DEFENDER
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Sidebar

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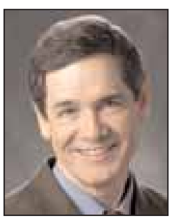
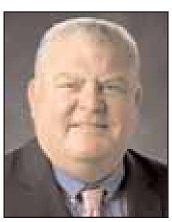
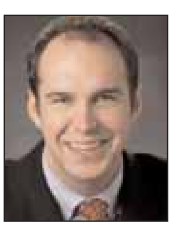


Lawrence Young



Wayne Kitchens



Patrick McCarren

Some Critical Issues in Automobile Dealer Bankruptcies – Part 1

Lawrence Young, Esq., Wayne Kitchens, Esq. and Patrick McCarren, Esq.

Introduction

Chrysler has filed Chapter 11 and is quickly selling its major assets to a new entity. General Motors will likely follow suit, creating the most complex bankruptcy ever filed. Dealer bankruptcies will inevitably follow. Here are some of the key critical issues that will occur in the ensuing dealer bankruptcies.

The Franchise Agreement as an Executory Contract

A. Assumption and Rejection of Executory Contracts. Under Bankruptcy Code §365 ("Code" or cited by section only), a debtor-in-possession ("DIP") may assume or reject its executory contracts. Assumption continues the relationship between the parties. Rejection is treated as a pre-petition contractual breach and creates an unsecured claim.

Assumption of an executory contract must be in the "exercise of a sound business judgment" and benefit the estate. To assume a contract in default, the DIP must cure the default and compensate for loss or provide adequate assurance of prompt cure and compensation. The DIP must also provide adequate assurance of future performance. Excluded from cure requirements, however, are defaults from (1) the debtor's insolvency or financial condition; (2) bankruptcy; (3) the appointment of a trustee or custodian and (4) penalties for failure to perform a non-monetary, contractual obligation.

Can a non-monetary default be cured? The 2005 Code amendments allowed cure of non-monetary defaults in a lease but not in other executory contracts, strongly implying that they are not curable and the contracts cannot be assumed.

Contract restrictions on assignment of executory contracts are invalid in bankruptcy. However, the DIP cannot assign (1) contracts which cannot be assigned under state law, (2) promises to make a loan to, or issue security for, the debtor, and (3) expired leases.

B. Franchise Agreements as Executory Contracts. An executory contract is one that remains materially unperformed by both parties. Franchise agreements have continuing mutual obligations. They are executory but differ from other executory contracts. A franchise imposes a duty to maintain the goodwill of the franchisor's name and trademark. From the franchisor's perspective, one bruise to a franchise's reputation can damage the entire franchise system. For the franchisee, its most critical asset is its franchise agreement. Assumption and

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President's Message

Rob Cohen

On May 18, 2009, I requested a special board meeting to discuss what more the NADC could be doing to assist dealer attorneys during these unprecedented times. Before batting around various ideas, though, we went back and reviewed our charter to help focus on what our role should be.

In September, 2004, the founding directors agreed upon the following:

The NADC will concentrate on:

- Information Resources (including the network of members sharing information; a website and members-only list serve for quick query and response; and publications, such as CounselorLibrary.com's Spot Delivery® for all members);
- Education (including periodic meetings and presentations on issues of interest or concern to members and for which members can earn continuing legal education (CLE) credit);
- Leadership (including developing and issuing position papers and formal position statements; becoming a resource to state attorneys general; and filing amicus briefs); and
- Specialty Sections (as the membership grows, NADC will develop appropriate specialty sub-sections to offer information and support on specific concerns).

In keeping with this charter, the Board decided to take the following actions:

1. Create a separate "auto bankruptcy" list serve at bk.list@dealercounsel.com. All current list serve subscribers have been added to this list automatically. For those who would prefer not to receive bankruptcy-specific email discussions, an opt-out mechanism is available.

   Of course, for this to work, members must post bankruptcy-specific postings to

   bk.list@dealercounsel.com

   rather than the "whole membership" list at

   list@dealercounsel.com.
2. Conduct additional webinars regarding the Chrysler and hypothetical GM bankruptcies.
3. Create an ad hoc Bankruptcy Committee to provide assistance to NADA and/or the firms representing affected dealers. This new committee will also meet to discuss further actions and/or offerings.

The Board has moved quickly on these items and will continue to work on new projects as necessary to ensure our membership is kept up-to-date. In the interim, please feel free to contact me or Jack Tracey if you have any questions, comments, or concerns.

Rob Cohen, President of Auto Advisory Services, Tustin, CA, is President of NADC.

Do You Have a Memo or Article on a Legal Issue?

We are always looking for submissions to publish in the Defender. Have you done a memo on a legal issue that is important for dealers? Do you have a firm newsletter or bulletin in which you have published an article important for dealers? If so, we could use it in the Defender.

Please send any proposed contributions or proposals for articles to mike.charapp@cwattorneys.com

Advising Your Clients: Standing Your Ground Against Floorplanners

Les Stracher, Esq.

Les Stracher

It is not news that creditors serving dealers, including those that have extended floorplan lines, have been engaged industry-wide in attempts to renegotiate those credit instruments. The goals they attempt to achieve are not always the same. In some instances, the creditor seeks to re-price its loan to regain profitability lost in current money markets. In other instances, the creditor seeks greater security or capital contributions to increase working capital. The instinct of your dealer client will be to look at the draconian documentation from the creditor and decide it has no alternative but to accede to the creditor's demands. In an environment where dealerships are unlikely to find a substitute finance source, defending the rights of a dealer, who is not in monetary default, to continue the lending relationship will be critical to your client's survival. This article reviews and explains some of the defenses and approaches you may want to review with your dealer client.

Forbearnace or Forbearance Lite

One disturbing aspect of the conduct of the creditors is their practice of notifying the dealer of some perceived non-monetary default and then sending a letter that, at the same time, notifies the dealer of the default and asks the dealer to agree to a forbearance agreement. The terms of such agreements typically include an admission that the dealer is in default (whether it is or not), a time frame for the dealer to meet the demands for additional concessions as a condition of forbearance, and a stipulation for the entry of a consent judgment in the event that such demands are not met within the time frame provided. These agreements also typically contain waivers of jury trial as well as consents by the dealer to extraordinary remedies such as injunctive relief and the appointment of a receiver.

Desperate times call for desperate measures and your dealer client, seeking relief of its financial straits, may feel especially vulnerable and sign such an agreement. Hoping to obtain the additional rights and remedies as well as the damaging admissions of the dealer, the creditor will try to reassure the dealer of its earnest desire to continue their relationship and that the forbearance arrangement is a means of reaching that end. No dealer should enter a forbearance agreement without a thorough review by a professional who approaches the task with suspicion and skepticism.

Two obvious approaches to a forbearance agreement are to declare war or negotiate an uneasy peace (forbearance lite). If your client is inclined to negotiate terms, then negotiate to remove the admissions, executory provisions and waivers of jury trial, and attempt to get the creditor to accede to an offer of additional capital, additional securitization or some other form of incentive (such as a re-pricing of the loan). After all, you can argue, why should the creditor insist on admissions and waivers if, in fact, it feels that it has a strong case for declaring a non monetary default. In short, ask the creditor to show the courage of its convictions by leaving in place the arms length agreement that was originally entered, supplemented by the new concessions to which the dealer agrees.

Setting Up A Defense

Should your client elect to stand and fight, there are a couple of steps that it should take. The underlying arguments of the dealer will be breach of contract, estoppel or fraud in the inducement. If your client is not in monetary default, courts will be far more receptive than ever before to these kinds of arguments. If the creditor is attempting to avail itself of language that allows it to declare a default if it deems itself insecure, an action for declaratory relief may also be appropriate.

While counsel for the creditor will doubtless argue that the exact language contained in its instruments is inviolate, there are several other arguments that may meet with some success, although this may vary from jurisdiction to jurisdiction. The first argument is that the creditor has, in the past, forgiven what it now argues is a non monetary default, and in so doing, has modified the loan instruments through its course of dealing. The second is that the creditor solicited your client and

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assignment of the franchise are often critical to a successful reorganization.

C. Assumption and Rejection of Vehicle Dealer Franchise Agreements. In the leading case of *In Re Pioneer Ford Sales, Inc.*, 729 F.2d 27 (1st Cir. 1984), a Chapter 11 debtor, a Rhode Island franchisee sought to assign its Ford franchise to Toyota Village. Rhode Island law, like many states, provides "[n]o dealer. . . shall have the right to . . . assign the franchise. . . without the consent of the manufacturer, except that such consent shall not be unreasonably withheld..."

The First Circuit Court of Appeals ruled that Ford reasonably withheld its consent to assignment. The Toyota dealer had incurred several years of losses, was deficient in working capital and also did not provide adequate assurance of future performance. Accordingly, Ford was "perfectly reasonable" in withholding its consent to the assignment.

Courts have also disallowed assumption and assignment because the debtors could not cure a nonmonetary default. The debtors in *In re Claremont Acquisition Corp., Inc.*, 113 F.3d 1029 (9th Cir. 1997), defaulted on GM and Ford franchise agreements by failing to operate the franchises for seven consecutive business days. The Ninth Circuit Court of Appeals ruled that curing the nonmonetary default was impossible because it was an historical default with no penalty provision.

Floor Plan Financing – Operating "Out of Trust"

Dealers go "out of trust" by keeping money from the sale of vehicles securing a floor plan instead of remitting their wholesale price to the floor plan lender. Upon discovery, the floor plan lender may foreclose on the dealer's inventory. Accordingly, when a dealer goes out of trust, Chapter 11 may follow.

Dealers who are "out of trust" create their own bankruptcy issues. Under §523(a)(6), debtors cannot discharge liability for debts resulting from willful and malicious injury to another's person or property. Under §523(a)(4), embezzlement and other fiduciary defalcation are also non-dischargeable. In the right circumstances, "out of trust" can fit both characterizations. Similar non-dischargeability issues arise when dealers fail to remit 941 payroll taxes, state sales taxes or fuel taxes, and other funds held "in trust" for creditors.

Some courts hold that an officer of a dealership who actively participates in the conversion of vehicle proceeds is personally liable to the floor planner and the personal debt is non-dischargeable in his or her bankruptcy. Additionally, one court has held that §523's non-dischargeability provisions apply only to individual debtors and not to corporations.

Other issues that arise with an "out of trust" dealer in bankruptcy are (1) whether the court should appoint a trustee under §1104; (2) whether to convert the case to Chapter 7 or dismiss it under §1112, and (3) whether the debtor should be allowed to use cash collateral under §363. The court may appoint a trustee for cause, including fraud, dishonesty, incompetence, or gross mismanagement. Selling vehicles "out of trust" does nothing to endear the dealer to the bankruptcy court.

Finally, a DIP may not use cash collateral unless each entity with a security interest in the cash collateral consents. A floor plan lender has a security interest in vehicle proceeds and must consent to their use or have the Bankruptcy Court adequately protect their value. The inability to use cash collateral leads to a very short stay in the Chapter 11 model.

A Word About Dueling Bankruptcies

With both manufacturers and their dealers in Chapter 11, there will be dueling bankruptcies and dueling automatic stays. Manufacturers will want to reject dealer franchises but they (and their bankruptcy court) will

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induced it into doing business by persuading your client that their commercial relationship would be more akin to a joint venture than that of a borrower and lender. There is, of course, also the argument of forgiveness of past nonmonetary defaults creating a course of dealing modifying the terms of the loan documents.

To augment these arguments your client should go through emails, letters, notes, and any other documentation from the creditor it may have received. Not so long ago, floorplanning loans were coveted by creditors, and more and more lenders were getting into the market, and the market became more and more competitive. Typical of representations made by creditors was that they were after a "relationship" that was broader than merely that of a lender and depository; that, in fact, they wanted to be your client's partner, grow together, and the like. Your dealer should also look into its own records to determine whether there were occasions when breaches were declared and forgiven without a request for forbearance. The conduct of the creditor, in this regard, should be used to weave a story before the court to impress the trier of fact with the creditor's past easy-going practices and to contrast those with their sudden alarm. It is important to stress to the court, as well, that the effect of granting the relief sought would, in effect, destroy your client's business.

A slightly different approach may need to be adopted if the credit is based on a demand instruments or term loan. In a demand loan, the creditor will not need to justify having decided to call the loan based on any perceived breach of covenant or default. It will simply declare the loan due. This is distinct from the situation where the creditor declares a default because, for example, under the terms of the documents it deems itself insecure. Again, when dealing with a demand note, one should look to the representations made to the dealer and its past relationship with the creditor. The goal should be to establish that, based upon the expectations that both parties had of the business relationship, the actions of the creditor are precipitous and contrary to the expectations of your dealer client that the arrangement was to be for a longer term than the creditor now desires. Again, these arguments may be augmented through your client's own documentation and the conduct of the creditor in soliciting your client's business.

In keeping with the strategy that the best defense is a good offense, you should review the law in your jurisdiction for liability under applicable statutes which lend themselves to broad application (*e.g.* ECOA redlining claims based on the demography of your client's customers or RICO). You may feel, as I do, that you can afford to be a little more creative when your client has nowhere else to turn. In the same vein, you may want to consider whether the creditor has engaged in a pattern of attempting to terminate other non monetary defaulting customers. Surprisingly, I have had creditors admit they are engaged in trying to find defaults to re-price their dealers. I think this is, to say the least, a damaging admission. The argument that the dealer segment is now suddenly being singled out for this sort of treatment may help shore up your argument for estoppel and/or help establish a predicate for filing a class counter claim against the creditor, and therefore, obtain the ability to engage in class discovery. One might want to also explore whether there was collusion among the community of creditors in your locale to engage in industry-wide re-pricing (or at least consider making that allegation). Finally, you should not overlook whether there may be purely administrative remedies available.

Conclusion

There can be no doubt that, given the fluidity of the current environment, advising your client is going to be difficult. It should be noted that I am not attempting to predict anyone's chances of success should a case be filed against your dealership by the creditor. Moreover, it should be understood this article only applies to those dealers

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who are not in monetary default. However, at a minimum these arguments create a useful template for framing a defense and a vehicle for incentivizing the creditors to engage in productive dialogue and negotiations with your dealer client who, after all, is only asking the creditor to allow it to continue to perform on its loan.

Les Stracher is a Shareholder with Rothstein Rosenfeld Adler, PA, in Fort Lauderdale. He is the Chairman of the firm's Automotive Law Practice Group and advises dealers on mergers and acquisitions throughout the country.

New Members

NADC welcomes the following new members:

Full Members

Charles G. Cole
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Kyle Harnek
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Dallas, TX

John Sande IV
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Reno, NV

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be stayed by the automatic stay in the dealer bankruptcy. The automatic stay of §362(a) stays "all entities" from "any act to exercise control over the property of the estate." The franchise agreement is the essential property of the dealer's Chapter 11 estate.

In the meantime, dealers in Chapter 11 may not be able to assume the franchise agreement either. Assumption could be deemed control of the estate property in the manufacturer's bankruptcy. It is a standoff.

One thing is certain, however. Dueling bankruptcies between manufacturers and dealers are the mysterious, dark forest of the Bankruptcy Code. Few dealers, if any, have ever ventured there and fewer still will find their way out.

Lawrence Young, a partner at HughesWattersAskanase (www.hwa.com) in Houston, Texas, wrote part of the Bankruptcy Code and was involved in two successful bankruptcy cases in the United States Supreme Court.

Wayne Kitchens is a co-managing partner at HughesWattersAskanase with more than 20 years of business bankruptcy experience.

Patrick McCarren is an associate at HughesWattersAskanase and practices bankruptcy, commercial finance and commercial real estate.

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Michael Charapp, Editor
mike.charapp@cwattorneys.com
Trudy Boulia, Assistant Editor
tboulia@jpharveylaw.com
Defender, The NADC Newsletter is published by the National Association of Dealer Counsel
7250 Parkway Drive, Suite 510
Hanover, MD 21076
410-712-4037
Fax 410-712-4038
www.dealercounsel.com