“DISASTER PACK” - December, 2008

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Those of us who were fortunate enough to live through the relatively carefree years of the 50s remember that the real downer was the threat of nuclear war with the Soviet Union. Threats that necessitated air raid drills in school (getting under your desk, as if that would do any good) and the self-contained bomb shelters with their radiation-proof ventilation systems that you just had to have buried in your backyard. You were supposed to stay in those things for two weeks and if you didn’t strangle the other members of your family, you could get out, walk around and presumably be okay.What nobody thought of was that there wouldn’t be any living vegetation for miles and that the radioactivity of everything around you would be fatal, but, in any event, they were the rage. For the well-appointed bomb shelter (or your basement for those of us who couldn’t afford bomb shelters), you were supposed to have a checklist with provisions, etc., which was commonly called a “disaster pack.” Given today’s rather radioactive times, the good folks at NADC (the National Association of Dealer Counsel for whom this original was originally written) thought we might develop a dealership advice “disaster pack” in case of one or more catastrophic events. This article could not, of course, be exhaustive, and is simply a compilation of bullet points that, in my opinion and experience, dealers should be aware of and reviewing during this time.

1. Employment – On the employment front, a major issue would seem to be the applicability of the Federal Worker Adjustment and Re-Training Notice (WARN) Act. The WARN Act applies to businesses with over 100 employees and requires a 60-day notice if an employer is going to lay off over half of the workforce at a particular location. The 100-employee mark is subject to some calculation adjustments (i.e., no part-time employees, etc.). Most dealerships, if they have not already done so, are in the process of trimming their work staffs at this point.

You might wish to note that a WARN Act class action is in the works against the Bill Heard dealerships. As cutbacks are made, I have been stressing for employers to be sure, if possible, to stay below the 100-employee limit, although there is a 90-day rolling look back and look forward as to the number of employees subject to layoffs. Care should be taken to check appropriate state WARN Acts also, for if the state act gives greater protection than the federal, the state act will be applicable. Otherwise, the federal act supersedes state law. Also note that employees of a dealership in bankruptcy are given priority claim status for WARN Act violations. There are a couple of bankruptcy issues if the dealership, not the manufacturer, takes bankruptcy.

A. Layoffs versus Layoffs Without Recall versus Termination – In most states, a layoff has a connotation that an employer will call people back. This course of action could be fraught with discrimination claims, depending upon minority mix, gender, age, etc. I counsel that the safest method of layoff is performance-based, based upon statistics, for example, over the past year. If done correctly, those are generally foolproof from successful challenge.

I spoke to a dealer recently who wanted to lay off four salespeople. He wanted to retain a white employee over age 50 because he was sure the white employee would sue. He was willing to lay off an African-American employee who was a bit more productive but was a gambler, had bad work habits, etc. (the usual story about keeping someone he never should have hired in the first place).

After going through performance standards, he is going to lay off the over-50 individual, take his chances and start properly disciplining the minority employee. It's best to run through, in some detail, layoffs with your lawyer so you understand the appropriate standards, protocol, etc. I generally counsel dealers that they should simply terminate employment because of lack of work; then, there is no question concerning any recall rights. Occasionally, a dealer will make a choice to use the term "layoff" and I counsel them that they should do so with the terminology of "layoff, lack of work with no right or possibility of recall." Employees are going to have unemployment compensation rights anyway, so the more you try to sugarcoat a bad situation, the worse off you can be. If you have a good, solid employee handbook in place, follow the provisions of the handbook.

B. Expect your unemployment compensation rate to increase. It is simply a factor of employees drawing unemployment.

2. Lending relationships – If you have a current floorplan provider, keep them. Floorplan shopping is almost impossible at this point. Review your floorplan agreements, as well as mortgage loan documents. Many lenders are trying to strong-arm their way out of lending relationships they have with dealerships that are still profitable and have never had any credit problems or other covenant issues. Make sure that loan ratios and other loan covenants have been met and can be maintained.

Don't let a floorplan lender try to increase the cost of capital or increase their security position, if such actions are not allowed in the loan documents. Don't let them get away with the argument that they are "insecure." That argument is for Linus of Charlie Brown fame. Make sure you are not out of trust. There is virtually no defense to an out-of-trust situation and there is substantial bankruptcy case law holding that debt to be non-dischargeable. Also, beware of lenders that are trying to reduce the pay-off time midstream. Push back against any attempt of this sort or against unreasonable curtailment demands. During the past few weeks, compromises have been able to be reached assuming the dealer is not out of trust.

3. Cash Management Account – Take steps to guard your cash management account. Your cash management account could be an unsecured debt in the event of a manufacturer bankruptcy if it is maintained by a factory division or subsidiary. One possible step that, to my knowledge, has not yet been taken by a dealer is to request that the Cash Management Account be held in a separate trust account or be transferred to an FDIC insured national bank. By making that request, the dealer may have heightened the obligation of the holder of the account to a "trust account" status, which might give a claim some priority if the account holder filed a Chapter 11 Reorganization. I have been advising dealers to get money out of cash management accounts and if they wish, pay down used car floorplans.

Depending upon the amount of water they have in their used car inventory, this course of action could be a much safer investment. The dealer's cash management account terms would need to be checked, as that might affect capital requirements under various loan documents. In any event, I think it's worthwhile to retrieve that money, if possible. The future of the domestic three auto companies will probably be determined by the end of the first quarter next year. Certainly, within one year we will know what will happen with those manufacturers.

4. Factory Accounts – Bankruptcy experts are not in agreement as to holdback. Since holdback is generally credited to the general factory account, it might be deemed to be an unsecured debt. Again, one step that might be taken is to write a letter to the factory asking that holdback amounts be placed

into a separate trust account (although it might be permissibly commingled with other dealers' holdback monies). If it were in a separate trust account, then some of the bankruptcy experts I have spoken with believe the holdback would probably be deemed a "fiduciary" or "trust" type of payment and would be given some priority in the bankruptcy. Positive parts accounts, reserves, warranty claims, rebates or other incentive payments would only qualify for general creditor status, and hence could be subject to a cram-down in a Chapter 11. Most people understand that the difference between a Chapter 11 bankruptcy and a Chapter 7 bankruptcy is that Chapter 7 is a liquidating bankruptcy. The company will, in fact, cease operations and liquidate. A Chapter 11 bankruptcy is different in that the company will formulate a plan subject to approval of various creditor committees of the court, seek to implement that plan and come out of bankruptcy, theoretically capable of remaining viable. In a Chapter 11, there must be sufficient cash flow to meet current obligations. Past obligations and contracts are subject to being modified, voided or "crammed down" in terms of dollar amount.

There are some obligations that might not be subject to setoff; however according to bankruptcy experts, Section 553 of the Bankruptcy Code could allow setoff of obligations owed by the dealer to the factory against amounts owed by the factory to the dealer. However, there are certain procedural requirements which are necessary in order to perfect a right of setoff. A filing in the manufacturer bankruptcy case would be necessary to set up the claim. Post-filing debts are not subject to setoff, only that debt which exists at the time the manufacturer filed the petition. The setoff can only go to debts involving mutual obligations, which in my judgment, would be factory account transactions. However, any excess obligations owed by the factory would be in the nature of a general, unsecured claim. Therefore, dealers would be general creditors with regard to those amounts and subject to a cram-down or extended pay and would probably only be worth pennies on the dollar. You should be proactive with regard to trying to obtain prompt payment of any amounts and particularly amounts in excess of your obligations. This is why I advise clients to keep their factory accounts as lean as possible.

Undoubtedly in a Chapter 11, manufacturers would continue to make parts available. Obligations to parts suppliers would be current accounts, and while the past-due balance would be subject to cram-down, current obligations after the date of the bankruptcy would need to be paid. Again, certainly a manufacturer seeking to exit from bankruptcy and continue business is going to make parts available. If any manufacturer was unfortunate enough to declare Chapter 7 or show during the operation of the Chapter 11 bankruptcy that they could not sustain their business and be converted to a Chapter 7, then everything would cease. At that point, the result would be catastrophic for those having anything to do with that manufacturer. As to manufacturers' vehicle warranties, certainly in a Chapter 11, the manufacturer will continue to honor warranties since they want a market for their vehicles after exit from bankruptcy.

5. Franchise Alignment – In the event any of the three domestics merge, file Chapter 11 or otherwise, those dealers who are properly aligned with product lines will have, in my opinion, a higher chance of survival. There is little doubt in the minds of any experts that if Chapter 11 comes about, the factories will not only seek to rid themselves of inordinate legacy costs, union pension funding obligations and renegotiate labor agreements, but will also try to trim their dealer networks. This does not bode well for single-line dealerships, particularly in mid- to smaller-sized communities.

For example, Chrysler dealers who have Chrysler, Dodge and Jeep are going to be in a much better position to survive than any stand-alones. The same is true for dealers with regard to Buick, Pontiac, and GMC or Chevrolet, Cadillac, and Saab (or some combination thereof); they will be in a much better position than stand-alone Pontiac or GMC dealerships (I don't believe there are many stand-

alone Buick stores left). Undoubtedly, Ford will (and is currently in certain markets seeking to) combine Ford, Lincoln and Mercury. The bet is that Mercury will eventually go away, which would seem to make sense.

Look around your market area and determine what consolidations might be helpful to your business, and have your attorney act as an intermediary on your behalf in trying to facilitate those transactions. It would behoove dealers to get into a proper alignment prior to the expiration of any term agreements. For example, all of General Motors' agreements expire in October of 2010. If I were advising a GM dealer, I would try to get that dealer aligned by that time or I would start to prepare a challenge to non-renewal under state franchise law if a decision was made not to renew a particular dealer.

Publicly, all of the domestics say they are not putting money into transactions to consolidate dealerships. However, there will continue to be some exceptions to that general rule. Although, it is clear that the days of putting money into transactions of marginal value are over. Any manufacturer participation in transactions is going to be limited to major market areas where it is clear there is something to be economically gained for the manufacturer. As one GM official told me, "We're going to have to let the marketplace pare the dealer body." One thing that competing dealers could consider would be merging with another competing dealer. The real estate problem may remain depending upon the two sites, but the second piece of real estate might be able to be used for a used car operation or something of that sort. I have used merger a couple of times in the past; however it is imperative that the agreements involving such a transaction contain a clear understanding of the rights and responsibilities of the prior owners. This can be done with well-drafted shareholder and employment agreements.

I am actively looking at some potential transactions on behalf of clients. The usual problem, however, is the real estate that's involved. While there are some alternative uses for dealership facilities (ambulance services, construction companies, auto parts or services, cab companies, etc.), there is not a lot of utility for dealership real estate. Bankruptcy for a manufacturer would be a way to avoid state franchise laws that currently protect dealers; manufacturer mergers would not. Federal bankruptcy law would trump state franchise laws. Dealers whose agreements were terminated would have a claim in the bankruptcy, but the claim would be a general claim, probably worth only cents on the dollar. Other claims for repurchase of vehicles, parts, etc., would be general unsecured claims under the franchise agreement and not subject to priority treatment; therefore not only would dealer be delayed with regard to collection of monies but might be subject to cram-down. One could see a situation where the floorplan lender would not be bankrupt and the factory would not be able to promptly buy back inventory, thereby subjecting the dealer to additional liability. I would keep my inventory at barest minimums for the next period of time. Refuse to allow the factories to overstock you if you don't need the vehicles. Consultation with your floorplan lender might allow you to put a hold or cap on the floorplan whereby you could say that you couldn't take any additional cars. This is being done by some dealers in different parts of the country. Thoroughly check out and beware of any programs whereby you would have to take a certain number of vehicles to get discounts that might be violative of state franchise laws.

A. REAL ESTATE LEASES

Many dealers hold the dealership real estate in a separate entity and lease it to the operating dealership entity. If this applies to you, it is absolutely imperative that you check the lease to make sure that 1) the lease is current and in full force and effect and 2) that the rent charged is expressly stated in the lease and is reasonable in relationship to the value of the real estate. Many dealers either don't have a

lease, let the lease lapse or have reduced the rent for one reason or another. If nothing else, put the rent at a fair market value and accrue it as a liability if you can't afford to pay the entire rent amount. This is important because in the event of a manufacturer Chapter 11, the dealership's claim might be enhanced. In the event of termination of your franchise in a Chapter 11, the lease obligation would need to be calculated into the amount of your claim, even though the claim would be unsecured. As I was revising this article, news of the potential manufacturer emergency loan program was announced. In the event of restructuring of the companies, albeit by a bankruptcy court or by the "car czar", it is important that the lease be in force and fairly stated. As you may or may not recall, many franchise agreements have termination assistance in them wherein the manufacturer either buys the real estate (which will not happen under any circumstance) or pays up to a year of lease payments. Therefore, it's imperative that you have a valid lease in full force and effect and that the rent be accurate. I have advised clients to establish the rent based upon a fair market value of the building; that rent should be between 10 and 15%, depending upon the age of the facility, location, etc. In today's market, values are down; therefore the rent might be somewhat less than it has historically been. Sometimes we have used a 1% per month rent factor. However you arrive at that, you should immediately check your existing lease, get it updated or get a new one drafted. In any kind of a franchise assistance program, the rent must be reasonable.

6. Facilities and Upgrades – Clients should resist factory-mandated stand-alone facilities and upgrades where it is not economically justifiable for the dealer. It's amazing in these times that factories still have the testosterone to try to require new construction and facilities upgrades where there is clearly no economic justification. The demand by KIA for a stand-alone showroom and service facilities for a projected 15 sales a month comes to mind. A good franchise lawyer can generally weave together an argument based upon even relatively weak state franchise laws that such an action would be illegal. If you have executed a facilities improvement agreement in the past, don't automatically assume that those are nonenforceable. You should meet with the factory and try to delay the obligations under that agreement. While I believe that these agreements will take a back seat for the domestics, the imports may try to continue to push for their enforcement. There are generally some state franchise laws relative to unreasonable facility demands. Depending on the agreement, you may or may not have waived those but again, a good franchise lawyer can help you discern your rights under the agreement vis-à-vis existing state law. The important thing to remember is not to ignore the issue and automatically assume that the agreements are not enforceable by the manufacturer. This would be particularly true where they are tied to a term agreement. Negotiation should start with the manufacturer well in advance of the termination date of the franchise agreement.

7. Short-Term Franchises – Resist short-term franchise agreements in case of facilities issues. Some of the imports, feeling their oats, are trying to force dealers into facilities improvements by cutting franchise terms down, thereby threatening the dealer with loss of the franchise. Toyota comes to mind, giving one dealer a six-month agreement with facilities as a qualifier for renewal. Again, many of these strong-arm attempts are invalid under state law and should be challenged.

8. Performance and CSI Requirements – Resist stupid franchise performance standards and CSI requirements. Develop a paper trail, pointing out the statistical flaws in the measurements. There are experts available who can show these performance statistics are flawed, generally because they don't relate to local market standards or are otherwise statistically invalid. The domestics are trying to trim dealer bodies by placing dealers on cure periods as a precursor to franchise termination. Build a record in case you have to litigate or argue administratively under state franchise law that any proposed termination is invalid.

9. Personal Debt Planning – Engage in a bit of personal debt planning. Now might be a good time to move assets into joint names, trusts, family limited partnerships, etc. While dealers must be aware of the bankruptcy preference periods and the rules against fraudulent transfers, if you believe that your long-term future is insecure, now would be the time to start planning asset preservation moves. It might be wise to run a Uniform Commercial Code (UCC-1) check on your dealership through the Secretary of State's office. Take a look at each UCC Financing Statement to check that the described collateral is, in fact, correct and you have not been subjected to the sometimes usual lender conduct of grabbing a security interest and collateral that they should not have claimed. If there are any errors in financing statements, demand that the creditor immediately file an amended statement. Many times in a business liquidation or sale, there are multiple claimed "first" liens in the same property. If you are a guarantor of a dealership obligation, you should check the terms of your guaranty. After counseling with your advisors, you might try to cap the guaranty or if you are a minority shareholder in a dealership, notify the creditor that you are terminating your guaranty. These steps should be taken only after consultation with your appropriate advisors.

10. Punt – Try as we might as good lawyers, there are some dealers who are just, for whatever reason, not passing muster. In those situations, counseling could take place concerning after-dealer life and a used car and service operation. Sometimes in life, we do have to drop back ten yards and punt.

Ronald C. Smith, past President of Stewart & Irwin, P.C., chairs the Business, Automotive Retail and Employment/Labor sections of the firm's practice. Ron represents numerous non-publicly traded companies of virtually every type and has specialized in representing hundreds of automobile dealerships throughout the Midwest, Southeast and Eastern United States, together with various vehicle trade associations, for over 39 years. Matters handled for clients, as well as automobile dealerships, have included manufacturer disputes, acquisitions and sales, consumer defense, estate and succession planning, class actions, wage/hour compliance, OSHA compliance, environmental compliance, Union avoidance and representation of dealerships in organizing attempts, Equal Employment Opportunity Commission and other discrimination and family leave issues. Ron has also been active in dealership consulting with regard to all other aspects of the human resource process, including the design and implementation of various policies and procedures, handbook drafting, preparation of human resource forms, etc.

For over 35 years, Ron has lectured and conducted programs for numerous trade associations and trade groups and has written extensively in automotive trade publications. His most recent article appeared in the December, 2007 issue of *Auto Dealer Monthly* dealing with succession planning.

The contents of this article are general in nature only and reflect the opinions of the author. The comments herein are not to be construed as legal advice with regard to any particular question or jurisdiction. Dealers reading this article should contact their personal attorney or an attorney that has experience in dealership law.

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