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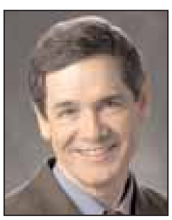
Some Critical Issues in Automobile Dealer Bankruptcies – Part 2

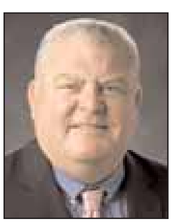
Sidebar

Contents:

Feature Articles 1, 2, 3
Board of Directors 6
New Members 8



Lawrence Young



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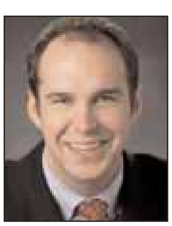


Patrick McCarren

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

Part one of this article appeared in the May issue of the Defender and dealt with the dealer's franchise agreement and "out of trust" issues in bankruptcy reorganizations. If you need a copy, please email the editor at mike.charapp@cwattorneys.com or the authors at lyoung@hwa.com.

Critical Vendors – the Doctrine of Necessity

The Chapter 11 debtor in possession (DIP) will file a series of "first day motions" seeking the court's approval for acts necessary to keep the debtor in business. The rationale behind them is the *doctrine of necessity*, a doctrine historically founded upon §105(a) which states that "a court may issue any order . . . that is necessary or appropriate to carry out the provisions" of the Code.

Under this doctrine, debtors seek to pay critical vendors in full because these vendors will stop supplying the debtor unless the debtor can pay them. The vendor may (1) represent the only source of essential goods or services, (2) provide them at a lower price, or (3) be unable to survive without payment of pre-petition claims. The debtor decides which vendors are critical but the court must approve payment.

The court in *In re Coserv, L.L.C.*, 273 B.R. 487 (Bankr. N.D. Tex. 2002) announced one of the stricter definitions of "critical vendor"- unless the debtor deals with the vendor, it risks loss to the debtor's estate or going concern value that is disproportionate to the vendor's pre-petition claim. There must also be no practical or legal alternative to dealing with the vendor, other than payment of pre-petition debt.

The Seventh Circuit in *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004) tried to obliterate the doctrine of necessity. It held that §105 "does not create discretion to set aside the Code's rules about priority and distribution; the power conferred by §105(a) is one to implement rather than override." Accordingly, an order under §105 must find support in, or not contradict, another provision of the Code. The Seventh Circuit concluded that §105(a) does not permit a bankruptcy court to authorize full payment of any pre-petition debt unless all creditors of the same class are paid in full. Nevertheless, they left a glimmer of hope that §363(b)(1), which authorizes use, sale, or lease of estate property other than in the ordinary course of business, allows the court to pay "critical vendors" in full.

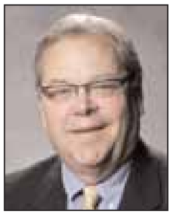
Key Employee Retention Plans ("KERPs")

Chapter 11 debtors want to retain knowledgeable employees.

continued on page 5

Safety Recalls

Michael G. Charapp, Esq.



Michael G. Charapp

May the National Highway Transportaton Safety Administration (NHTSA) require an auto dealer to remedy defective equipment manufactured by an independent third-party manufacturer that is no longer in business? The answer: probably not, but other issues complicate this answer.

The safety recall regulations and requirements developed by NHTSA have been codified in Title 49 of the U.S. Code. That law targets motor vehicle manufacturers as the responsible parties for remedying safety defects. It does not require motor vehicle dealers to remedy defects on their own, without the manufacturer. When a motor vehicle equipment manufacturer goes out of business, there is no one to look to for the prescribed remedy, and the law does not provide for a “finger-pointing” interpretation that would draw dealers into liability for remedying defective equipment.

Saleen is a recent example. The company retrofitted Ford Mustangs to create performance vehicles. Saleen operated through select Ford dealers who sold vehicles with Saleen equipment installed. Saleen is now out of business, and another company acquired its assets, but it did not assume liability for warranties on the vehicles. This raises the issue of whether Saleen dealers may be liable for repairing or replacing a Saleen vehicle in the event of a recall, as is normally required of manufacturers under the recall regulations developed by NHTSA.

The Motor Vehicle Safety Act (the “MVSA”) assesses the bulk of responsibility for solving recall issues on a manufacturer, as opposed to a dealer. Specifically, the MVSA defines motor vehicle equipment to include “(A) any system, part, or component of a motor vehicle as originally manufactured; (B) any similar part or component manufactured or sold for replacement or improvement of a system, part, or component, or as an accessory or addition to a motor vehicle.” 49 U.S.C. §30102 (7). Certainly, under this definition, the aftermarket products developed, manufactured, and fitted to vehicles by Saleen qualify as motor vehicle equipment. The definitions also specifically delineate between dealers and manufacturers, and it is clear from these definitions contained in 49 U.S.C. §30102 that Saleen was a manufacturer, and the selling dealers qualify as dealers under the statute.

The MVSA specifically assigns responsibility and liability for instances where defects and/or noncompliance are found prior to the sale of a vehicle to a buyer. 49 U.S.C. § 30116 (a)(2) states that, in such cases, “the manufacturer or distributor immediately shall give to the distributor or dealer at the manufacturer’s or distributor’s own expense, the part or equipment needed to make the vehicle comply with the standards or correct the defect.” Subsection (b) of the same section then imposes a duty on the dealer to install the complying equipment within a reasonable amount of time after receipt from the manufacturer.

When a defect is discovered after sale to the buyer, § 30120(a) of the MVSA sets forth three options for remedying the defect: repair, replacement or refund. These three obligations are directed specifically to the manufacturer, however, and not to the dealer. 49 U.S.C. § 30120 (a) (“[W]hen notification of a defect or noncompliance is required under section 30118 (b) or (c) of this title, the manufacturer of the defective or non-complying motor vehicle or replacement equipment shall remedy the defect or noncompliance without charge when the vehicle or equipment is presented for remedy.”)

There seem to be no provisions in the MVSA itself allowing for third-party liability in instances where manufacturers go out of business. The law mandates that a “manufacturer shall

continued on page 4

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Internet Sales – Driving Without a Map

Tom Hudson, Esq. and Cathy Brennan, Esq.

Dealers who sell cars using the Internet are operating in an area where there isn't much of a legal roadmap. There are very few state laws that deal directly with Internet sales, and, as usual, when the legislatures haven't weighed in with guidance, the courts have to sort things out.

That's beginning to happen. We watch the reported cases that deal with Internet sales, and we'd guess that there have been perhaps 10 reported cases on this subject. Nearly all of the cases have dealt with whether an unhappy customer who has bought a car from a dealer in another state can sue the dealer in the customer's home state.

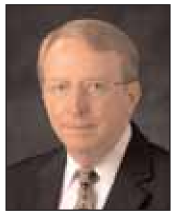
A recent case that we saw offers an interesting twist on this question – can a seller who sells to a buyer in another state sue the buyer in the seller's home state. Let's look at what happened.

Llexcyiss Omega and Dale York of Indiana listed a Porsche for sale on eBay, the auction website. The listing provided that the winning bidder was required to arrange and pay for delivery of the car.

Richard and Marlene Attaway of Idaho bid and won the auction. They paid Omega and York through PayPal, an online payment service owned by eBay.

The Attaways arranged for a transporter to deliver the car. After taking delivery of the car, the Attaways filed a claim with PayPal seeking a refund, stating that the car did not match the eBay auction listing. PayPal denied the refund and told the Attaways to work with the sellers.

The Attaways ultimately got their credit card company to refund their



Tom Hudson

Cathy Brennan

money, and Omega and York sued the Attaways in small claims court. The Attaways moved to dismiss, claiming lack of personal jurisdiction.

The trial court denied the motion, and the Attaways appealed to the Indiana Court of Appeals. The Attaways claimed that the Indiana courts lacked either general or specific personal jurisdiction over them. General jurisdiction exists where the party's contacts are so continuous and systematic in a state that the party should reasonably anticipate being haled into the courts of that state. Specific jurisdiction requires that the party purposefully avail himself of the privilege of conducting activities within the forum state and that the conduct would make the party reasonably anticipate being haled into court.

The appellate court noted that it could not locate any other case in which a seller sued a buyer for rescission of payment after the buyer collected the item from the seller. The appellate court found that the Attaways knew of the sellers' location before bidding. Additionally, the Attaways agreed to appear in Indiana to pick up the car when they submitted a bid.

The appellate court concluded that these facts satisfied the requirements for personal jurisdiction, finding that the Attaways purposefully availed themselves of the privilege of conducting activities in Indiana such that they should have anticipated defending a lawsuit there.

This case may prove useful for a dealer who needs to bring an action against an out-of-state buyer who bought a car over the Internet. Be warned, though, that this is a developing area of the law, and that courts may well come to different outcomes on similar facts.

Internet selling is one of those areas that will be a legal minefield until laws or court decisions give us more guidance. If your dealership clients are active in this area, and most are, it might be time to put on a seminar for them to alert them to potential risks and liabilities.

Attaway v. Omega, 903 N.E.2d 73, 2009 Ind. App. LEXIS 515 (Ind. App. Mar. 13, 2009)

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Safety Recalls ... from page 2

pay fair reimbursement to a dealer providing a remedy without charge under this section." 49 U.S.C. § 30120(f). No case has interpreted this subsection, and there is no basis to leap to a conclusion that a dealer bears the burden of repair and the risk of non-payment of reimbursement.

While the MVSA may not pose problems for dealers, however, state laws may be a different story. There have been cases discussing the interplay between and applicability of the MVSA and various state law claims. In an unreported decision, the Eastern District of Michigan found that it was clear that the remedial provisions of the MVSA were not intended by Congress to be exclusive, but rather that they were "in addition to other rights and remedies under other laws of the United States or a State." *In re Ford Motor Co. Speed Control Deactivation Switch Prods. Liab. Litig.*, 2007 WL 2421480, *5, (E.D. Mich. Aug. 24, 2007). Additionally, the Northern District of California held that the language of § 30103(d) of the MVSA made it clear that Congress intended consumers to have access to claims under both the MVSA and State law. *Chamberl v. Ford Motor Co.*, 314 F.Supp.2d 953, 960 (N.D.Cal.2004).

Under state laws, dealers may potentially face claims based on products liability, strict liability, negligence, breach of implied warranty of merchantability and/or fitness for a particular purpose, and possibly other bases. While there are issues for dealers under these theories, proof in support of an action by a plaintiff can be difficult. In products liability actions, which are based upon theories of negligence, breach of warranty and strict liability (and combinations thereof), the claimant must prove the existence of a defect, the causal link between the defect and the injury claimed, and also the attribution of the defect to the seller.

Actions for breaches of implied warranties also have problems for plaintiffs. Most dealers disclaim implied warranties in the sales of motor vehicles in states where that is permitted. Even in states where that is not permitted, or where permitted but limited by law (for example, the federal Magnusson Moss Warranty Act provides that implied warranties cannot be disclaimed but can only be limited to the duration of an extended service contract sold with a vehicle), the burden on the plaintiff is still significant. The plaintiff must prove that the vehicle *was sold with a defect* that actually renders the vehicle unmerchantable or unfit for its particular purpose.

Finally, state lemon laws must be considered. Most state laws make such lemon laws applicable only to the manufacturer. However, some state laws are applicable to manufacturers and to dealers. In those cases, a vehicle that is tendered to a dealer for repair but remains unrepaired could trigger dealer obligations.

Consequently, for any dealer of a product of a defunct manufacturer presented with a recall problem, the answer is far from obvious. The MVSA may not impose on that dealer the obligation to solve the problem for the customer. However, state laws may be an issue. And one can never disregard the desire of a dealer to satisfy its customers.

Michael G. Charapp is a partner in the McLean, VA law firm of Charapp & Weiss, LLP who specializes in the representation of motor vehicle dealers and their trade associations.

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Some Critical Issues ... from page 1

Accordingly, debtors will seek court approval to pay employees' salaries for pre- and post-petition work and provide retention incentives for key employees. Employees need some incentive to stay aboard a "sinking ship." Thus, debtors use a KERP to persuade "key" employees to stay and operate the business.

Prior to 2005, critics questioned providing incentives to "key" employees. In most retention plans, the "key" employees are the debtor's upper management and directors who forced the company into bankruptcy. In light of this criticism, the 2005 Code amendments restricted key employees' incentives.

A. Retention Payments. Under §503(c)(1), payments to retain an insider are prohibited unless (1) the payment is essential because of a bona fide competing job offer at the same or greater compensation, (2) the insider's services are essential to the business's survival and (3) one of two payment limits are met. The employee must have an actual, legitimate job offer and must be willing to take the offer. All components of compensation are considered in determining if the offer is the same or better. Strangely, this "retention" provision encourages the employee to find another job.

B. Severance Payments. Under §503(c)(2), no severance payment to an insider is permitted unless (1) the payments are part of a program for all full time employees, and (2) the amount of the payment is not greater than 10 times the mean severance payment "given" to non-management employees during the calendar year. This provision embodies uncertainty.

First, the term "given" indicates that the calculation should be based on the actual severance paid to non-management employees instead of the mean payment for which they are eligible. Secondly, the term "non-management employees" is not defined in the Bankruptcy Code. Finally, it is uncertain (1) whether an insider's severance payment is precluded until the end of the calendar year, since it is impossible to calculate the mean severance "given" to non-management employees until year-end or (2) whether the "mean" language refers to the year up to time of the termination.

C. Payments Outside the Ordinary Course. Section 503(c)(3) precludes payment of "other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case." Unlike §§503(c)(1) and 503(c)(2), this section applies to all employees, not just insiders. Thus, if a transaction is in the ordinary course of business and applies to all employees, §503(c)(3) will not apply. Accordingly, a DIP may structure compensation for key employees as a management incentive plan (MIP) under the more lenient standard of §503(c)(3). The more the bonus depends on performance, the more likely it will be considered a MIP.

A Word About Dueling Bankruptcies

With both manufacturers and their dealers in Chapter 11 as a result of the Chrysler and probable GM bankruptcies, there will be dueling bankruptcies and dueling automatic stays. Manufacturers will want to reject dealer franchises but they (and their bankruptcy court) will 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.

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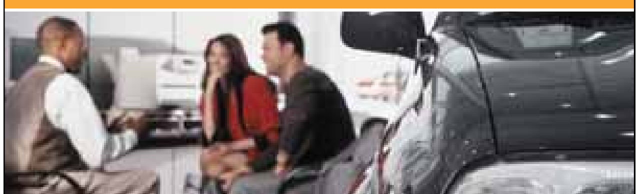

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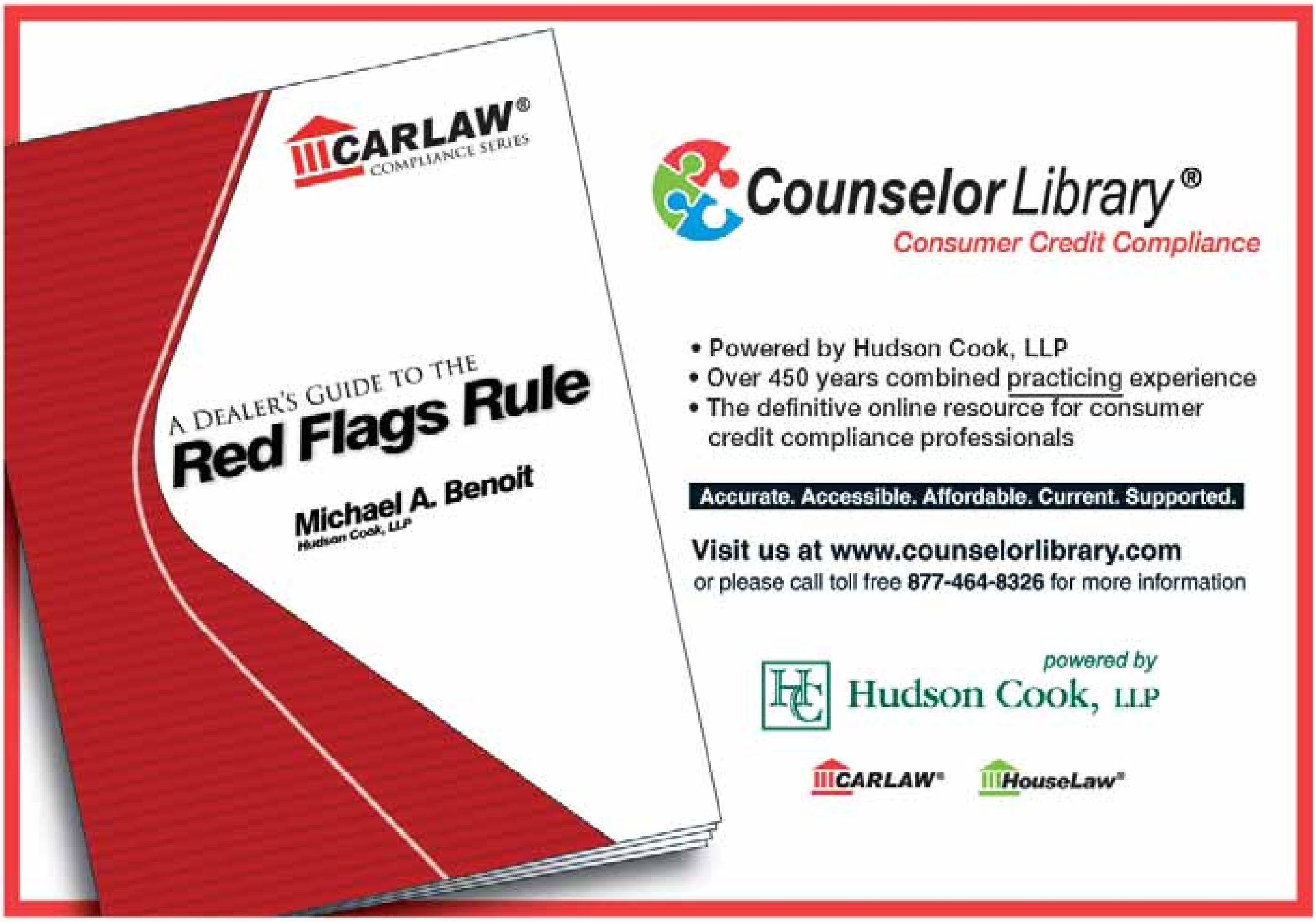

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