real estate where it operates, the OEM will likely require landlord consent to the access right.

An access and security agreement contains detailed information on the OEM's obligations in the event that it exercises its right of access, from the expenses that the OEM will pay to the ability of any secured lender to enter the premises and liquidate collateral not necessary for production. This agreement will also address the allocation of expenses and production capacity in the event that more than one customer exercises its access right.

Conclusion

The pace and extent of change impacting the auto industry is unprecedented, and increased turmoil in the supply chain is highly likely in coming years. Understanding the landmarks of the automotive landscape will help navigate a client through the next wave of financial distress. **abi**

Editor's Note: *For more on this topic, purchase Interrupted! Understanding Bankruptcy's Effects on Manufacturing Supply Chains, available in the ABI Bookstore (store.abi.org). Members must log in first to obtain reduced pricing.*

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¹⁶ See, e.g., *Leasing Serv. Corp. v. First Tenn. Bank Nat'l Ass'n*, 826 F.2d 434, 437 (6th Cir. 1987) (security interest nonexecutory and therefore not subject to the rejection power of trustee).