Advising the Foreign Client

[on American Insolvency Law]

By Ethan Gilan and Max Newman

Introduction

The automotive industry has faced a number of challenges during the past 15–20 years. Among the accelerating challenges faced by the industry are globalization and insolvency. The intersection of the challenges has created a unique opportunity for Michigan attorneys to take the lead in advising foreign clients about the unique and often perplexing features of American bankruptcy law.

This article focuses on the perspectives and experiences of German and Japanese automotive suppliers given their prevalence as part of the local Michigan economy.[1] Germany and Japan share their knowledge of U.S. law through post-war occupations, which facilitated the introduction of various bodies of law, including those dealing with insolvency. The influence of such laws, however, did not—and could not—import the regulatory histories that typically accompany and, in many instances, provide the practical interpretation of, such laws. Consequently, expatriate commercial leaders and executives have little knowledge and even less experience as to how insolvency laws operate in this country, despite some common origins from their home countries.

This article discusses several areas of U.S. law that often perplex foreign suppliers. While none of the concepts are without their cognates in foreign law, the differences often outweigh the similarities. Specifically, the following concepts are uniquely American in origin and (usually) in practice:

- Debtor-in-possession
- Automatic stay
- Rejection/assumption of executory contracts
- Preferences and fraudulent conveyances
- Plans of reorganization

In each area, the Michigan practitioner should gain insight as to the contrast between U.S. and foreign law, as well as some strategies in advising clients on unique American challenges.

Fast Facts:

With the trends of globalization and insolvency as the new reality in the automotive industry, Michigan attorneys need to appreciate the unique backgrounds and sensitivities of their foreign clients.

Properly understanding and explaining the legal nuances associated with topics such as debtor-in-possession, automatic stay, executory contracts, preferences, and reorganization plans will facilitate a more effective attorney-client relationship.

Debtor-in-Possession

Under Sections 1107 and 1108 of Title 11, the Bankruptcy Code, in most circumstances, the insolvent company's management remains in control of the company through the Chapter 11 case. Generally, management is replaced only in circumstances of gross incompetence, dishonesty, or conflict of interest.[2] While outside consultants are commonly brought in to strengthen managerial resources, the consultants obey the writ of the pre-bankruptcy Board of Directors, and generally serve only an advisory, not executive, function.

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Culturally and legally, this concept is not as rooted in Japan and Germany. In Japan, but also to an important degree in Germany, corporate directors and officers of a company that has become insolvent have been expected to feel a degree of shame not common in American culture. Even without legal prohibitions, unsuccessful corporate directors and officers would be expected to step aside, and not entrench themselves in the management of a troubled company.

The legal systems of both countries reflect this cultural attitude. Japan has several types of insolvency procedure: liquidation, special liquidation, composition, corporate reorganization, and corporate arrangement. In each of these systems, the court appoints a supervisor. While existing management may exercise a degree of authority under the supervisor in a composition or corporate arrangement, a court-appointed individual supervises the debtor and usually is the deciding voice on the survival, sale, or liquidation of the corporation. Even when a reorganization is sought, companies generally must obtain substantially all creditors' support for a reorganization plan.[3]

In Germany, in 1994, the Parliament adopted the new Insolvency Statute. Typically, an insolvency administrator is appointed to control the company when proceedings are initiated. In rare circumstances, existing management may remain in control of the company, but does so under the supervision of a trustee, whose duties are to the creditors. In most cases, the insolvency administrator issues a report about the company, which determines whether the company will be liquidated or reorganized.[4]

Unlike the United States, where continuation of management is the rule, continuation of management in Germany and Japan is unusual, and management never continues without supervision. For this reason, foreign-run clients may look askance on the U.S. system.

To advise the client, the attorney must first understand that it is the U.S. system that is unusual. Most foreign systems are similar to the German or Japanese models, and only rarely do other countries adopt debtor-driven, reorganization-focused insolvency laws.

Second, the difference between the insolvency systems amounts to a policy decision by the U.S. The successful reorganization of the debtor through a fresh start is the objective of the U.S. bankruptcy laws insolvency system, perhaps best exemplified in another facet of the U.S. system, the automatic stay.

Automatic Stay

All insolvency systems have certain features in common—including the determination of distributional priorities among secured creditors, employees, and administrative costs. In addition, to protect and accumulate assets and create the largest fund for distribution to priority creditors, as well as maintain an orderly process, most insolvency systems have some version of a stay against collection proceedings and other actions against an insolvent debtor. At a minimum, the stay protects higher priority creditors from lower priority creditors.[5]

In the U.S., however, the automatic stay provides unique and significant protection for an attempt at reorganization. The first difference is that the stay is automatic and covers secured and unsecured creditors. There is no *automatic* stay against secured creditors (and only rarely against unsecured creditors) in Japan or Germany. The automatic stay prevents suits, seizures, foreclosures, and secured party remedies held by even the highest priority creditors. The stay provides the debtor with breathing space to attempt a reorganization.

In other legal systems, and particularly in Japan and Germany, a reorganization is permitted (and protected by a broad stay on the rights of creditors) only if an objective observer determines in the early stages of a case that an attempted reorganization is likely. Thus, for example, in Japan, the stay is discretionary, and the court must determine whether to permit a stay.[6] However, the U.S. system—exemplified by the automatic stay—allows an (often extended) attempt at reorganization if, in the early stages of the case, it is feasible that a reorganization could occur.[7]

Effectively, through the strong shield provided by the automatic stay, the U.S. system shifts the risk of reorganization onto creditors. At the same time, however, it also preserves jobs and prevents forfeiture of equity interests—to the extent that there is any chance they can be preserved.

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Assumption or Rejection of Executory Contracts

U.S. law enhances the possibility of a successful reorganization by allowing the Chapter 11 debtor to escape bad business deals by, for example, rejecting an above-market lease or below-market executory contract[8] with its customers. As a result, creditors may find themselves facing the threat of rejection of a long-term supply contract, sometimes in situations where the creditor has spent millions of dollars in research, development, factory capacity, tooling, component parts, and other sunk costs.

Alternatively, if a creditor is irreplaceable (or if its price is good enough), such creditor may find itself the beneficiary of an assumption of its contract. Its claim is elevated in priority over other creditors, as it requires that the debtor "promptly" cure all arrearages under the contract and that it provide "adequate assurance" of future performance under the contract.[9]

Finally, the creditor may find that the debtor is proposing to assume and assign its contract to another company. In many cases, this is a good thing, as any arrearages must be cured, and the new company must provide adequate assurance of future performance. In other cases, it may be stuck with a below-market contract from which it would have preferred to have been freed, or may be stuck in a supply arrangement with a start-up or competitor entity that it would prefer to avoid.

From the foreign perspective, certain of the Japanese insolvency proceedings allow assumption or rejection of an executory contract, although there are no apparent provisions that would allow an involuntary assignment of any such contract. Similarly, the German administrator may assume or reject—but not assign—executory contracts. Foreign clients generally expect contracting parties to complete their obligations. The concept of "efficient breach," which underlies much of executory contract law, is not a well-recognized concept overseas.

There are several ways to provide your foreign clients with the highest quality representation in connection with the assumption, rejection, or assignment of executory contracts. The key is to know the economics of the creditor's supply arrangements—whether the debtor is a customer or a supplier. Passivity is not an effective option when a customer or supplier is in bankruptcy.

Substantially all of the American automotive industry is now run on some variable of the "just-in-time" inventory system. In this system, companies do not maintain large warehouses of inventory.[10] Rather, they rely on regular delivery of quality goods to ensure that production lines do not shut down. A shutdown at

any level of the supply chain will ripple to the ultimate original equipment manufacturer (OEM) customer, perhaps leading to shutdowns of OEM lines and charges of hundreds of thousands of dollars per day.

In Germany, in particular, it is common for customers of an insolvent supplier to rely on the court-appointed administrator to set revised prices on parts. If the administrator tells a company that the new price of a part is 50 percent more than the old price, the company commonly accedes to the request with a minimum of negotiation. Executory contract law in the United States provides far greater flexibility and far more opportunity for the customer to control its own position.[11]

Michigan attorneys should thus advise their foreign clients of the risks and potential benefits as early as possible, even before a debtor enters Chapter 11. An informed client is a well-armed client. Such a client can:

- prepare alternative supply strategies if a supplier is considering rejecting a contract;
- cancel goods orders with a long lead time and limit its exposure to losses if the contract is rejected;
- enter into negotiations with a customer considering rejection of a contract;
- position itself with its customer to make assumption of its contract more likely by offering favorable terms, or simply by making itself irreplaceable in the marketplace;
- avoid "automatic annual renewals" of purchase orders, which may terminate the prepetition executory contract (and the opportunity to have any arrearages cured); and
- most important, avoid surprises that may interfere with its ability to supply quality parts to its customers on a timely basis.

In contrast, if a client is surprised with a rejection, it will be a very unhappy client that rapidly needs to reformulate its business strategy and supply/customer networks.

Similarly, the attorney's obligation is to inform his or her client of potential purchasers who may seek an assignment of the client's contract. If an attorney learns early that a client does not wish to supply (or be supplied by) a particular assignee, he or she can file objections, enter into negotiations, and otherwise put parties on notice that the assignment is not voluntary and may lead to an objection to a larger sale transaction.

Preferences and Fraudulent Conveyances

Preferences and fraudulent conveyances are the most common, and probably the most perplexing, issues faced by foreign companies dealing with U.S. insolvency law. There are cognates to preference and fraudulent conveyance law in both the Japanese and German insolvency codes. However, the foreign laws allow the administrator or trustee to examine transactions between the debtor and outsiders to determine if there was anything improper about the transactions (e.g., purchase of assets for an unusually low price, clearly preferential treatment of suppliers).[12]

The key difference is that U.S. bankruptcy law allows avoidance of transfers as preferences even when neither the debtor nor the non-debtor party has done anything improper. In fact, certain transactions that might be avoided in Germany or Japan are not preferences in the United States.[13]

The preference statutes, as currently drafted, do not fulfill Congress's goals and are inherently inequitable. The use of the word "preference" does violence to the English language, in a manner not comfortable for non-native English speakers. It is often very uncomfortable to be advising a client that it has significant exposure to a preference claim when the client is certain that a competitor had both a more favorable payment history from the debtor and a lower preference exposure. Further, selling the idea of "redistributive equity" does not work when the client can easily see that any proceeds recovered from preference claims are going to attorneys, banks, bond holders, and other non-trade creditors.

From the perspective of a new German or Japanese client, one that may not yet be comfortable with or fully trusting of its attorney, it can be bewildering to learn that a preference claim must be settled for a significant sum when the foreign entity has done nothing wrong—nothing anyone would consider unethical or improper. In that regard, it is important to counsel the foreign client that there is nothing equitable about preference law, the statutes are read quite literally, and courts apply the letter of the statute, rather than accepting arguments about the equities of the transaction.

Plans of Reorganization

Examining the broad picture of reorganization plans, and not their details, it is clear that all systems recognize the plan of reorganization as a binding contract between the debtor and all of its creditors and equity holders. Such a plan provides how claims will be paid and other information about the debtor's business operations after the conclusion of the insolvency proceedings.

In all systems, control of the ability to propose the plan amounts to control of the agenda for the case. In the U.S., debtors have the exclusive right to file a plan for 120 days after commencement of the case, absent termination of the right (which is exceedingly rare). The exclusive period may be extended for up to 18 months. If the debtor files a plan within the exclusive period, the debtor will have the exclusive ability to confirm its plan without competition for a period of time (which may be extended to a maximum of 20 months after the beginning of the case).

In Japan, in a civil rehabilitation (designed for smaller corporations, but also usable by large companies), the debtor drafts the plan, but creditors, trustees, and other interested parties may also submit plans. There is no exclusive opportunity to file a plan (and no exclusive opportunity to focus the agenda of the case).[14] In a corporate reorganization (designed for larger companies and offering a more comprehensive stay on proceedings), the court-appointed trustee drafts the plan.[15]

Germany allows the insolvency administrator only three months to submit a plan (the debtor may also submit a plan). No party has the exclusive right to submit a plan. If a plan is voted down, the creditors have the option of letting the administrator try again, or forcing the debtor into liquidation.

In the U.S., a plan is approved and binding on all classes of creditors if greater than 50 percent in number and 66.7 percent in dollar amount of each class of creditors who submit ballot votes to accept the plan. If at least one class votes to accept (not including "insider" classes), a plan may be confirmed through "cram-down" over the objection of non-consenting classes of creditor.

In Japan, in civil rehabilitation cases, 50 percent of eligible voters and 50 percent of eligible equity holders must vote to accept the plan. In corporate reorganization, unsecured creditors retain the 50 percent rule, but the required percentages toward secured creditors may vary depending on the terms of the plan.[16] There is no comparable cram-down in Japan.

Similarly, there is no cram-down on classes of creditors in Germany. In Germany, a simple majority of each class of creditor must vote to accept the plan. Moreover, the court reviews the plan to make sure that the majority is not oppressing the minority.

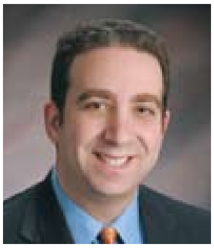
Both Germany and Japan provide opportunities for a bankrupt corporation to negotiate consensual plans with its creditors. The concept of a non-consensual plan simply does not exist.

Again, American law favors the debtor in a manner that may be mystifying to debtors and creditors from Germany or Japan. By allowing extended reorganization proceedings, and by allowing non-consensual plans, American law favors the prospect of reorganization over the building of consensus that is more common in German or Japanese law.

Conclusion

The trends of globalization and insolvency in the automotive industry are the new reality. To address the trends, Michigan attorneys need to understand the unique backgrounds and sensitivities of their foreign clients to facilitate a more productive attorney-client relationship.

While this article sampled experiences with German and Japanese clients, given their prevalence in the current automotive marketplace, it is important to recognize that the Chinese are coming! Unlike the Germans and Japanese, who both developed some experience of U.S. law through post-war occupations and who both have well-established laws dealing with insolvencies, the Chinese are less experienced both with U.S. law and concepts of insolvency law generally. The emergence of Chinese-owned suppliers in the global automotive industry will present an even greater challenge for the local bar—further underscoring the need for cultural sensitivity, effective communication, and focused consultation with experienced bankruptcy counsel. ■



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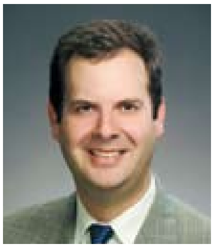

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FOOTNOTES

1. See *Top 100 Global OEM Parts Suppliers,* Automotive News (June 2007) (showing 27 are U.S.-based entities, while 23 are based in Germany and 26 are based in Japan).
2. 11 USC 1104.
3. See McAlinn, ed, Japanese Business Law (Kluwer Law Int'l, 2007), ch 15; InsolvencyAsia, *Insolvency Law Reforms* <http://www.insolvencyasia.com/insolvency_law_regimes/japan/section_i.html> (accessed June 19, 2008).
4. Federal Law Gazette [BGBl], (1994), Part I, pp 2866 *et seq.*
5. See, e.g. Bankruptcy Act (Japan) Articles 25–29; Germany provides for a three-month stay of secured creditors in reorganization proceedings, see Franks et al., *A Comparison of US, UK, and German Insolvency Codes* (Special Issue: European Corporate Finance, Financial Management, 1996), available at <http://www.encyclopedia.com/doc/1G1-19161963.html> (accessed June 19, 2008).
6. See Japanese Business Law, *supra,* ch 15—4.2.6.1.
7. *In re Plastech Engineered Products,* 382 BR 90, 109 (ED Mich, 2008).
8. To insolvency lawyers, an executory contract is like pornography was to the late Justice Potter Stewart—difficult to define, but "you know it when you see it." The most satisfactory and common definition of an executory contract is one where performance obligations remain on both sides—such as a long-term supply contract. Countryman, *Executory Contracts in Bankruptcy: Part I,* 57 Minn L R 439, 460 (1973); *In re Ravenswood Apts, Ltd,* 338 BR 307, 311 (BAP CA 6, 2006).
9. 11 USC 365(b).
10. Even if companies did maintain large warehouses full of component parts, rejection of an executory contract could be devastating because it often takes months—even years—for alternative suppliers to have their parts approved through the exacting production part approval process (PPAP).
11. While German law may also permit some flexibility, such flexibility is rarely exercised for cultural reasons. Instead, customers tend to rely on the recommendations of the administrator, even if it imposes a substantial increased cost to them.
12. In addition, the Japanese system allows recovery of payments made within 30 days of the bankruptcy if the recipient of the payment knew it would harm other creditors. Bankruptcy Act, Article 162.
13. Imagine a supplier (Company A) run by management friendly to the debtor. The supplier invariably is paid for goods and services 10 days after it submits invoices. Company B is paid intermittently, sometimes 50 days after invoice date, sometimes 110. Absent certain facts not present in this brief description, under U.S. law, Company B received a recoverable "avoidable preference," while the clearly "preferred" Company A did not.
14. Japanese Business Law, *supra,* Chapter 15—4.2.11.1
15. *Id.* at Ch 15—4.4.5.1.
16. *Id.*