Best Practices for Auto Supplier Workouts

By Scott A. Wolfson

Auto supplier workouts are more chess-like than traditional distressed situations. They are unique because each affected party faces significant loss if a consensual global resolution is not reached. The process often includes brinksmanship as each party flaunts its nuclear-like rights. These competing concerns make counsel's job in auto supplier workouts stressful, particularly for an attorney new to them, but also provide a chance to shine by employing strategies to achieve supply chain détente.

The playing field

The supplier is usually the sole source of parts it provides to its customers, who are higher-tier suppliers or original equipment manufacturers using a just-in-time manufacturing process, meaning they incorporate the supplier's parts into assemblies or vehicles within hours of receipt. If the supplier stops producing parts and shipping them to its customers, the supply chain seizes.[1] This can be very costly. I have propagated court testimony from auto manufacturers countless times that shutdown damages can be in the millions of dollars *per hour*. The supplier may threaten to cease production absent financial accommodations in an "accommodation agreement" from its customers.

The supplier typically has a loan from a lender secured by a first-priority lien on all of the supplier's assets. The lender could force a cessation of production by foreclosing on its collateral, but doing so would put some of its collateral at risk. The supplier's accounts receivable could be decimated by the setoff rights of the supplier's customers if the supplier ceases production for even a day.[2] That is, the customers would deduct their production shutdown damages from their payables to the supplier, likely leading to a significant negative balance. The lender may threaten to foreclose absent customer financial accommodations, including customer agreements to limit their setoffs.

The best alternative for the customers may be to immediately leave the distressed supplier for a financially and operationally healthy one by terminating their contracts for default or for convenience. But customers are typically unable to promptly source to another supplier. The just-in-time production process means that customers will need a bank of parts to move to a replacement supplier. A parts bank of several weeks to months is necessary to enable customers to continue production without supply from the supplier while the customer moves its tooling from the supplier and re-sources production. If the parts at issue are deemed safety-related, the parts bank will have to be large enough to cover an extensive validation of the replacement supplier. This inability to quickly exit forces customers to the negotiating table.

All this transpires while stretched vendors terminate supply absent cash in advance, landlords pursue eviction, and the supplier's owners seek ways to protect their dwindling equity stake.

Financial advisors key

We are lawyers, not CPAs. Having a seasoned financial advisor on your team is vital to understanding the supplier's financial issues and analyzing strategies to address them.

Customer strategies

The supplier's customers need the flow of parts to continue. To continue producing and stave off foreclosure, the supplier needs money. The easiest way to increase the supplier's liquidity is for customers to shorten their payment terms; for example, paying in 15 days instead of 60 or 90. These accounts receivable are typically the lender's collateral and part of the supplier's borrowing base with its lender, such that only a fraction of receivables collections will flow through to the supplier for use in its operations. Therefore, suppliers often need more relief and request retroactive and prospective price increases. Rather than gifting funds to the supplier for price increases with no chance of repayment, savvy customers should find a way to provide unavoidable financial support via a secured loan. The question is, how?

In addition to the lender's first-priority lien, a financially distressed supplier typically has numerous financing statements filed against it perfecting security interests in its assets, meaning a new loan would be last in priority in the collateral.[3] However, participating in the existing, first-priority secured loan may provide a customer the ability to inject funds with a realistic opportunity for repayment. To do so, the customer funds additional loan advances from the lender to the supplier by paying the lender for the advances in exchange for participating in the lender's loan and collateral position.

The existing lender will insist that all amounts owing to it are paid in full before the customers are repaid anything. These agreements are called "subordinated participation agreements" because the customers' repayment rights are deeply subordinated to the repayment of the existing indebtedness owing to the lender. Standard provisions typically include:

- the lender selling the customers subordinated, last-out, non-voting participation interests in one of its loans to the supplier;

"Best Practices" is a regular column of the *Michigan Bar Journal*, edited by Gerard Mantese and Theresamarie Mantese for the Michigan Bar Journal Committee. To contribute an article, contact Mr. Mantese at gmantese@manteselaw.com.

- the lender agreeing to make available to the supplier the payments made by the customers as advances under the loan;
- the lender not applying any payments or proceeds of collateral to the subordinated participation interests until the lender is paid in full; and
- the customers having no recourse against the lender for anything except actual fraud.

Loaning the funds through the existing senior secured lender gives the customers a chance to recover the emergency financial support they provide to the supplier. I have been involved in cases where customers who funded the supplier's liquidity needs through subordinated participations were paid in full with interest while customers who paid pricing surcharges received nothing.

Other important items for customers include building a parts bank; obtaining or reaffirming the customers' right to use the supplier's intellectual property to make their parts; receiving an acknowledgment of the customers' ownership of the tooling used to make their parts; affirming or broadening the customers' right to purchase equipment dedicated to the production of their parts at defined prices; and, if necessary for a change in ownership of the supplier, agreeing on a sale process and timing milestones.

The ultimate insurance policy for a customer is to obtain the right to operate the supplier's facility. This is done through an "access and security agreement" granting customers a security interest in and right to use the supplier's assets necessary to manufacture the customers' parts for a set period if the supplier defaults. The reason for obtaining a security interest in the supplier's operating assets securing the customers' right of access is to prevent a supplier from having the ability to renege on the agreement by rejecting it in a bankruptcy.[4]

Supplier must-haves

The supplier should ensure that it obtains sufficient financial and other accommodations to bridge to a liquidity event, which will typically be a sale. The supplier needs the ability to accurately budget during the workout, making an experienced financial advisor critical. The supplier must, for example, know that it will be paid for parts it supplies to its customers. This is typically done by limiting the amounts customers can set off against their payables to the supplier, commonly known as "bullet-proofing" the receivables.[5] A setoff limitation benefits not only the supplier, but also its lender that is advancing loans against the supplier's accounts receivable. Without a setoff limitation, customers' damages could severely compromise the receivables.

Other essential deal points for the supplier include obtaining a commitment from the customers to stay during the sale process to allow enough time for the supplier to maximize the value of its assets. Customers should be required to keep their production with the supplier absent a supplier default that interrupts customers' production. The supplier should also clarify what manufacturing equipment it owns and, in conjunction with its lender, set the purchase price for each item if a customer exercises an option to purchase equipment.

Lender interests

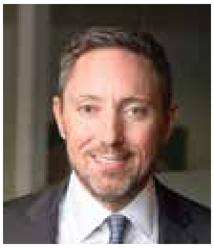
The lender's interests are often aligned with the supplier, at least with respect to maximizing the value of the supplier's assets, which are its collateral. The lender should agree to forbear from exercising its rights only if it receives appropriate collateral enhancements, such as the "bulletproofing" of the supplier's receivables. The lender should also require that it receive appropriate value for other working capital collateral if customers leave for another supplier. To that end, the lender should require that exiting customers purchase the supplier's raw materials, work-in-process, and finished goods related to each customer's production and pay a minimum price for any supplier-owned equipment they purchase.

Equity tips

Equity is also incentivized to enhance the sale process. If there will be no money for equity post-sale given the amount of indebtedness and the anticipated market value of the supplier's assets, principals should consider negotiating a cooperation payment, perhaps on a sliding scale tied to the sale price. Similarly, if a principal guaranteed the indebtedness, an attempt should be made to obtain relief from the guaranty. Principals must, however, ensure that they always act in accordance with their fiduciary duties to the supplier.

Conclusion

Auto supplier workouts are likely to be more prevalent in the coming months given the unprecedented issues suppliers are facing. For many attorneys, this will be their first foray into a distressed automotive case. Whatever your seat at the negotiating table, these strategies should enhance your participation and advocacy. ■



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ENDNOTES

1. "It is well known that in an effort to promote efficiency, car manufacturers are reducing the size of their reserve banks of parts. As a result, component parts are often incorporated into a finished product within a few hours of their delivery. A supplier's failure to make scheduled shipments may have immediate and dramatic consequences." *Kelsey-Hayes Co v Galtaco Redlaw Castings Corp*, 749 F Supp 794, 798 n 7 (ED Mich, 1990).
2. MCL 440.2717 ("The buyer on notifying the seller of his intention to do so may deduct all or any part of the damages resulting from any breach of the contract from any part of the price still due under the same contract.").
3. MCL 440.9322(1)(a) ("Conflicting perfected security interests...rank according to priority in time of filing or perfection.").
4. See 11 USC 365(c).
5. Customer contracts often expand setoff rights to include affiliates. For example, Ford Motor Company's Production Purchasing Global Terms and Conditions, Section 11.02 (January 1, 2004), provides: "The Buyer [Ford] or its Related Companies may also setoff and recoup against the accounts payable of the Buyer or its Related Companies to the Supplier or its Related Companies any amounts for which the Buyer or its Related Companies determines in good faith the Supplier or its Related Companies is liable under any Purchase Order or other agreements with the Supplier or its Related Companies." Section 11.02 also defines a "Related Company" as "any parent company of the Buyer or the Supplier, as appropriate, and any subsidiary or affiliate in which any of them owns or controls at least 25% of the voting stock, partnership interest or other ownership interest."