A GM Good Asset/Bad Asset Bankruptcy; Chrysler Chapter 11 Bankruptcy
by : Richard N. Sox, Jr., Esq.

Until last year, the attorneys at Myers & Fuller, P.A., were familiar with bankruptcy proceedings only as they relate to a dealership seeking bankruptcy protection from creditors, usually a floorplan lender or manufacturer. Since the summer of 2008, like everyone else, we have been educating ourselves on the different types of bankruptcies, which could be filed by GM or Chrysler and what impact these various bankruptcy filings might have on dealers. Following is a summary of what we have learned.

Chapter 11 – Bankruptcy filing
As everyone knows by now, a Chapter 11 bankruptcy filing provides protection to the bankrupt entity from creditors while the entity attempts to "reorganize" itself in order to come out of bankruptcy as a viable, going concern.

We know that in all Chapter 11 bankruptcy proceedings, the court enters an initial order staying for a limited period of time payments due to creditors and legal actions being brought against the bankrupt entity. This provides the bankrupt entity some breathing room to begin to gets its financial house in order.

One requirement of a Chapter 11 bankruptcy is that the entity, known as the "debtor-in-possession," be in a position to demonstrate to the bankruptcy court that it has sufficient capital to operate while being reorganized under the bankruptcy court's protection. This is where we have seen significant discussion concerning whether or not the U.S. government will provide GM or Chrysler with enough cash through loans to allow the manufacturer to demonstrate that it can financially survive. This question remains unanswered.

If the bankrupt entity cannot demonstrate sufficient debtor-in-possession financing, then the creditors and/or the court can push the entity into a Chapter 7 – liquidation.

Assuming that GM or Chrysler can demonstrate sufficient debtor-in-possession financing, they then have the upper hand over creditors, in particular the unions, debt-holders and, unfortunately, dealers. At this stage, the bankrupt entity will present to the court a list of those agreements that should be rejected as part of creating a viable entity going forward. Certain types of agreements, known as "executory" contracts, can be rejected out-of-hand by the bankruptcy court with a minimal showing by GM or Chrysler that the entity cannot be viable under the terms of those contracts. Union contracts and dealer franchise agreements, among others, are considered "executory" contracts.

GM and Chrysler undoubtedly already have a list of the brands and dealers they wish to terminate by rejection of their dealer agreements. After this list is presented to the bankruptcy court, dealers will have the opportunity to argue that there is no rational basis for rejecting their particular franchise agreement over another dealer's agreement. Of course, in the situation of entire linemake discontinuance, these arguments will be limited. But, with regard to individual dealer agreement rejections where the brand is not being discontinued (i.e. Cadillac and Chevrolet), the dealer will have the opportunity to argue that there is no rational basis to eliminate his or her franchise as compared to those dealers within the market whose dealer agreements are not being rejected. Using dealership facilities, location and performance differences will be crucial in convincing the bankruptcy court not to accept the manufacturer's request to reject a particular dealer's franchise agreement.

For dealers whose franchise agreements are ultimately rejected, those dealers will be allowed to make a claim with the bankruptcy court to recover their damages. The claims would be eligible for payment in either a Chapter 11 or a Chapter 7 bankruptcy, likely for cents on the dollar. Though state franchise laws technically will not apply, it is our understanding that it will be in the bankruptcy court's discretion whether to allow payment of all or a portion of termination benefits called for under the franchise agreement and state franchise laws. These benefits generally include repurchase of certain new vehicles, parts and special tools.

Once certain dealer agreements and brands are rejected, and the union contracts and other debt-holder agreements are renegotiated so that they favor the manufacturer's long-term liability, the manufacturer will be ready to be released from bankruptcy with the court blessing the company's "reorganization plan."

'Good GM, bad GM' bankruptcy
This type of bankruptcy is the latest on the list of speculative maneuvers by GM to reshape itself into a viable company. It is our understanding that in this situation, GM would file for a Chapter 11 reorganization and seek to have certain contracts rejected as discussed above. In particular, it seems that GM would want to use the guise of a reorganization to seek to eliminate dealers in over-dealered markets for those brands which it intends to keep – known as the "good GM." Once GM completes this process, a new entity created outside of the bankruptcy, let's call it "New GM," would come to the bankruptcy trustee and offer to purchase the viable brands and associated assets of "Old GM." It is unclear to us whether the creditors to GM, sitting as a "creditor's committee" including bond holders, the UAW, suppliers and dealers would or could attempt to prevent the sale of these assets.

Assuming General Motors is successful in selling its profitable brands to "New GM," then at that point it is our understanding that the Chapter 11 will likely revert to a Chapter 7 liquidation with creditors lining up to take what they can get in the sale of the remaining assets.

In this scenario, the "New GM" would presumably assume those dealer agreements which are left after being culled in the reorganization proceedings and would negotiate new UAW and supplier contracts. We don't know what the new ownership structure would look like for "New GM," other than the U.S. government will likely have a large stake in the company.

Pre-packaged Chapter 11 – bankruptcy
This iteration of a standard reorganization filing involves an agreement ahead of time by the largest creditors to a renegotiation of contracts. After a renegotiation of those major creditor agreements (i.e. UAW, supplier and lenders), the bankrupt entity files for a "summary" Chapter 11 proceeding in which it seeks the formal rejection of the old contracts and acceptance of the new contracts by the bankruptcy court. Our understanding is that the idea behind this type of bankruptcy is that it (i) in theory allows for a relatively quick time period in which the entity is in bankruptcy thus saving substantial expenses and limiting damage to consumer confidence; and (ii) allows the bankrupt entity to limit the need for a showing of debtor-in-possession financing.

In our minds, the good news for dealers in this scenario is that unlike major lenders and the UAW, there is no single representative that GM or Chrysler could sit down with to negotiate which dealer agreements will be rejected and which will not. Thus, it is less likely that a pre-packaged bankruptcy filing would harm a large number of dealers. If GM or Chrysler begins to propose the rejection of certain brands and dealer agreements after the pre-packaged Chapter 11 filing is made, the proceedings will no longer be short in duration and will cause the manufacturer to lose the advantages of this type of bankruptcy proceeding.
Of course, as an initial matter, a pre-packaged bankruptcy will require the cooperation of the UAW and other major creditors, which at the time of this writing, is difficult to envision.

Chapter 7 – liquidation

As most folks know, a Chapter 7 bankruptcy proceeding involves the liquidation of the bankrupt entity. The assets of the entity are generally sold in order to pay creditors. Creditors are paid by virtue of their "position" as a secured creditor or an unsecured creditor. For most, if not all monies owed to them by the manufacturer, dealers would be considered "unsecured" creditors, which will leave them with pennies on the dollar for the amounts owed. It is important to remember that if debtor-in-possession financing is not sufficient or the creditors can make the argument that a reorganization is not practical, the bankruptcy court could unilaterally send GM and/or Chrysler into a Chapter 7 liquidation.

Dealers' claims against manufacturer in bankruptcy

1. Payment due from the manufacturer to dealers: As we have discussed in past articles in this column, monies owed to a dealer by the manufacturer at the time of the bankruptcy filing will at best be put on hold for some period of time before payment. Dealers will have to seek an order from the bankruptcy judge releasing monies to make these payments, such as warranty reimbursement and incentive payments, arguing that these payments are critical to covering dealers' expenses to allow them to remain open to sell and service cars. Dealers whose franchise agreements are retained would have to be paid these monies as part of the final reorganization plan. Dealers whose franchise agreements are rejected would be "unsecured" creditors in seeking these payments.

Conversely, monies that become due during the bankruptcy proceedings for payment of critical items such as warranty reimbursement will likely be paid. Shortly after the filing for Chapter 11 bankruptcy, the court enters an order directing that certain expenses "necessary" to the viability of the bankrupt entity continue to be paid in the normal course of business. It is expected that the court would agree that paying dealers to repair the manufacturer's vehicles is necessary to maintaining the viability of the manufacturer. Without those repairs continuing uninterrupted, consumers would rapidly lose confidence in the manufacturer's product. These payments may, however, not be made within the timeframe that dealers have become accustomed to but, instead, may be somewhat delayed.

2. Dealer litigation against the manufacturer: Dealers that have brought legal claims against the manufacturer prior to the bankruptcy filing will have their case put on hold and either settled within the bankruptcy proceeding or continued following the bankruptcy proceeding.

In the case of the good GM/bad GM bankruptcy scenario, for dealers who have brought litigation against GM pre-bankruptcy, depending on the ownership structure of new GM, there will be a strong argument that the new GM is the successor-in-interest to the old GM and thus should be added as a defendant to the lawsuit.

3. Repurchase obligations of the manufacturer upon a dealer's franchise termination: Dealers that have effected a "voluntary" termination of their franchise but haven't received payment for the repurchase of vehicles, parts, tools or any other item required under state franchise laws at the time of the bankruptcy filing would appear to be left with being in the position of an "unsecured" creditor in the bankruptcy proceedings.

Impact of bankruptcy filing on floorplan lender agreements

It is important to remember that your wholesale finance agreement is between you and your floorplan lender. Whether or not your manufacturer files for bankruptcy protection and whether or not your manufacturer repurchases your vehicle inventory as part of a rejection of your dealer agreement, the amount owed on your floorplan line is the dealership's responsibility. There will be very little that a dealership can do to avoid liability for the payment of the balance owed on the floorplan.

If a dealer's franchise agreement is rejected by the bankruptcy court and the court directs that vehicles be repurchased pursuant to either the franchise agreement or state franchise laws, then the dealership will be responsible for the difference between the balance on the floorplan and the amount paid by the manufacturer to your floorplan lender. There is typically a difference between what the manufacturer is required to pay for the vehicles – net cost paid by the dealer for the vehicle, less holdback, etc. – and the balance on the floorplan for that vehicle.

If a dealer's franchise agreement is rejected by the bankruptcy court and there is no payment for vehicle inventory, then the dealer is left with the likely situation of selling those vehicles (either as new or used, depending on the state of your new car license) for nickels on the dollar. The dealership will be responsible to the floorplan lender for any deficiency on the floorplan balance.

Most floorplan loans have an associated personal guaranty from the dealer/principal or primary owner of the dealership as well as a "cross-collateralization agreement" if the dealer has ownership in other franchises through separate corporations in order to secure the floorplan loan. If the dealership does not have the wherewithal to pay the balance on the floorplan line, the floorplan lender will next pursue the assets of the individual personally guaranteeing the loan and/or the assets of the related companies under the cross-collateralization agreements. At this stage, it is likely that the floorplan lender would be open to some compromise payment on the balance of the loan in exchange for not pursuing these personal or related-company assets.

Conclusion

No matter what situation a dealership finds itself in as it relates to a manufacturer bankruptcy and the fallout associated with that process, the dealer will need to be represented by experienced motor vehicle franchise counsel, as well as bankruptcy counsel in order to address the numerous pitfalls which will undoubtedly arise.

Richard Sox is a lawyer with the firm of Myers & Fuller PA, with offices in Tallahassee, Florida and Raleigh, North Carolina. The firm's sole practice is the representation of automobile dealers in their quest to establish a level playing field when they deal with automobile manufacturers.