

Avoiding & Navigating Financial Crisis for Franchised Automotive Dealers

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Introduction to Automotive Dealer Franchising, the Franchisor/Franchisee relationship & the Economic Impact of Franchises:

The following is an overview of bankruptcy as applied to a new car franchised dealer. This overview is intended to provide a general synopsis on dealership bankruptcy and is not intended as legal advice and should not be relied on as counsel or advice. As frequently espoused in this document, anyone having questions regarding his or her particular dealership or situation should consult his or her own trusted legal advisors for aid in navigating the complexities associated with his/her fact specific enquiry.

Franchise businesses represent a large part of the United States economic engine. In a 2010 article, the vice president of government relations for the International Franchise Association (IFA) declared that “franchising plays a vital role in our nation’s economy; it’s one of the big engines driving new job creation”.¹ Franchise businesses make up more than 10 percent of all U.S. businesses.² In the 2007 Economic Census Franchise Report, which was lauded as the first comprehensive report on the franchise segment as part of the U.S. economy, reported that franchise businesses accounted for nearly \$1.3 trillion of the \$7.7 trillion in total sales.³ The study further reported that franchise businesses employ 7.9 million workers.⁴ Ultimately, the franchising engine generates one of every seven jobs in the private sector in the United States.⁵

¹ Ned Smith, Franchises Play Vital Role in U.S. Economy, Business News Daily, Sept 15, 2010, <http://www.businessnewsdaily.com/213-franchise-businesses-play-vital-economic-role.html>

² *Id.*

³ *Id.*

⁴ *Id.*

⁵ Judge Margaret Mahoney, Selected Issues arising in franchise bankruptcies, Southeastern Bankruptcy Law Institute.

New car dealers lead in sales for all the various categories of franchise businesses with \$687.7 billion in annual sales.⁶

The automotive franchise distribution model dates back to 1898 when William E. Metzger, established what is believed to be the first General Motors dealership as a franchisee.⁷ Proponents for the franchise model point to the fact that individual franchised dealers invest millions of dollars of their own private capital in their dealerships to provide local communities with top sales and service experiences, while allowing auto manufacturers to limit their investment in sales outlets and reserve their capital for the core areas of designing, building and marketing vehicles.⁸

Although the industry has spawned large public groups over the last decade, franchised dealers are predominately locally owned. Franchised dealers live, work and play in their communities and are important members of communities all across the nation. Dealers and their employee teams play important roles from sponsoring sports teams, philanthropic endeavors, local employment, tax generation etc. as they generate billions of dollars for their local economies. The investments that franchised dealers make in their own business's allows manufacturers to benefit from the high financial returns of capital invested in manufacturing as opposed to the low sales margins gained from retailing automobiles.

⁶ *Id.*

⁷ The First Century of the Detroit Auto Show, Society of Automotive Engineers Inc., January 2000, at 265.

⁸ Auto Retailing: Why the Franchise System Works Best, NADA, last visit September 27, 2014, http://www.nada.org/NR/rdonlyres/DF4863B1-591A-4CA4-917D-45FF870AE3D0/0/Auto_Retailing_Why_the_Franchise_System_Works_Best.pdf.

The most important element that creates economic value for local franchised new car dealers is their ability to use the trademark that the franchisor owns and their resulting opportunity to purchase new cars from the franchisor/manufacturer. By allowing the franchisee to sell their products and services and use their trademarks, the franchisor essentially lends dealers its national and/or global goodwill.⁹

In the case of new car automobile franchises the franchisor is also the brand specific manufacturer of the automobiles the dealers sell. As such the franchisor lends their good will to the franchisee in order to stimulate the dealer to sell more cars which in effect means the dealer will order more new cars from the franchisor/manufacturer and grow the franchisors sales and profitability. As a result of the franchisor's desire to sell more cars, the franchisor and the franchisee have a strong mutual interest in seeing one another flourish. This mutual interest mandates that the franchisor and the franchisee work closely together to protect the brand and enhance one another's mutual interests.

Introduction to Automotive Dealer Bankruptcy:

The average dealership requires an investment of \$11.3 million dollars and has annual operating costs of approximately \$4.6 million dollars. Since most dealers are entrepreneurial organizations these financial investments often result in highly financially leveraged dealerships. This leverage results coupled with many dealer principal's lack of experience with large-scale financial management can lead to great challenges when the automotive economic engine abruptly changes.

⁹ LaGuardia Associates, 92 F.Supp.2d at 225.

Often entrepreneurs skilled in starting and growing a business do not have the skills or experience necessary to operate large-scale operations in times of financial turmoil. Strong operators in virtually all business segments and especially the capital-intensive automotive retailing business need to consider cash flow very carefully in order to protect the economic viability of their operations.

Optimistic entrepreneurial dealers for example see “profit” as the equivalent to “cash”. Overly optimistic outlooks and simple misunderstandings often make dealerships prime candidates for bankruptcy. Although cash flow is a fundamental financial concept many business operators either fail to grasp this or more likely fail to properly track and control their cash flow. All businesses must have cash to operate and when the cash runs out, the business whether in bankruptcy or outside of bankruptcy, fails to operate. The bankruptcy attorney, the dealership operator and the trustee in a bankruptcy all have a similar desire to get the dealership to stop bleeding cash and become cash flow positive. If the dealership is going to survive financial crisis the dealership cash flow must stabilize while the dealership is still operational. As a result, in order to save a dealership, the first priority will be to develop the statement of cash flow and other financial statements to assure the entrepreneur has sufficient cash to operate.

Once the bleeding has been stopped or at least slowed to the point that cash flow will allow short term survival, the professionals, stakeholders and other interested parties can move on to the process of implementing necessary organizational changes. This will allow the business an opportunity to reorganize

the operations to enable the dealership to survive and meet the goals of the various stakeholders.

Franchised dealers have the same or very similar overall goals as typical business owners do in bankruptcies. Dealers and their stakeholders have varying reasons to file bankruptcy. Generally the reasoning is either to preserve assets in a financial crisis in an effort to turn around the operation or to utilize a mechanism to allow an orderly way to distribute assets equitably when the circumstances are so dire the dealer sees no alternative but to facilitate a liquidation.¹⁰ A fundamental goal of the federal bankruptcy laws enacted by Congress is to give debtors a financial "fresh start" from burdensome debts. The Supreme Court made this point about the purpose of the bankruptcy law in a 1934 decision:

*[I]t gives to the honest but unfortunate debtor...a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.*¹¹

This goal is accomplished through the bankruptcy discharge, which releases debtors from personal liability from specific debts and prohibits creditors from ever taking any action against the debtor to collect those debts. In order to take advantage of the new opportunity that bankruptcy is designed to offer dealers, they must consider the bankruptcy very carefully and make decisions based on a host of legal allowances and operational considerations all whilst operating in an honest manner with creditors who appear adversarial. If a dealer or any other business operator lacks integrity in the process or fails to understand important timing issues

¹⁰ Rick Pedone & Craig Tractenberg, Bankruptcy Issues in Franchising: An Overview, Nixon Peabody LLP, http://www.nixonpeabody.com/files/Bankruptcy_Issues_in_Franchising.pdf

¹¹ *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

and decisions related to their operation, distribution of the businesses assets, decisions relating to executive contracts or even worse engages in fraud, the benefits that bankruptcy is designed to offer will likely not be available.

Avoiding Crisis is the Best Alternative, Advance Planning is Key:

The dealer in bankruptcy as stated above must carefully consider their financial circumstances and their decisions. It is through careful consideration of the impact of each decision that the dealer will be able to make decisions that will maximize their chances for a positive outcome. Equally or arguably even more importantly, dealers who are either experiencing financial crisis or are realists and recognize that such crisis often lurks in the highly leveraged automobile retail business should employ sound strategic planning in advance, to either avoid financial strife or at least know how to minimize the negative effects if they encounter crisis in their dealerships. Franchised automotive dealers are involved in very complex business' that need to be considered with a strategic plan in a comprehensive manner. This short discussion on strategies to avoid financial crisis cannot go into the necessary depth to fully guide dealers and is instead meant as an eye opener to prod dealers to take the necessary steps to put together the appropriate team of legal and financial counsel to help the dealer guide his/her business. The dealers goal should be to take a realistic look at their operation, their unique business so that they can attain a clear understanding of their dealership's economic condition. With sound analysis, and understanding coupled with a desire to succeed, dealers can successfully navigate the unpredictable realities inherent in

the auto business. This will help the dealership to ride out or even gain ground in the economic valleys that are sure to come, all while taking advantage of the economic peaks. Dealers that are wise will make the effort before a crisis, to develop a strategy for holding on through economic turbulence and aid them in maintaining a stable operation to better position themselves for future success.¹² If a dealer is past that point and in the midst of financial turmoil, creating a strategy will help the dealer facing difficult decisions make the necessary judgment call as to whether or not to reorganize or liquidate.¹³

Changes in the Economy can Wreak Havoc on Dealerships:

Even though changes in the economy can wreak havoc on car dealerships the effects can generally be anticipated. As a first generation franchised auto dealer for almost 20 years I am keenly aware of the financial pressures dealers face. All dealerships can become victims of a dramatically changed environment but multi-generational dealers are more likely to have less debt, more liquidity and a greater access to cash reserves, giving them a greater ability to withstand changes. Many entrepreneurial dealers have no experience operating dealerships in crisis as they have succeeded by creating growth organizations. In my case, after operating my dealership for almost 15 years with every year representing year over year growth, I encountered the great recession in 2008 with little experience in a declining market and all of the strife that goes along with a dramatic economic shift.

¹² James J. Kaufman, What to do Before the Money Runs Out, (1993).

¹³ *Id.*

Although the most recent recession was dramatic for many dealers and resulted in bankruptcy filings for GM, Chrysler and an endless litany of auto dealers, suppliers and related businesses, the downturn also has many stories of survival. The dealers that stuck their heads in the sand and ignored the crisis did not survive, for the most part. As a result of the economic changes many stellar dealership operators failed and many barely survived. At the same time, other dealers suffering from all the same environmental challenges were able to utilize advance planning to grow their dealership holdings when the opportunities to grow were stellar.

In 2007 the December Seasonally Adjusted Automotive Sales Rate (SAAR) was 16.03 Million vehicles. By December 2008, the SAAR was down by over 35% to 10.38 Million vehicles and the following year in 2009 SAAR was still only 10.89 Million vehicles.¹⁴ Those statistics are demonstrative of the quick pace of the downturn, but in many segments within the industry the downturn was even more dramatic. For example, in the Ultra-Luxury segment of the automotive industry the shift in the economic climate was even more pronounced with retail sales plummeting by approximately 75% from the peak levels in 2007 to the bottom of the market in 2009.

This decline in new car sales affected every franchised dealer in every community all across the United States. With new car sales down, trade-ins quickly became sparse. With less trade-ins and dramatically declining values in dealers used car inventories, it became increasingly difficult to keep used car volume and

¹⁴ US Vehicle Sales Chart, YCharts, Last visited November 3, 2014, http://ycharts.com/indicators/auto_sales

used car gross profit up. Dealers traditionally relied on used car sales and related gross profits when new car sales declined. In 2008 this was very challenging for even the most astute and capable dealership operation.

At the same time, loans to consumers became harder and harder to obtain, resulting in a nightmarish glut of new car inventory. To make matters even worse, the reduction in new and used car sales meant lower customer pay sales in service and parts and for a period of time reduced internal service and parts repair orders. Many dealers feared that their warranty work would evaporate in looming franchisor(s) bankruptcies and the time it took manufacturers to pay cash strapped dealers for warranty receivables became longer and longer. Even the areas that dealers traditionally turned to in times of slower sales were deserts that bore little to no fruit and challenging payment terms.

If these factors did not make it impossible for dealers to figure out how to quickly downsize their operations that had high fixed expenses, the banks that lent money to dealers hit the crunch too. For most dealers like mine, the lenders crunch was first seen when all of the unexpected floor plan audits went from occurring at most twice a year by auditors who were more interested in chatting and maintaining friendships than auditing, to what seemed like sudden visits to extract cash flow for the lenders on a weekly basis. The lenders auditors were often agitated and frustrated, fearing for their own jobs and looking for discrepancies to help their cash flow instead of the traditional mutually beneficial relationship. Lenders and dealers alike realized that instead of having banks and captive finance companies competing for dealer's patronage, the only options that were available were from

dealers existing lenders, as lenders and captives closed off the opportunities even for well-to-do dealers to open new lending relationships.

Prior to the recession, as lenders competed for dealer's patronage, most dealers experienced little or no curtailments on aged inventory. Once lenders started experiencing challenges with lending limits, cash reserves and other mandates, many floor plan lenders dramatically curtailed inventories. When dealers questioned harsh curtailments they were referred to the lending contracts that they signed, often with little consideration to the terms and blind reliance on the course of trade the dealers engaged in with their respective lender(s). The audits, curtailments, reduced sales and high inventory levels created cash flow crisis for even well heeled dealers. When dealers went to trade-in or buy more cars, instead of being advanced at the rates traditionally experienced (generally the purchase price or trade-in value), they were often referred to the lending contracts and reminded that advances were 70% or 80%, not the lenders "100% trade practice" prior to the downturn. The walls began closing in around many dealers as their banks course of dealing had changed in what felt like overnight. As a result, a profusion of dealers began hemorrhaging cash and many couldn't navigate the crisis.

If the changes in floor plan lending failed to bring a dealer to his/her knees, many dealers who had attained real estate mortgages found their mortgage balances were all of a sudden higher than what banks new appraisals were. When unsuspecting dealers either went to refinance or when their lines of credit were reduced or eliminated, as they were collateralized by their equity in the real estate,

the dealers found they were squarely in the middle of unexpected needs for cash. These circumstances were not just for a select group of dealers because dealers traditionally favored short-term 35-month loans to avoid intangible taxes. The loans short nature naturally lead to many that came to their intended expiration in the midst of the worst economic period the dealers had ever experienced. All of this was complicated by the extremely devalued commercial real estate market that hampered reasonable appraisals. As a result of these loans coming to their natural end, lenders demanded what often amounted to huge amounts of cash to close on new loans to make up for the dramatically lower commercial appraisals of the dealership properties. Many dealers that had already experienced huge drains of cash trying to operationally work in the new lending environment, found themselves without the ability to close on new real estate loans and ended up in default even whilst paying their monthly payments in a timely fashion. Without the ability to renew real estate loans or without lines of credit that many dealers had attained for the specific purpose to use when financial challenges reared up, many dealers collapsed because they simply didn't have the necessary cash to weather the storm.

Dealers that survived the crisis that the economy brought on realized that lending relationships are a unique blend of the personal relationship with the lender, the lenders team, the dealership team, the documents and contracts the dealer has signed, the financial position of the bank, the financial position of the dealer and the overall economic climate. All of these elements need to be keenly considered, ideally in advance of economic crisis to determine the best course of action and to

determine the options that the dealer has that will be the most mutually beneficial to the dealers long and short term goals. Even though the new car automotive industry is currently experiencing boom times the concepts and long-term decisions that these concepts aid in determining, are very appropriate to consider in good and bad economic climates.

For example, a few weeks ago one of my dealer peers who owns a very successful multi-brand dealership asked me for advice about refinancing his real estate and pulling out a large portion of his equity to set aside in the event of another recession. This is the kind of thing that dealers consider as they plan for tough times but the problem is that they often don't consider the whole picture. What my friend wanted to do may or may not be a wise decision for him but the elements that he was using to determine if it was a good decision were seriously lacking. You see, my friend like most dealers was thinking: "if I pull out a million dollars and set it aside, my mortgage payment will only go up by \$6,000 a month because I can refinance at a lower rate than I currently have. This \$6,000 a month won't hurt me because I am making 10 or 15 times this and my cash flow supports the new payment." This car dealer and his partner are both very astute business people and they have amassed a stellar dealership operation. The problem is not their ability to operate the dealership; the problem is that often car dealers simply rely upon their own experience, circumstances and common sense. Since the dealer's use of his or her experience and common sense has allowed him or her to succeed or at least theoretically succeed, relying on these elements seems

prudent. Go back to my friend who wants to refinance his dealership real property to pull out some cash... Is it a no brainer?

Well, let's consider a host of elements that he may or may not consider prior to making what may or may not be a good decision or what may or may not be the decision that puts him one step closer to calling and having to engage a bankruptcy lawyer. Going further the central objective should be to help the dealer understand where their dealership is financial, where they want to go and ultimately how to get there. In the end you should know whether you should withdraw and liquidate the dealership instead of throwing good money after bad, whether to sell the dealership, whether you need a turnaround plan, or whether you must need to tweak things to maximize your efficiency.¹⁵

Maintain Trusted Advisors:

Dealers need advisors around them that they can trust and that understand the dealer's goals, propensity for risk, personal and dealership financial state and overall dealer and dealership aptitudes. Unfortunately most dealers have worked very hard to build their empires. Their blood, sweat and tears have earned them a healthy living and a nice lifestyle but they are also self-starters, tending to rely on themselves instead of others for guidance. Generally, dealers love their business, the cars and the lifestyle that goes along with owning a dealership. Along with that often comes a host of preconceived notions about the state of their business, what is wrong and how to fix it that is biased and often myopic in scope. Dealers love to

¹⁵ *Id.*

consider how many new and used cars they have sold, what the service gross sales and profits are, etc. but they seldom talk about, much less consider, the cash flow of their dealerships. When financial strife comes into the picture, especially if it is in the form of a cash flow issue, time is generally the biggest enemy. This is not a good time to assemble a team of trusted advisors because trust takes too long to develop. This is when good people who know the dealer, know the dealership and with whom the dealer has trust, can mean the difference between liquidation and financial prosperity.

Dealers should have financial records that they trust and they should be reviewed and understood routinely by an accountant that understands not only the specific dealership but also the industry. Perhaps even more importantly, dealers need a financial expert to filter the information that the dealer needs to the dealer in a way that the dealer can not only understand but also use to make operational decisions in a timely fashion. Dealers generally have an uncanny ability to be creative and find solutions to even the most daunting and overwhelming problems but they need sound information to find the solutions to their financial issues.

Although it may seem self-serving for a lawyer to point out that dealers need to have legal counsel whom they trust, it also seems obvious especially given the legal culture we live and operate in. Dealers need legal counsel to help them in an almost limitless quagmire, ranging from contracts to manufacturer franchise issues, insurance, litigation and everything in between. In times of financial crisis it is critical for the dealers legal counsel to understand whether the dealership is adhering to the dealers guidelines with their franchisor/manufacturer, bank, zoning, city,

environmental, taxing authorities and other guidelines to help the dealer manage their decisions. Often the determination of whether the dealer is meeting his/her contractual and legal obligations is very fact sensitive and represents a legal argument in and of itself and dealers must have a professional help them through these situations.

Dealers should also have a group of other dealers whom they trust to help guide them with their dealership operation. Ideally, dealers will create camaraderie and friendship in a “dealer 20 group” of similarly situated owners dealing with similar or identical franchisors. Groups like these help the dealers gain practical insight into how their manufacturer(s) treat other dealers, how captive finance lenders treat other dealers, pressures lenders put other dealers under, regulatory and legal issues that other dealers are facing, other sources of funding and access to benchmarks for financial performance, use of assets, level of liabilities, etc.

Most importantly, the dealer needs this trusted team of financial, legal and operational advisors to help the dealer fully understand the legal, financial, operational and relational condition of the dealership so that the dealer has a full picture of his/her dealership and can better make decisions. Decisions need to be made with all of the information and an advisory team can aid a dealer in making this a reality for his/her dealership. My friend above may not realize that if he takes out a bunch of cash and puts it aside for a later date, the cross collateralization contract, the personal guarantee or a host of other contracts that he signed may preclude him from using the money the way he plans if and when a crisis occurs. He may not be aware of the tax ramifications of the action, he may not realize that

increasing his leverage may throw off his ratios with his manufacturer or lender, he may not realize it may take him out of compliance with their franchise agreement, he may not be aware that other lenders are offering far better terms to other dealers... He needs to know the variables and a team of trusted advisors will likely help him answer these questions and make a better decision.

Maintain and recognize the importance of Dealership Contracts:

Dealers need to rely on their understanding of the dealership operations and their practical knowledge of what needs to occur in varying circumstances along with their advisors, to make sure they have the appropriate contractual arrangements in place for foreseen and unforeseen occurrences. Although not every contingency can be planned for, most can be considered in advance with some pre planning. Dealers should assess whether they need to prepare certain documents or in the event they have already created and/or entered into contracts, dealers need to understand their responsibilities with relation to the various dealership contracts. One set of documents that dealers need advance planning is for the continuation of their dealership given circumstances such as death, which is sure to come. Considerations such as: is there a buy-sell in place if the business has multiple owners?...or is the buy/sell funded with life insurance policies or some other mechanism to fund a buy/sell in the event that one is triggered? Often these types of considerations are not addressed until a significant emotional event occurs such as death, dissolution, bankruptcy, a sale transaction or a divorce. Dealers need to have a succession plan in place to make sure that in the event of a tragedy

the dealership transfers per their wishes and with the least amount of added turmoil, financial stress and business interruption as possible. It is much better both financially and emotionally to have prepared and entered into agreements prior to significant events occurring. Without such agreements, financial strife can arise in these circumstances and often the results lead to bankruptcy. For example, dealers should determine whether the corporate minutes, articles of organization or other necessary documents up to date. Many dealers have not considered these documents for years or perhaps not since the dealership was formed.

Dealers should consider their franchise agreements and the various responsibilities they have contracted to, the renewal times, the acts or omissions that could allow the franchisor/manufacturer to terminate the agreements, whether they are conforming to the reporting mandates set forth in the agreement, etc. Along with understanding and maintaining the franchise agreement, not enough can be said about the importance of maintaining an effective relationship and communication with the manufacturer. The importance of keeping good personal and business relationships with the manufacturer at all levels not just with area managers but with management as high as possible, can be absolutely critical in avoiding conflict with the manufacturer or in the worst case scenario, rebuilding bridges when problems occur.

Know the Actual Value of Dealership Real Estate:

Dealers really need to know what their real estate is actually worth. Is the dealership really only valuable as a special purpose property? Even though this can be the difference between success or failure, in financial crisis dealers often are unaware of this important valuation difference. A special purpose property can be defined as:

*A property with a unique physical design, special construction materials, or a layout that restricts its utility to the use for which it was built. A special purpose property has relatively few potential buyers at a particular time, sometimes because of unique design features or changing market conditions. Special purpose properties include structures with unique designs, special construction materials, or layouts that restrict their utility to the use for which they were originally built. These properties usually have limited conversion potential because the use is appropriate for one use or limited use and cannot be converted to another use without a large capital investment.*¹⁶

Many of the descriptive elements in a special purpose property are inherent in franchised automotive dealerships. Just using practical experience, most have driven through areas that were once home to many new car dealerships but now have changed. If the previous dealerships were torn down, the value of the purchase would not have included the dealership improvements for buildings, corporate identity expenditures, etc. If the previous dealerships remain, they most often are very easy to distinguish as previous dealerships and are most often financially underutilized as compared to when the facilities operated as new car dealerships. As such, their value as an alternative use is greatly diminished as compared to an appraisal that assumed the value in use as a new car dealer or perhaps even more specifically the value in use as a “Ford” dealership, for

¹⁶ Special-Purpose Properties, Appraising WNC, <http://www.appraisingwnc.com/services/special-purpose-properties>

example. If the dealership real property value is based on the use that the dealership currently uses, the dealer needs to be aware that if the dealership was to sell to a competitor that needed to move the dealership, if the area changed, if the franchisor/manufacture ceased to operate or a host of other circumstances occurred, the real estate may not be worth even close to what the appraised value assessed, because the appraisal was not for an alternative use.

If the dealership was built with alternative uses in mind, the value is not as dependent on the dealership operating as a going concern. This is the ideal situation for the dealer but generally is very challenging to implement with the manufacturer. The current trend is to create very unique brand experiences in which a great deal of money is spent on facilities that conform to the sole use of the manufacturer demanding the implementation. With that being said, it is important to know if the appraisal is an accurate assessment of what the real estate is worth and what the appraisal is based on. My friend must understand that just because the bank will allow him to cash out, it is not a guarantee that his real estate would sell for the amount he cashed, especially if he was forced to sell it as an alternative use to the specific franchises he is utilizing it for today. Additionally he must recognize that he probably has signed a personal guarantee and a cross collateralization agreement that will tie him and all his other ventures and assets up in the case of a breach.

Assets the Dealership can Use to improve cash flow

Part of the assessment is to determine if in a financial crisis there are areas that the dealer can draw on to add cash to the business without affecting the operational viability of the dealership. The dealer should utilize his team to determine whether there is hidden cash on the balance sheet; whether the dealership can attain accounts receivable financing; whether the dealership can increase collection efforts; whether certain profit centers are a burden that needs to be liquidated; whether excess parts can be sold to increase cash; and whether current dealership practices are designed to limit the bleeding of cash flow.

Maintain an Honest Relationship with the Lender

A good relationship with the various lenders the dealership works with, especially the floor plan provider, is an extremely important aspect of a successful dealership operation, especially if financial crisis occurs. The first thing a dealer needs to understand is that although lenders are not equity partners in the dealership they really are like partners. They often have the power to allow a dealership the latitude necessary to survive or contrarily they may reign in their power and be a critical part in a dealer's demise. Even though many dealers do not consider the people they engage in working relationships with as "friends," an old motto "you can only be as successful as your friends allow you" is very appropriate. In this case dealers, especially those who are in financial turmoil are well served by recognizing that their lenders are key players. Dealers need to successfully reorganize or come out of financial turmoil. Along with that key recognition, it is

also important to recognize that the first priority of most dealers lending partners is to minimize their own risk. Dealers must work with this goal in mind. Since lenders don't enjoy a percentage or larger share associated with the upside of a successful dealers operation, they are much less inclined to engage or be part of riskier behavior that entrepreneurs often consider part of operating dealerships.

In order to properly assess a dealers situation, the dealer needs to ascertain information relating to their lenders and their related obligations. Information such as:

- A clear understanding of the security associated with the loans the dealership has with the lender;
- The actual value and the perceived (if different) value of the collateral;
- An understanding of whether the dealership is operating in trust with its obligation to pay off floor planned vehicles after the allotted hours or days allowed per the dealer/lender contract after the vehicles have been retailed;
- An understanding of whether the lender has tolerated, condoned or encouraged the dealer being out of trust;
- The trade-custom of the lender when dealing with the dealership especially if it varies from the contractual obligations set forth in the dealer/lender agreement;
- Whether the dealer has signed cross collateralization agreements with the lender and the effect of cross collateralization on the dealers real estate and inventory loans and other assets and other dealerships and companies that the dealer owns;
- Determining whether the dealer has entered personal guarantees on the loans the lender has provided the dealership with;
- Determining whether the dealers spouse or other family members or friends or partners are personal guarantors on the loans with the lender;
- Determine whether the lender is effectively the same lender that made the loan or has control of the bank shifted, the bank been sold, the FDIC set up new rules or has the property undergone other structural changes that effectively makes them different than the original lender the dealer was working with;
- Whether new oversight agencies changed the way or not, the lender must operate in general and/or specifically with the dealer;

- Whether the loan officers or lending committees understand the dealerships loan, trade-practices and whether they know the dealer, the operation and the specifics that make the dealer different;
- Whether the contact person at the bank is new or the same person that the dealership had a relationship with and historically dealt with;
- Whether the lender aided has helped the dealer in their crisis or whether they have contributed to some of the dealers financial problems;
- Whether the lenders manner of dealing with the dealer has created lender liability issues and has lender liability been addressed by the dealers legal council.¹⁷

This list of questions seems long and laborious but it in no way is exhaustive and the dealers specific circumstances and relationships must be considered by the dealer and her team in order to assess the true state of the dealerships lending relationship. This list represents good examples and is a good starting point for the dealer in financial turmoil to consider in an effort to shed light on some of the issues both for his/her awareness and to bring their professional advisors up to speed on the dealers circumstances.

Although it is often contrary to what many dealers have been taught by previous generations and even contrary to a dealers gut feeling, the best advice a dealer can take is to be honest with their lenders, no matter what. Being honest and frank when discussing the financial condition of a dealership is the first priority a dealer in financial crisis must take. As previously stated, in order to survive crisis, a dealer who is not financially independent must have the support of his/her lenders and as such he/she must engender trust and a sense of partnership with that lender. Trust, although not full proof given the dealers specific circumstances, is the most likely way to promote good faith dealing between the parties. Once both

¹⁷ *id.*

parties are willing to work together in a transparent manner they have a much better chance of finding common ground. In most circumstances, both parties will be much better off if the dealer is able to come out of the financial struggle operational and profitable. If the dealer survives in some form or fashion, the likelihood is that all the parties concerned will (in all but the rarest of examples) be much better off financially and emotionally. The chance of this happening is exponentially better if the parties work together, having the common goal of survival.

Lenders do not like silence

Lenders do not like silence and it is almost always better to give lenders bad news instead of no news. When the bad news is delivered it is very important to explain the strategies that dealers are taking to combat the financial turmoil and to simultaneously demonstrate the efforts that they are taking to enhance their viability. During the hardest part of the 2008/2009 recessions, the lender that my dealership was dealing with was in the midst of financial turmoil itself. Coupled with my dealership's challenges, that led them to exert policies that made it harder to operate my dealership successfully. During one of my meetings with my lender's loan committee, I presented a carefully prepared business plan outlining all of the changes my team and I had put in place to turn the dealership into a financially viable operation, even in spite of the dramatically changed operating environment we found ourselves in. The plan gave values for all of our assets at the new post-recession value. It assessed all of the dealership liabilities and gave alternative plans that would allow for both the lender and my dealership's mutual goal(s), the

dealerships survival and our ultimate return to prosperity. I put in as much effort creating this plan as I put into my initial business plan and franchise presentations. I assessed each aspect with transparency, honesty, integrity and a zeal for survival. In no way was it “fun” to consider my life’s work under such scrutiny. From an entrepreneur’s perspective, it was sheer pessimism on my part that was totally necessary to gain the support of my lender. Ultimately this plan led my lender to relax some of the constraints they had put onto my dealership to protect themselves in the short-term, so that they could be a part of my dealership’s return to profitability. Their ultimate goal was to assist me so that I could thrive, continue to be a stellar partner and ultimately fulfill all the obligations I made to them to repay the loans.

In my case just as mentioned above, I had to understand my lender. First I had the same contact relationship with my lender, but beyond that most of the people that originally approved my loan were gone, demoralized or scared into a panic. I had to re sell the new people on why they should want to be my partners, why they could trust me, what my business acumen entailed and so on and so forth. There may have been other dealers who lost their lending relationships because they never recognized that the faces changed and they needed to tell their story, and form a bond with the decision makers because ultimately they relied on these people just as they would their partners. For a dealership lender to stick with a dealer, especially in times of financial turmoil, the lender must be able to trust the dealer and see that the dealer has a plan that they will follow through on to lead them out of the turmoil.

Know Thy Dealership and Demonstrate that Knowledge to the Lender:

When lenders suspect that a dealer is in financial trouble they will go over the dealers financial and operating statements and look to find whether the dealers financials show appropriate or inappropriate ratios, capitalization and opportunity to succeed. The lenders first detailed look will help them answer whether the dealer is in control of his dealership and the dealerships affairs. This will help them determine whether they believe the dealers operation will be able to protect their collateral to ensure that the bank is repaid. If the bank determines that the dealer is not in control of his/her affairs as assessed by the dealers accessible and appropriate answers, honest assessments, good records, realistic understanding of where the dealership is and what needs to occur to return to financial ability, the dealer has a much lower chance of having the lender work together with his operation as a partner.

A big part of the assessment will be whether the lender determines if they can trust the dealer and whether the dealer has the capacity and ability to return the dealership to a road of recovery with a realistic operational plan that the dealer can implement. The bank has the option of working with the dealer or trying to protect the assets the dealer pledged to get the loans or a hybrid of the two. The lender will need to determine whether the dealer will have to liquidate, file bankruptcy to reorganize, decide to voluntarily sell, etc.¹⁸ In determining how the lender will approach the dealer, often the most important determination is whether the lender thinks the dealer will cooperate with them or work against them. If the lender thinks that the relationship will become adversarial they will often afford much less latitude

¹⁸ *Id.*

to the dealer. However, if they think the dealer will cooperate with them operationally (or in the case of the operational changes not working, in turning over the available assets) they will often be much more amenable.

Lender Liability

In some cases dealers are victims of what the law calls lender liability. Lender liability has developed into a substantial body of law and this overview cannot give the subject justice here but a short discussion ensues to help dealers consider their dealerships circumstances. Fundamentally, lender liability law mandates that lenders must treat their borrowers fairly, and when they don't, they can be subject to borrower litigation under a variety of legal claims.¹⁹ Although lender liability is a very important set of legal theories to consider, dealers are well advised that litigation with lenders does not create harmonious relationships and will very likely fracture the lending relationship beyond repair. Typically, claims of lender liability come in one of three common areas.

The first theory of lender liability is a claim made by the dealer of a breach of a *fiduciary obligation* by the lender. Although when the lender and borrower relationship is an arms-length relationship, lenders have no fiduciary obligations when this relationship turns to one in which the lender exerts too much control, lenders become fiduciaries of the dealership and as such they owe special duties to look out for the dealers interests with special care.²⁰ In *Waddel v. Dewey County Bank*, the court created three elements to aid in determining if a fiduciary

¹⁹ Capello & Noel, *What is Lender Liability?*, Cappello & Noel, LLP, March 26, 2008, <http://corporate.findlaw.com/finance/what-is-lender-liability.html>

²⁰ *id.*

relationship between a lender and their borrower had formed.²¹ The elements the court considered were: 1) the borrower must have faith, trust and confidence in the bank; 2) the borrower must be in a position of inequality, dependence, weakness or lack of knowledge; and 3) the bank must exercise dominion, control or influence over the borrower's affairs.²² Ordinarily, the element that is of particular issue creating a fiduciary relationship is when banks, in an effort to protect the assets that collateralize their loan, exercise too much control over the dealership operation. This is a fact sensitive inquiry and the dealer will need to consider all of the circumstances and the actions the lender has taken to come up with a good determination with their legal counsel.

Another area that can create lender liability is when lenders inappropriately sell collateral of a dealer after a loan default. The Uniform Commercial Code (UCC) requires that the method, manner, time, place and terms of the sale of collateral be "commercially reasonable."²³ Although "commercially reasonable" leaves both sides many arguments for or against, there are a host of areas that tend to show a lack of "commercially reasonable" behavior. Lenders can run afoul when they rely on poor appraisals, provide insufficient publicity for asset sales, when they fail to hold public auctions of repossessed cars, equipment or parts and when they offer assets to a limited market of dealers they know, at prices lower than the actual values.

The last common area that creates claims by dealers against lenders for lender liability is for breach of contract or fraud. Most commonly the dealer claims

²¹ Waddell v. Dewey Cnty. Bank, 471 N.W.2d 591 (S.D. 1991)

²² *Id.*

²³ *Id.* at 18.

that the lender has made an oral promise that the lender fails to make a part of the written contract. When questioned, the lender assured the dealer that the provisions or absence thereof are formalities and that the dealer doesn't need to worry about their absence. When dealers make these claims, the lenders often use the parol evidence rule to try and prevent the dealer from recovery. The parol evidence rule in general prevents the introduction of evidence of prior or contemporaneous negotiations and agreements that contradict, modify or vary the contractual terms of the written contract. In the case of a dealer, this is usually the loan document.²⁴ Courts have recognized in many dealer actions against their lenders, that allowing lenders to arbitrarily stand behind the Parol Evidence rule as a veil of protection over such promises they purposely made, could open the door to lender misconduct allowing the lenders to make oral promises that they had no intention of fulfilling. As such there are exceptions to this rule. There are 7 enumerated exceptions to the rule. The most common exception dealer's use is that the parole agreement does not contradict or change the main contract. In *Siegner v. Interstate Prod. Credit Association*, the borrowers brought an action against their lenders claiming a breach of their contract. The borrowers claimed that the lender partly orally and partly in the written contracts agreed to lend them money per a written agreement but orally assured them that the loan was renewable annually.²⁵ The court held that: (1) parol evidence concerning oral agreement was admissible; (2) that the borrowers established existence of oral agreement which supplemented and extended the written agreement to loan

²⁴ The Parol Evidence Rule, Judicial Education Center, <http://jec.unm.edu/education/online-training/contract-law-tutorial/the-parol-evidence-rule>

²⁵ Siegner v. Interstate Prod. Credit Ass'n of Spokane, 109 Or. App. 417, 820 P.2d 20 (1991)

money; and (3) evidence showed violation of the oral agreement.²⁶ This case evidences the concept that dealers may bring in evidence of oral contracts as parole evidence when the facts surrounding their agreement show that the oral agreements supplement and extend the written agreements between the lender and the dealer.

Although lender liability is a very real growing body of law and in some cases lenders act in a manner that demands action, dealers can minimize these circumstances in many cases by acting proactively. Dealers that are aware of their lenders needs, who understand what their lenders desire and who maintain open dialog are much less liable to fall into either actual or perceived situations in which lender liable arises. Many times dealers feel like their lenders are putting them out of business or treating them unfairly. Although these feelings can be very real they are often due to the dealer not looking at the whole picture and failing to realistically consider the need for dealership change. Often dealers who are on the brink of financial collapse feel like their lender has an obligation to aid them to stay in business. Realistically, the lender has an obligation to protect its own interests. The dealers must make a conscious effort to make the protection of the collateral a byproduct of the dealers plan to succeed. By taking a realistic view, the dealer can better determine whether the bank is treating them wrongly or whether the dealer must make appropriate changes. Generally, in these cases (although very challenging or in many cases impossible), the dealer will need to look for other lenders, banks, captive financial organizations, private capital or even selling off all or part of the dealership to shore up his/her financial situation. This goes back to

²⁶ *id.*

the necessity of the dealer having a realistic view of his/her dealership and a strategic plan on how to overcome the financial and other obstacles that are in the way of financial success.

The bank must trust the dealer, and the bank must have a lucid and well-designed workout plan if the dealer has any chance of gaining a working relationship with the lender. The dealer must persuade them to conclude that their goal is mutually beneficial and the best outcome is to work together in a way that will help return the dealership to a healthy operation that will be able to make the lender whole.²⁷ Part of the dealers plan must be to answer the questions that the lender has and show them that they understand the lenders concerns. The dealer must be ready to implement a plan to meet their concerns and maintain protection of the assets that the dealership has pledged. The dealer must go back to the beginning of this discussion and remind himself or herself that the lender constructive partner's primary interest is to minimize their lending risk. The dealer's lender advanced them money in the form of loans with the expectation of repayment. Even though repayment is in jeopardy they still maintain the fundamental desire to minimize their risk. At the very beginning of the lending relationship, the lender put in a host of protections in place in the event the dealer was unable to repay the monies lent. Now it is up to the dealer to provide a plan that shows the lender, utilizing the relationships that they have with their lender, that it is in their lenders best interest to help them through the financial turmoil instead of implementing their contingency plan to minimize their risk.

²⁷ *Id.*

Stay Away from Selling Out of Trust

Even though many lenders condone selling out of trust and look the other way, one sure fire way to lose the trust of a dealerships floor plan lender is to sell inventory out of trust when financial crisis prompts lender scrutiny. Selling out of trust occurs when a car is sold by the dealer to a retail or wholesale customer and the dealer fails to pay the lender the amount due within the time frame allowed in the dealer's floor plan contract. It seems pretty clear that since the vehicle is the collateral the lender uses to allow the dealer to pay for the car the proceeds of the sale need to be used to pay the obligation to the bank when the bank is relieved of their collateral. This is the case when a bone fide sale is made to a third party of the collateral by the dealer.

Unfortunately, many dealers who experience financial challenges don't even recognize that they are sold out of trust until it is too late. Often the dealer principal relies on his/her back office to stay within the contractual confines of the lender/dealer but when there is too little cash flow for daily activities the back office often falls into the trap of paying down the floor plan slowly to make up for cash flow shortfalls. Often the dealer finds out that they are out of trust when the lender performs a routine floor plan audit. If the auditor finds cars that have been sold and not paid for, the dealer's floor plan contract generally says that the dealer must pay off the car to the auditor on the spot. This can be a very challenging situation that puts the dealer under major scrutiny overnight. If the dealer can't pay off a car or in some cases dozens of cars, the bank may react in ways that severely restrict the dealers operation instantly, which dramatically alter the dealers financial turmoil.

In addition to severe trouble with the dealers lenders, there are other serious legal implications and risks, which come with being out of trust. The most serious is a risk that the act is construed by law enforcement to be criminal. If the dealers jurisdiction considers selling out of trust to be a criminal act, the dealer may risk criminal prosecution. In these cases the dealer can be prosecuted under a theory of theft, larceny, fraud, conversion or false pretenses. Criminal prosecution is not only costly to defend, bears the risk of losing the dealers freedom, can result in large fines and penalties but also can be grounds for the dealers franchisor/manufacturer to terminate the franchise agreement.

There are other implications that become part and parcel with dealers selling out of trust that will be discussed in many of the following sections. Dealers need to understand that although many lenders, managers and back offices condone this behavior, selling out of trust can result in the demise of the dealer and his/her dealership.

Maintain Relationship with Manufacturer/Franchisor

A final but critical consideration that dealers must make is that it is extremely important to understand and consider the relationship between the franchisor and the lender. Once the lender perceives that the dealer is in financial trouble the lender begins to consider at what point they need to notify the franchisor. In these cases, the lenders are concerned with advancing more money on behalf of the dealer for more inventory purchases. In order to stop advancing, they need to notify the franchisor/manufacture that the dealer is on finance hold or worse that

the lender has terminated the finance or floor plan contract with the dealer.

Lenders generally are required to provide letters outlining the dealers access to floor plan lending, enabling the purchase of new inventory as part of the franchise agreement and as such, lenders often have a responsibility to notify manufacturers to protect themselves from liability.

As far as the dealer is concerned, the timing of *when* a manufacturer is notified (and by whom) of impending dealer financial crisis is a key element in the likelihood of the success of the dealer both prior to and during bankruptcy. What the lender does in this circumstance and when they give notice to the franchisor is very important, as once the notice occurs the dealer may be in breach of the franchise agreement. When the franchisor finds out the dealer has financing issues with the lender, the next logical step in the progression is that the dealer's franchise agreement comes under scrutiny and their relationship is in serious jeopardy.

The relationship the dealer has with the franchisor at this point is also very important. If the dealer maintains a stellar working relationship with the manufacturer the manufacturer is more likely to see the issue as less of a surprise and be more reasonable with their dealer. If the dealer is wise he will stay ahead of the issue by maintaining and preserving a good relationship with the manufacturer and understanding that his/her manufacturer interrelates to his/her lender.

The Pitfalls Dealers Fall into Prior to Bankruptcy

Franchise Termination Prior to Filing for Bankruptcy Protection

Under bankruptcy law, it is well settled that a franchise agreement that has not terminated or expired is an executory contract.²⁸ Bankruptcy protection affords the dealer many options that non-bankruptcy law fails to offer the same dealer. This important element of the bankruptcy estate will be discussed further in a host of pertinent discussions following this section. If a dealer's franchise agreement is terminated or expires prior to the filing of bankruptcy it is not an executory contract that will become part of the bankruptcy estate and it is not subject to assumption and assignment.

When a dealership files a petition for relief under the Bankruptcy Code a bankruptcy estate is created.²⁹ Section 541 of the Bankruptcy Code determines which property becomes property of the debtor's bankruptcy estate.³⁰ In its simplest form the dealers bankruptcy estate includes all legal and equitable interest that the dealer had in property both real and intangible as of the commencement of the bankruptcy case. If the dealer is no longer party to a valid franchise agreement at the commencement (the filing of the bankruptcy petition) the franchise agreement is not eligible to become part of the dealer's bankruptcy estate and is not an asset that the dealer can use to reorganize his/her dealership. *Just to be clear franchise agreements are not property of the estate if they were properly terminated pre-*

²⁸ In re Tornado Pizza, LLC, 431 B.R. 503, 510-11 (Bankr. D. Kan. 2010).

²⁹ Rick Pedone & Craig Tractenberg, *Bankruptcy Issues in Franchising: An Overview*, Nixon Peabody LLP, http://www.nixonpeabody.com/files/Bankruptcy_Issues_in_Franchising.pdf

³⁰ *id.*

petition.³¹ As a result dealers must act very carefully as they enter into financial turmoil because generally the most important asset the dealer has, and ultimately in the case of bankruptcy the bankruptcy estate will have, is the franchise agreement between the dealer and the manufacturer. This allows the dealer to operate as a representative of the brand and the franchise agreement is necessary if the dealer wants the opportunity to assign the franchise agreement to add value to the bankrupt estate.

Prior to filing for bankruptcy protection dealers generally have periods either long or short of financial turmoil. During that turmoil there often are many elements within the franchise agreement that the manufacturer/franchisor could cite as grounds for termination or default under the terms of the agreement. One of the dealer's key efforts must be to maintain a close relationship with the manufacturer and continue to make sure they have the support of the manufacturer and at minimum, understand whether the dealer is likely to be terminated per the franchisor's sentiment. The manufacturer has considerably leeway as to when they initiate termination of the franchise agreement. Much of that discretion will be the result of the relationships between the dealer and the manufacturer's representatives. If the dealer is concerned that their manufacturer is about to terminate their dealer agreement, a Chapter 11 filing will initially prevent the termination notice from the manufacturer from being served because the bankruptcy filing will initiate the automatic stay, which is one of the protections

³¹ *id.*

afforded to the filer under Bankruptcy Code.³² The automatic stay is arguably the most powerful tool granted by the Bankruptcy Code under section 362. Section 362 allows for an automatic injunction against almost all third parties from continuing or commencing an action against the debtor or its assets. This includes injunctions against third parties trying to enforce liens, take possession of property, set off a debt or in regard to the point at hand, the automatic stay will prohibit the manufacturer from terminating the dealers franchise agreement. If the dealer fails to file bankruptcy until after the franchise agreement has been terminated, their dealerships bankruptcy estate will not have the option to assume the franchise agreement. Also, they will not be able to assign the franchise agreement and as such, their dealerships chance of a successful reorganization is greatly reduced. This is a key pitfall that dealers can inadvertently fall into and that can be determinative in whether they can successfully reorganize their dealerships.

Sold Out of Trust:

Although most dealers are keenly aware of what Selling Out of Trust (SOT) is, it is important to not only explain the issue but also important to understand the dangers with being sold out of trust. We previously discussed the potentially devastating relational effect SOT can have on the dealer's relationship with their lender in times of financial turmoil. Here we will look at SOT in more detail. When a car dealer sells a vehicle that they own but that they bought through a floor plan

³² Paul Norman, Synopsis of Bankruptcy Law Applicable to Motor Vehicle Manufacturers and Dealers, Boardman, Suhr, Curry & Field LLP, <http://www.stlautos.com/newsletter/april09/bankruptcyLaw.pdf>

loan and fails to use the proceeds of the sale to pay back the floor plan provider, the scenario is termed selling out of trust (SOT). Generally dealers finance their new car and often their used car purchases by utilizing floor plan lending. When the car that they purchased from their manufacturer or another source is sold, the proceeds should be used to pay the loan advance on that particular piece of inventory off by remitting a portion of the proceeds to their lender. When the loan is not paid off, the collateral that the floor plan provider used to make the loan to the dealer is no longer available because a bone fide purchaser has the rights to the collateral. The dealer pitfall stems from the fact that the dealer contract with most floor plan providers allows some leeway to the dealer to pay off the loan. Lenders give dealers leeway to allow the dealer the necessary time to collect the proceeds from the sale from the bank that financed the customer or from the trade-in car, etc. More often than not, the sale transaction does not immediately afford payment for the vehicle at the time of sale. This leeway which varies with the contracts dealers have with their lenders can range from days or in some cases, weeks. This allowed contractual delay can act to create the potential bad habit of dealers paying off floor-planned cars far after they have received the proceeds from the vehicle sale. Often this bad habit is compounded by the floor plan providers desire to collect interest from the dealer, to maintain the lending relationship with the dealer and the lenders inability to track the sales without burdensome oversight. These circumstances often further lead dealers into the false assumption that the lender is fundamentally okay with late floor plan payments. Ultimately this situation enables the dealer to get deeper and deeper into debt and farther and farther sold out of

trust. The specific consequences of being sold out of trust are discussed more fully below in the section; four critical challenges to a successful franchised dealer reorganization. Suffice it to say, that when dealers start selling out of trust and making the false assumption that their lenders will allow this practice to go on indefinitely, the dealer is taking a very risky step that may end up making reorganization impossible and making the debt non-dischargeable.

Fraudulent and Preferential Transfer(s) of Assets

Dealers who are facing bankruptcy have a natural temptation to salvage as much of their property as possible to protect themselves and their families when financial collapse seems imminent. This self-protection is in direct opposition to the bankruptcy trustee who is tasked with amassing as many assets as possible to transfer to the bankruptcy estate for the benefit of the bankruptcy estates creditors or it's reorganization. Additionally the property that the dealer perceives as his/her property generally has been collateralized by the agreements the dealer entered into with their creditors.

There are two types of fraudulent transfers in a bankruptcy case. First, there is actual fraud in which the dealer debtor intends to defraud his/her creditors. Second, there is constructive fraud where the dealer transfers ownership of an asset in exchange for grossly inadequate consideration.³³ In addition to fraud, if a dealer has paid back certain preferred creditors or transferred property out of the dealership prior to filing for bankruptcy, the bankruptcy estate can potentially gain

³³ Bankruptcy Law: Understanding Fraudulent Conveyances, Cadden & Fuller LLP., last visited November 3, 2014, <http://www.caddenfuller.com/CM/Articles/Articles38.asp>

access to these funds or to this property under what is generally referred to as a “claw back” provision.

It is very easy for entrepreneurial dealers or families to fall into one or all of these situations because they see the dealership and the dealership assets either very close to their own personal assets or in some cases they consider the assets their own. Additionally, the dealerships have frequently been funded by family loans and there are certain creditors (often who the dealer debtor has a personal relationship with) who have either less perceived ability to take a loss if the dealership fails to survive, or that are simply closer to the dealer operators and have a preferential spot to the dealer.

Under Section 548 of the Bankruptcy Code fraudulent transfers may be avoided if they were made within 2 years of the date of filing the bankruptcy petition, if the debtor voluntarily or involuntarily made the transfer with actual intent to defraud or if the debtor received less than a reasonably equivalent value in exchange for the transfer.³⁴ Generally the trustee can use the claw back provision to undo fraudulent transfers of money, property or any other asset. Dealers who are faced with financial turmoil must be very careful with any and all transfers that are made during the turmoil as all the transfers will come under great scrutiny in the event of a bankruptcy filing.

Along the same lines, dealers must be careful about making payments or transferring property to those that the bankruptcy trustee may consider preferential creditors. For example if the dealer makes a loan payment to his wife, his parents, a friend, a sibling etc. just before filing for bankruptcy, the transfer will probably be

³⁴ 11 U.S.C. § 548 (2004).

considered a preferential transfer. Whether or not the trustee will be able to void the transfer and claw back the property depends on the value, the timing and the recipient of the preferential transfer.

A simple overview is that if in the 90 days preceding the bankruptcy filing the dealer transferred money or property worth over \$6000 in total to one of the dealers creditors while the dealer was insolvent, and the result is that the creditor got more than they would be entitled to through the dealership's bankruptcy, the transfer will be deemed a preferential transfer. Additionally, these rules apply to transfers of including payments or transfers of property or other assets to insiders of the dealership such as friends, family members, or business partners. In the case of insiders, the transfers will be considered preferential if they are made within one year prior to the bankruptcy filing.

Dealers should avoid making fraudulent or preferential transfers during periods of financial turmoil or else the transfers will likely be subject to claw back by the bankruptcy court. If transfers have been made that may be considered preferential or fraudulent, dealers may be able to avoid claw back by delaying the bankruptcy filing or making sure that the requisite statutory time has passed since the transfer was made. However, this is a dangerous game for a host of reasons. First, as mentioned above, timing is very important and trying to protect a transfer may result in missing out on the all-important assumption of the franchise agreement as an executory contract. Additionally, hiding assets or intentionally committing bankruptcy fraud, can result in the loss of the property, the disallowance

of a bankruptcy discharge and may even lead to criminal investigations and prosecutions of the dealer or the parties responsible for the fraud.

The Fundamental Elements of a Franchise Automotive Dealership Bankruptcy - Synopsis of Dealership BK law

This discussion of the fundamental elements of a franchised new car dealer in bankruptcy is designed to give automotive dealers a practical introduction to many of the overall issues related to bankruptcy. Every dealer's situation is unique based on the surrounding facts and circumstances. As mentioned previously, this material should not be used in place of legal counsel. Dealers need a team of advisors that understand the specific dealer's circumstances. An astute dealership operator should marry their unique business experience with that of a bankruptcy practitioner in order to create a plan utilizing the teams combined skills that works for his/her operation, personal interests and the interests of their creditors and other stakeholders. This plan should not be created the day the dealer desires bankruptcy protection and ideally will be part of a well-considered plan that can aid the dealer in accomplishing his/her goals.

Car dealers often initially consider bankruptcy protection as a relief from the severe stress that comes with financial pressure, uncertainty and creditor demands. Dealers seek to utilize bankruptcy as either an aid to going out of business or in other cases, to give them breathing room while they work to restructure their dealership operations from crippling debt, for example, in order to maintain their dealership operation.

Timing Issues:

The timing for dealers seeking bankruptcy protection is critical and ultimately is determinative of whether bankruptcy can afford the dealer the protection that they need to realize their individual goals. We will speak more about timing issues in *the pitfalls dealers make* section later but suffice it to say timing is critical.

Unfortunately, often dealers initiate bankruptcy after the ideal timing and therefore limit the effectiveness of bankruptcy. Since the timing of filing is very important, it is necessary for the cognizant dealer operator and dealership stakeholders to consider the fundamentals of dealership bankruptcy and the various bankruptcy alternatives in advance to maximize its effectiveness. Issues such as whether a dealer can assign their franchise agreement to another dealer to access blue sky, whether they can stave off their manufacturer(s) from terminating the dealership(s) franchise agreement(s) or whether they can prevent foreclosure on the dealerships vehicle inventory by their floor plan provider(s) are all issues in which timing plays a critical part.

Peripheral Agreements, Contracts & the Dealers Obligations

In addition to the operational elements of a dealership bankruptcy, the owners of a dealership should consider the peripheral agreements that they have made with their creditor(s). One such agreement routine to dealerships is the Personal Financial Agreement in which the dealer pledges his/her personal liability to their lenders. Although dealers may assume that their dealerships which they have organized as corporations or limited liability corporations shield them from

personal liability, more often than not they *will* have personal liability due to the contracts that they have entered into with their lenders. Dealers likely signed personal guarantee(s) in which they have personally promised their lender(s) to make good on the loan(s), even if the business cannot repay the loans per the terms of the contracts. Additionally dealers may find that even their spouses have personal liability based on similar contractual obligations. More often than not, the dealership's creditors or specifically the real estate and floor plan providers have attained personal guarantees from the dealer principal, their spouses and perhaps other parties to secure their debt. If any of the dealership debt is secured with a personal guarantee, in addition to accessing the dealership collateral, the creditor will also be able to pursue a personal claim(s) against the guarantor(s). If there is a personal guarantee, the guarantor will also need to consider personal bankruptcy protection in addition to the dealership's bankruptcy protection depending on his/her ability to pay the debt that the dealership is unable to pay.

Dealers should also gather and consider the other documents and agreements that they have signed with their lenders. Although the list is endless one example is a *cross collateralization agreement or provision*. Cross-collateral agreements can be separate agreements or a provision in a security agreement that the dealer signed when their lender closed their real estate, lien of credit or floor plan loan. This clause provides the bank with a legal right to seize any or all assets pledged by the borrower even when only one loan is in default. Under this agreement, dealers often utilize not only the specific asset that is attained based on a loan from the lender, but all their other assets. This puts not only the dealership

under financial pressure, but may include other business entities, real estate, stock accounts, etc. as collateral to compel the lender to make a loan to the dealership. If the dealer has entered this type of agreement he/she may not be aware that being in default (for example on their mortgage) not only jeopardizes foreclosure of the real estate but also of their vehicle inventory. If the dealership has a cross collateral agreement additional consideration needs to be made to all the assets that have been cross-collateralized. When the dealer files for Bankruptcy protection for the dealership entity, the automatic stay will not provide an automatic injunction against creditors from continuing or commencing an action against the non-filing debtor(s) or their assets. As such, those who have pledge collateral in other corporations or personally must consider whether they will need Bankruptcy protection either personally or for other entities in which they have pledged its collateral.

Liabilities that are not Dischargeable:

Another very important consideration is the liabilities of the corporation that are not dischargeable in a Bankruptcy filing. The first broad category of non-dischargeable liabilities is tax liabilities. To be dischargeable, individual income tax liabilities must meet the “mechanical” rules of 11 USC §§ 523(a)(1) and 507(a)(8) which are summed up as follows:

- More than three years must have elapsed since the tax return generating the liability was due, including extensions. Various acts such as prior bankruptcies, collection due process (CDP) hearings, innocent spouse relief and tax assistance orders can extend the three-year time frame.
- The tax return must have been filed more than two years earlier than the bankruptcy petition (generally applicable to late-filed returns). Note, however, that IRS-prepared “substitute for returns” are not considered filed returns for this purpose, and thus a tax liability assessed from them would not be

- subject to discharge (IRC § 6020(b)). Therefore, it is almost always advisable for the client to file all delinquent returns and, if possible, let the mechanical time frames pass before the bankruptcy petition is filed.
- At least 240 days must have elapsed since the date of an IRS assessment

Specific consideration also needs to be made if the dealership is delinquent on its payment of sales tax or employee withholding for income tax as these types of withholdings are deemed “trust fund” taxes. IRC § 7501 provides that whenever any person is required to collect or withhold any internal revenue taxes from any other person and to pay over such tax to the United States, the amount of the tax shall be held in a special trust fund for the United States.³⁵ Trust fund taxes include employment taxes and certain types of excise taxes. Taxes that are referred to as “trust fund” taxes are not dischargeable in bankruptcy. Section 523(a)(6) provides that the debtor’s bankruptcy discharge does not discharge liability for any debt resulting from willful and malicious injury by the debtor to another’s person or property.³⁶ These non-dischargeable liabilities include taxes that are technically being paid by someone other than the business, with the business being responsible only for collecting the tax and depositing it with the taxing authority. Dealers and dealer employees need to be especially careful to make sure that these taxes are remitted to the appropriate taxing agency in a timely fashion even in the midst of financial struggle. In re Calabrese the New Jersey bankruptcy court considered a business that had withheld sales tax and failed to pay it over to the state. The bankruptcy court held that the sales tax was a trust fund tax that the business had collected from customers and held in trust for the state and as such

³⁵ Internal Revenue Code § 7501, July 18, 2012

³⁶ 11 U.S.C. § 523 (2004).

was non-dischargeable.³⁷ Just like sales tax collected on behalf of the state the dealer operates in, the federal government requires employers to withhold a portion of their employees' wages to pay Social Security and Medicare taxes. Like sales tax employee withholding tax must be paid to the IRS by the dealer. Dealers often find themselves in trouble with a failure to remit these employee taxes because the IRS is not as active as lenders, suppliers, or employees in demanding that the struggling dealer remit payment. Unfortunately, this can cause the dealer to fail to remit the taxes and pay other louder creditors in the face of financial struggles. This is a bad idea because just like sales tax, withholding taxes are not discharged in bankruptcy, and the liability can grow very fast especially when IRS penalties and interest is factored into the amount the dealer owes. Dealers may find long after bankruptcy they are strapped with huge and insurmountable tax obligations from sales and employee taxes that they once held in trust and misappropriated to other lenders of which their debts, if not paid, would have been dischargeable. Additionally, failure to pay these trust fund taxes can lead to personal liability for not only the dealer principal but also other parties within the dealership operation. Under IRC Section 6672 those that are subject to the trust fund recovery penalty include: responsible parties within the company, officers or employees of a corporation, partners or employees of partnerships, member or employees of an LLC, Corporate directors or shareholders, another corporation and payroll service providers.³⁸

³⁷ In re Calabrese, No. 10-6583, 2011 BL 233776 (D. N.J. Sept. 13, 2011)

³⁸ IRC § 6672, July 18, 2012

Various Chapters of Bankruptcy:

Dealers may find it advantageous, in some instances, to use bankruptcy to go out of business with the least amount of continuing financial problems by using a Chapter 7 bankruptcy filing or to recover from issues like crippling debt while remaining in business under a Chapter 11 bankruptcy. Bankruptcy petitions can be made either voluntarily by debtors to help shield them from creditors demands or in rare cases bankruptcy filings can be commenced involuntarily by the debtor dealers creditors. Whether voluntary or involuntary, when a bankruptcy petition is filed, the filing creates an automatic stay against creditors pre-petition debt in which creditors cannot enforce their pre-petition debts against the debtor. Fundamentally, there are three types of bankruptcy that car dealerships, their dealer principals and other dealership debtors need to consider. There is Chapter 7 Bankruptcy, Chapter 11 Bankruptcy and Chapter 13 Bankruptcy.

Chapter 7 Bankruptcy

Chapter 7 Bankruptcy is the method that either personal or business filers can utilize to liquidate either their personal or business assets in an effort to pay their debts to their creditors. To qualify for relief under chapter 7 of the Bankruptcy Code, the debtor may be an individual, a partnership, or a corporation or other business entity.³⁹ A chapter 7 Bankruptcy case does not involve the filing of a plan of repayment, instead, the bankruptcy trustee gathers and sells the debtor's nonexempt assets and uses the proceeds of such assets to pay creditors in accordance with the provisions of the Bankruptcy Code. Part of the debtor's property may be subject to liens and mortgages that pledge the property to secured

³⁹ 11 U.S.C. §§ 101(41), 109(b).

creditors while other property will be unsecured property. The Bankruptcy Code allows debtors to keep certain "exempt" property but the trustee will liquidate the debtor's remaining non-exempt assets. Once the assets are sold and are liquid the properties proceeds are then distributed to creditors to fulfill the debtor's obligations to his/her creditors.⁴⁰ Chapter 7 Bankruptcies have the advantage of resolving claims against the dealership while mitigating the stress that's associated with trying to keep a financially distressed dealership alive while continuing to incur debt amidst major cash flow issues. Although technically creditor's claims against the dealership are not discharged in a Chapter 7 Bankruptcy, the practical effect is effectively the same as a discharge. Once all of the dealership's assets are liquidated and distributed to the dealership's creditors, the dealership ceases operations and ultimately there are no assets left for the dealership creditors to pursue. Accordingly, debtors should realize that the filing of a petition under Chapter 7 might result in the loss of property.⁴¹ At the end of the Chapter 7 filing the dealership will no longer exist as a going concern. In Chapter 7 personal bankruptcies the individual guarantor will have to liquidate all their non-exempt personal assets in order to fulfill their obligation(s) to the creditor(s) that are a result of the deficiency(s) of the collateral deficiency of the dealership. There are a host of obvious and not as obvious consequences to filing both a dealership bankruptcy and personal bankruptcy that the dealer principal needs to consider. While there is no bar on the bankrupt dealer principal from starting a new dealership or other venture the practical implication is that the principal's ability to obtain credit, new

⁴⁰ Liquidation Under the Bankruptcy Code, last visited October 26, 2014, <http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter7.aspx>

⁴¹ *id.*

franchise agreements or even enter the necessary trade agreements with vendors will be greatly impaired by a bankruptcy and will most likely effectively bar the dealer principal from obtaining a dealership in the near future.

Chapter 11 Bankruptcy

Dealers use Chapter 11 bankruptcy as a way to reorganize their dealership with the fundamental goal of allowing the dealership to continue as a going concern. Under Chapter 11 protection the dealer gets an opportunity to reorganize with reduced stress from their creditors and within the confines of the Bankruptcy Code, which has many attributes that allow dealers advantages in reorganization. Chapter 11 of the Bankruptcy Code generally provides for reorganization and usually involves a corporation or a partnership. Although a Chapter 11 debtor can be an individual, a Chapter 11 debtor usually proposes a plan of reorganization to keep his/her business alive and pay creditors over time instead of in liquidation.⁴² After a dealership files Chapter 11 the dealership creditors cannot take any action to enforce the claims that they have against the dealership and they cannot terminate any essential supply measures without first gaining the courts approval as a result of the automatic stay as mentioned previously. Generally a dealer in a Chapter 11 reorganization will stay in control of their dealership as a Debtor In Possession (DIP) and as such they will be under the bankruptcy courts supervision. The term refers to a debtor who keeps possession and control of its assets while undergoing reorganization under chapter 11, without the appointment of a trustee. A debtor will remain a DIP until the debtor's plan of reorganization is confirmed, the

⁴² Reorganization Under the Bankruptcy Code, last visited October 26, 2014, <http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter11.aspx>

debtor's case is dismissed or converted to chapter 7, or a chapter 11 trustee is appointed. The appointment or election of a trustee occurs only in a small number of cases. Generally, the debtor, as DIP, operates the business and performs many of the functions that a trustee performs in cases under other chapters all while running his/her dealership.⁴³

Since the ultimate goal of a successful Chapter 11 is to allow the dealership to emerge operating and functioning as a sustainable dealership that can pay its creditors, operational changes in the dealership generally must occur to return the dealership to sustainability. Dealers can utilize Chapter 11 to assume or reject executor contracts, which include the major categories of expenses like floor plan and real estate loans. Similarly dealers can assume or reject franchise agreements and other executory contracts and they can potentially assign non-assignable franchise agreements and other executory contracts to other dealers that would be prohibited from assignment outside of bankruptcy.

Although a key-determining factor to enter bankruptcy is often to relieve some of the daily stress resulting from financial turmoil, this is only partially attained in chapter 11. The very nature of a Chapter 11 case and operating as a DIP means that the dealer will still have to be immersed in the stress of trying to reorganize a troubled dealership while creating a plan that creditors must confirm.

A chapter 11 case begins with the filing of a petition with the bankruptcy court serving the area where the debtor has a domicile or residence.⁴⁴ The debtor

⁴³ 11 U.S.C. § 1107(a).

⁴⁴ How Chapter 11 works, last visited October 26, 2014, <http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter11.aspx>.

must file with the court: (1) schedules of assets and liabilities; (2) a schedule of current income and expenditures; (3) a schedule of executory contracts and unexpired leases; and (4) a statement of financial affairs.⁴⁵ The courts are required to charge a filing fee and a miscellaneous administrative fee and the fees must be paid to the clerk of the court upon filing or may be paid installments.⁴⁶ Voluntary petitions include standard information concerning the debtor's name(s), social security number or tax identification number, residence, location of principal assets (if a business), the debtor's plan or intention to file a plan, and a request for relief under the appropriate chapter of the Bankruptcy Code. Upon filing a petition for relief under chapter 11 the debtor becomes a "debtor in possession."⁴⁷

At the beginning of a Chapter 11 filing, a written disclosure statement and a plan of reorganization must be filed with the court.⁴⁸ The disclosure statement is a document that must contain information concerning the assets, liabilities, and business affairs of the debtor sufficient to enable a creditor to make an informed judgment about the debtor's plan of reorganization.⁴⁹ The information required is governed by judicial discretion and the circumstances of the case. The contents of the plan must include a classification of all of the claims against the dealership and must specify how each class of claims will be treated under the plan.⁵⁰ Most chapter 11 dealership cases deal with the restructuring of multiple types of debt, which is divided into classes. These classes include for example: priority tax debt,

⁴⁵ Fed. R. Bankr. P. 1007(b).

⁴⁶ 28 U.S.C. § 1930(a); Fed. R. Bankr. P. 1006(b); Bankruptcy Court Miscellaneous Fee Schedule, Item 8.

⁴⁷ 11 U.S.C. § 1101

⁴⁸ 11 U.S.C. §§ 1121, 1125.

⁴⁹ 11 U.S.C. § 1125.

⁵⁰ 11 U.S.C. § 1123.

secured debt, unsecured debt, and leases.

In the case of Priority Tax Debt, Chapter 11 can be a useful tool to reorganize past due taxes that the dealership incurred but failed to pay. Debts such as property taxes, income taxes, and payroll taxes can be restructured to allow the dealership to continue to operate while meeting its tax obligations at the same time. While most tax obligations usually get paid off during a five-year period, Chapter 11 allows the DIP to renegotiate repayment terms on grounds mutually acceptable to the dealer and the taxing authority.

In the case of Secured Debt Chapter 11 permits dealers to reorganize secured debts in a similar manner to individual cases. The DIP identifies which secured debts and corresponding collateral will contribute to the profitability of the business. Then, just like in the individual Chapter 11, the DIP may seek to pay the current value of the property as opposed to what the dealership actually owes on it. This can be a useful restructuring tool and a critical negotiation for collateral such as the dealership's real estate, business equipment, loaner cars, etc. because the DIP can ask the court to allow the dealership to pay only what the collateral is worth as opposed to what is owed. This allows dealers to reduce their monthly operating expenses in order to become more profitable.

Unsecured Debts such as company credit cards, signature loans, or other general unsecured loans can help with upstart and ongoing operating costs, but frequently act as a major burden on profitability. Chapter 11 allows dealers to restructure their unsecured debt and pay towards it with the company's future profit(s) either as lump sums at the conclusion of the Chapter 11 case or in periodic

payments over a term of years. Ideally, the DIP and his/her class of unsecured creditors will agree upon how much and when they will pay. If an amicable agreement cannot be reached between the dealer and the creditor class, the judge will decide what is fair and the DIP will be bound by the decision.

In the case of Lease or Executive Contract Debt Chapter 11 permits dealers to accept or reject their leases and executive contracts. Chapter 11 allows dealers to sever contracts that would not be severable outside of bankruptcy. If dealers can show that new contract(s) and corresponding service(s) will contribute to the profitability of the dealership, the dealer may then ask the court to allow them to seek a new, more affordable contract and generally, the judge will authorize the new contract.

Creditors whose claims are "impaired," which means claims whose contractual rights will be modified and the creditors will be paid less than the full value of their claims under the plan, vote on the plan.⁵¹ After the disclosure statement is approved by the court and the votes are collected and tallied, the court will conduct a confirmation hearing to determine whether to confirm the plan or not.⁵² A Chapter 11 bankruptcy in many cases is a contentious negotiation. Each class of creditors (priority, secured, and unsecured) are entitled to vote to accept or reject the dealers proposed treatment of them in their bankruptcy plan. After the initial hearings, the court authorizes the DIP to solicit votes. Ideally, the DIP will procure a vote of acceptance from every creditor and then the judge will approve the plan on that basis. Generally the DIP will have to negotiate various terms with

⁵¹ 11 U.S.C. § 1126.

⁵² 11 U.S.C. § 1128.

the individual creditor(s) to obtain acceptance so the process is wrought with emotion, negotiation and to be successful generally all the parties must compromise.

In the event a creditor rejects the plan, the creditor's non-acceptance may be a major impediment to court approval of the plan. If all the negotiations fail, the DIP will have to ask the judge to approve the case over the objection of the non-accepting creditor(s). This request is referred to as "cram down" because ultimately the DIP is asking the judge to cram the terms of the plan down the non-accepting creditor's throat.

If all goes well and the DIP can successfully negotiate the treatment of each participating creditor in the bankruptcy, and the newly negotiated terms allow the dealership to operate profitably, and the dealership has access to the necessary funds to operate the dealership, the DIP should be able to restructure the dealership debt in a way that allows the dealership to emerge from bankruptcy lean and profitable. After a successful Chapter 11 reorganization either the debtor or a new debtor/operator/franchisee will emerge and be confirmed by their creditors. Some or all of the creditors may have received less than the full value of their claims that they had against the debtor pre-petition.

Chapter 13 Bankruptcy

Although not available to corporations and only available to individuals, Chapter 13 Bankruptcy filings are an important consideration for dealership principals and other dealership personal guarantors. Chapter 13 petitions are used by individuals who have regular income in which a portion of the individual

petitioner's future earnings can be used to pay some or all of the creditor's claims. In a chapter 13 personal bankruptcy the individual guarantor will have a portion of their future earnings set aside by the bankruptcy trustee to fulfill their obligation to the creditor as a result of the deficiency of the collateral deficiency of the dealership. Chapter 13 allows individual debtors to keep their property and pay debts over a time period that is usually three to five years.

One of the most significant reasons dealer principals consider Chapter 13 filings is based on the idea that it offers them an opportunity to save their homes from foreclosure. There are clear eligibility requirements associated with a chapter 13 filing.⁵³ Individuals, even if self-employed or operating an unincorporated business, are eligible for chapter 13 relief as long as the individual's unsecured debts are less than \$383,175 and secured debts are less than \$1,149,525.⁵⁴ By filing under this chapter, and receiving the benefit of an automatic stay, dealer principals or other dealership guarantors in their individual capacity can stop foreclosure proceedings and may cure delinquent mortgage payments over time.⁵⁵ Nevertheless, they must still make all mortgage payments that come due during the chapter 13 plan on time. Another advantage of chapter 13 is that it allows individuals to restructure secured debts (other than a mortgage for their primary residence) and extend them over the life of the chapter 13 plan. Doing this may lower the monthly payments and aid the debtor in returning to financial stability. Finally, chapter 13 acts like a consolidated loan payment under which the individual

⁵³ Reorganization Under the Bankruptcy Code, last visited October 26, 2014, <http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter13.aspx>

⁵⁴ 11 U.S.C. § 109(e).

⁵⁵ Reorganization Under the Bankruptcy Code, last visited October 26, 2014, <http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter13.aspx>

makes the plan payments to a Chapter 13 Trustee who then distributes payments to creditors and Individuals. This results in the debtor having no direct contact with creditors while under chapter 13 protection which in many cases relieves the debtor of stress caused by the creditors collection efforts.⁵⁶

Four Critical Challenges to Successful Dealer Reorganization:

Dealers encounter many of the same issues that other businesses struggle with in the midst of financial distress yet in addition to the typical struggles, dealers have issues that are unique to the franchised automotive dealership industry and which are often fundamental to their ability to successfully reorganize under bankruptcy. The issues that are key roadblocks to dealers in their effort to reorganize often revolve around one or all of the following issues.⁵⁷ First the franchise agreement is imperative to the dealer to be a franchised new dealer and without it the dealer simply can either no longer survive or they must become a totally different operation. Second, selling out of trust is almost the norm for dealers that find themselves in financial turmoil and once the dealer is sold out of trust, emerging from the situation is perilous at best. Third, paying key vendors is imperative and often a very big challenge. Lastly retaining key employees and creating employee retention plans as a part of reorganization that are effective can be daunting.

⁵⁶ *id.*

⁵⁷ Wayne Kitchens & Patrick McCarren, Vehicle Dealers and Bankruptcy Panacea or Pandemonium, Hughes Watters Askanase, LLP.

Franchise Agreements:

The franchise agreement is so imperative we will discuss this executive agreement in detail in its own section. However, since the lack of a franchise agreement in the bankruptcy estate of a franchised car dealer makes reorganization practically impossible, it must be considered in virtually every discussion related to franchised dealers reorganization. A trustee may assume or reject any executor contract of the debtor under § 365 of the Bankruptcy Code.⁵⁸ In the case of a franchised dealer bankruptcy the franchise agreement is an executory contract. For an executory contract to be eligible for assumption, the dealer must have avoided the pitfall of filing for bankruptcy protection too late as outlined above.

When the Trustee or DIP chooses to assume the franchise agreement, the trustee or DIP cannot pick and choose the ideal terms found in the franchise agreement but instead must assume or reject the entire agreement.⁵⁹ The assumption of the franchise agreement acts as the continuation of the relationship between the dealer and the franchisor/manufacturer. In order for the franchise agreement assumption to be consummated the court must approve the assumption.

Normally courts that find that there is a benefit to the bankruptcy estate and will approve the assumption of the franchise agreement. In the case of a franchised car dealer's bankruptcy there is little doubt that there is a benefit to the estate as the franchise agreement is the cornerstone of a dealers operation. Without the franchise agreement other tangible and intangible assets that have real value are greatly diminished. For example, the intangible asset of good will can and generally

⁵⁸ 11 U.S. Code § 365 - Executory contracts and unexpired leases

⁵⁹ NLRB v. Bildisco & Bildisco, 465 U.S. 513, 531 (1984).

does enhance the value of a dealer operation but without a franchise agreement in all but very rare cases, there is nothing to enhance and as such, good will have little or no value. Similarly, dealerships real estate and real improvements are extremely valuable assets but if the bankruptcy estate has no franchise agreement the asset value(s) are greatly reduced because the value of the real property will be based on an alternative use instead of the use as intended for the very specific franchise brand as generally built out to the specifications for the corporate identity of the franchise/manufacturer. With that in mind, the trustee or DIP should have little difficulty establishing that the proposed assumption of the franchise agreement as an executory contract that will benefit the estate.

Franchise agreements differ though from other executory contracts because the agreements typically call for a much more intimate relationship between the franchisor and the franchisee. The franchise “intimacy” is because the ongoing relationship that is governed by the agreement involves the license of the franchisor’s trademark and the related goodwill of the brand. Although both the franchisor and the dealer both have a duty and perhaps more importantly, a desire to protect and maintain the good will of the automotive brand governed in the franchise agreement, the parties still end up with differing positions. This is especially the case when one of the parties is in financial distress. On one hand the franchisor has an international brand that they are obligated to protect and in which one isolated issue can cause substantial negative ramifications across their entire brand. As such the manufacturer must be vigilantly protective of their brand. Conversely, the franchise and related franchise agreement is often the most

valuable and important asset the dealer has. The ability to assume or assign the agreement is generally determinative of whether the dealer can successfully reorganize under chapter 11.⁶⁰ Even though the image of the brand is important to a dealer the value of his/her franchise is of paramount importance. These conflicting interests are the very interests that bankruptcy courts must analyze under § 365 to determine whether to allow the assumption or assignment of each franchise agreement.⁶¹

Although the trustee or DIP may find it a low hurdle to show that the assumption of the franchise agreement will benefit the bankruptcy estate that is just the first hurdle. Once approved by the court, if the franchise agreement is in default, the trustee then must cure the defaults and provide the franchisor with adequate assurance of future performance under the contract per § 365(b) before they can assume the franchise agreement.⁶² Although at first blush this appears to destroy the potential for dealers to assume their respective franchise agreements because of the many defaults dealers in financial distress will be in by the time they file for bankruptcy, there are a host of exceptions to the rule to cure their defaults prior to assumption. Any contractual defaults are excluded from the requirement for a cure if they arise from (1) the debtor dealers insolvency or financial condition; (2) the commencement of a bankruptcy case; (3) the appointment of or taking possession by a trustee or custodian in a bankruptcy case or before a case

⁶⁰ Wayne Kitchens & Patrick McCarren, Vehicle Dealers and Bankruptcy Panacea or Pandemonium, Hughes Watters Askanase, LLP.

⁶¹ *Id.*

⁶² 11 U.S. Code § 365(b) - Executory contracts and unexpired leases

commences; or (4) the satisfaction of any penalty for the debtors failure to perform a non-monetary obligation under the contract.⁶³

Often the reason that assumption of the franchise agreement is important to the DIP is because the DIP wants to assign the franchise agreement to a third party to enhance the value of the bankruptcy estate. Assignment is a key consideration for the DIP and will be discussed in detail below. For franchised new car dealers, the first hurdle is assignability of the franchise agreement itself. Most, if not all new car dealer franchise agreements explicitly prohibit dealers from assigning their franchise agreements. When a dealership is in bankruptcy the assignment of a franchise agreement is subject to two prerequisites outlined in § 365(f)(2).⁶⁴ First, the Trustee must assume the franchise agreement in accordance with § 365. Second, the assignee of the franchise agreement must provide adequate assurance of future performance. Ultimately the trustee may assign the franchise agreement regardless of whether the franchise agreement has provisions that prohibit, restrict or otherwise condition the proposed assignment.⁶⁵ The bankruptcy court will make a fact specific enquiry to confirm that the facts support that the § 365 prerequisites for the assignment of the franchise agreement are met. If for any reason the bankruptcy estate cannot assume the franchise agreement, the defaults cannot be cured by the estate, or the franchise agreement cannot be assigned the likelihood of a successful chapter 11 filing become virtually non existent.

⁶³ 11 U.S.C.A. § 365 (West)

⁶⁴ 11 U.S.C. § 365(f)(2) (2004).

⁶⁵ 11 U.S.C. § 365(f) (2004).

Selling Out of Trust:

In addition to the many potential pitfalls that surround the assumption and subsequent cure and/or assignment of the franchise, many dealers find that their financial distress has caused them irreparable harms in their relationships with their financing sources. Virtually every manufacturer requires that dealership franchisees maintain a means to finance the inventory that they purchase from the franchisor/manufacturer. The ultimate goal of automotive manufacturers is to sell more cars. In order to effectuate this process automobile manufacturers need dealers to *buy* the vehicles from the manufacturer/franchisor. It is generally necessary for the dealer franchisor to set up a line of credit termed floor plan in the auto industry to use to pay for the vehicles that the dealer purchases. The floor plan gives lenders a security interest in all the vehicles that the dealer purchases from the manufacturer to later sell.

This system works extraordinarily well until dealers find themselves in financial distress. Unfortunately when dealers face financial difficulty it is easy for them to go “sell out of trust” (SOT). -In the vast majority of cases the dealer does not have an intent to defraud the floor plan provider but instead they are optimistic and think that it is a short term solution and they will pay off the floor plan provider with the next transaction or when another receivable is collected or some other occurrence that has no contractual relationship with their failure to repay the floor plan provider. Lamentably, when the dealer fails to reimburse their floor plan provider with the proceeds from a sale the default when found out not only puts the dealer into a default position with their floor plan provider but may very well lead to

the bank foreclosing on the dealer and in some cases criminal fraud charges. When a dealer enters the slippery slope of selling out of trust in addition to the clear contractual default, the relationship the dealer has with the lender generally becomes very stressed. Instead of solely being under financial stress the dealer enters into a newfound position in which the lender loses trust in the dealer and their ability to operate under the confines of the agreement that protects the lender. Ultimately, the floor plan lender has lent the dealer substantial amounts of money that is collateralized by each piece of inventory in the form of new cars. When the lender has a credible reason in the form of the dealer selling out of trust, the trust relationship is broken, the collateral is put at risk and the relationship between the dealer and the lender becomes much more difficult to successfully manage.

In addition to the many consequences of the contract breach and the resulting unraveling relationship between the dealer and the lender, section 523(a)(6) as considered earlier with reference to sales tax and employee withholdings rears its head again. Since section 523(a)(6) provides that the debtor's bankruptcy discharge does not discharge liability for any debt resulting from willful and malicious injury by the debtor to another's person or property, a dealer's SOT can be construed as a willful and malicious injury to the lender's property. Although this is a fact specific enquiry the fact that the dealer is out of trust with its lender can defeat the dealer's ability to have the debt discharged and may even make the dealer personally liable for the debt even when the dealer has not personally guaranteed the debt. The risk of the lender foreclosing on the dealer's inventory, the risk of the franchisor finding out that there is no longer readily

available floor plan to purchase new cars, the risk of the debt being non-dischargeable and the ultimate risk of criminal charges all make it very hard for the bankruptcy estate to emerge from chapter 11 in the event the dealer has entered the dreaded “sold out of trust” territory.

Paying Key Vendors:

When a dealer cannot pay its key vendors the dealership will have a substantially more difficult time reorganizing their operation. Think of a retail automotive dealer without a phone, without access to parts to repair service customer’s vehicles, without fluids to fill customers cars, without ad sources that draw in prospective customers to buy cars, without the ability to purchase used cars from its best supplier. When you think of this dealer what you probably picture is a dealer who is on the brink of failure because he/she does not have access to the essential tools necessary to operate his/her dealership. When a dealer cannot make payment to its key vendors the vendors will generally protect themselves and cease supplying the dealers with products or services that are necessary for the dealerships success. Traditionally DIP’s used § 105(a) of the bankruptcy code that allowed the bankruptcy judge to issue an order “that is necessary or appropriate to carry out the provisions” of the bankruptcy code.⁶⁶

Courts used section 105(a) as a result of arguments by the debtor that critical vendors were the only source of essential goods, and that unless the debtor was permitted to pay its pre-petition debts the debtors would stop supplying the debtor and the bankruptcy would be hindered. In re Kmart Corp the opinion created

⁶⁶ 11 U.S.C. § 105(a)

uncertainty concerning a bankruptcy courts authority to grant approval of payments to critical vendors.⁶⁷ In Kmart the court held that section 105 “does not create discretion to set aside the Code’s rules about priority and distribution; the power conferred by § 105 is to implement rather than override.”⁶⁸ The Kmart decision concluded by determining that a bankruptcy court could not authorize full payment of any pre-petition debt to critical vendors unless all pre-petition creditors of the same class are also paid in full.⁶⁹ Although the holding seemed to remove the possibility of paying critical vendors, the Kmart case and future cases have given some hope that § 363(b)(1) provides the necessary statutory support for entering into critical vendor payments on pre-petition debt yet neither Kmart or other cases have made it clear. There remains the possibility that dealers will not be able to gain court approval to pay pre-petition debt, to their critical vendors and without those vendors the dealership operations will likely not be able to emerge from bankruptcy.

Key Employee Retention Plans:

Although all business operations rely heavily on people, car dealerships are especially reliant on key employees to manage and operate the various profit centers within a dealership. Dealerships cannot produce sales or profit without people and many of the roles require employees that are trained and experienced with the dealerships operation, the franchise brand, the customers they serve and a host of other very specific stakeholder relationships. Many dealer principals believe

⁶⁷ In re Kmart Corp., 359 F.3d 866 (7th Cir. 2004).

⁶⁸ *Id.* At 871.

⁶⁹ *Id.*

that the difference in stellar performance and mediocre performance is the result of the efforts of key employees. Key employees range from upper level managers down to specially trained technicians and even experienced sales people.

Employees are critical to any dealership but their value is particularly enhanced in dealerships that are trying to successfully navigate the minefield of reorganization.

Although dealerships require a skilled workforce that understands their specific brand and work related activities there is generally a large pool of other dealers seeking qualified staff. Key employees of any dealership have a high likelihood of readily finding alternative employment with little or any effort and are often recruited by other dealers who surmise that the employee's respective dealership is under financial stress. If a large number of key dealership employees leave as a result of a bankruptcy filing, the chances of a successful reorganization will be greatly reduced and will likely sink the dealership into liquidation in very short order. For key employees to stay with the dealership they will need an incentive to stay and they will need to be persuaded that they will be paid for their efforts even with bankruptcy looming.

Bankruptcy courts primarily use section 363 to justify employee retention plans. Generally the test of whether to approve an employee retention plan is determined based on the plan being created using good faith business judgment, as substantiated by the debtor if and when the debtor shows that without the key employees there is a significant chance the employees will terminate their employment and unduly burden the bankruptcy estate of the dealership. This argument is very real and represents the real world environment that dealers are in

during bankruptcy. Unfortunately the management is often made up of the very people that mismanaged the dealership and put it into the poor financial state that led it into bankruptcy. In the end, DIP's are faced with a real dilemma in that they must have employees to navigate reorganization but the employees that are trained and able to operate the business are likely the employees that got them in trouble. When working through this issue, dealers and courts must try to find solutions within the fact sensitive situations by providing retention plans that will allow key employees the opportunity to stay and aid the dealership in emergence from bankruptcy. Successfully navigating this difficult task and gaining court approval for an employee retention plan ranges from very challenging to impossible, and is often the challenge that ultimately makes a dealerships reorganization fail.

These four challenges that make dealer reorganization so difficult are just four examples. Many other industry specific issues make reorganization arduous for highly leveraged dealers to reorganize. One commentator on the subject of automobile dealership reorganization noted that he “can’t think of any case where any reasonably sized automobile dealership every truly reorganized”.⁷⁰ Although franchised new car dealerships can successfully emerge from Chapter 11 reorganization, the special issues that they confront that are unique to new car dealers make reorganization especially daunting.

⁷⁰ What Constitutes Success in Chapter 11? A roundtable Discussion. 2 Am. Bankr. Inst. L. Rev. 229, 247 (1993).

The Franchised Dealers most Valuable Asset – The Franchise Agreement as an Executory Contract:

Franchise agreements are executor contracts under the Bankruptcy Code and as such as previously mentioned, these agreements are pivotal to the bankruptcy estate. The franchise agreement is extraordinarily important for two reasons. First, from the perspective of the franchisor or manufacturer, the agreement represents the contract they utilizes to help them protect the standards that they deem important to enable them to protect their brand image and ultimately their trademark. Second, from the perspective of the franchisee, the use of the trademark and all that the franchise encompasses allows dealers the right to order and service the manufacturer's vehicles, which is a dealers most valuable asset.

The franchisor generally considers their trademark their most important asset too. The right the franchisor grants the franchisee to use the trademark to extend the franchisee's business value encompasses most of the franchisee's business value or as described by Judge Margaret A. Mahoney, Chief United States Bankruptcy Judge for the United States Bankruptcy Court for the Southern district of Alabama, "the cornerstone of the trademark license is based on the franchisor's ownership of the right in all trademarks used in the franchise operation".⁷¹ At the very heart of every franchise agreement is a license in which the franchisor allows the franchisee use of their most valuable asset.⁷² As a result of this use, franchisors mandate that franchisees must maintain standards of quality to live up to the franchise agreement in an effort to protect the franchisors trademark. As a

⁷¹ Judge Margaret Mahoney, Selected Issues arising in franchise bankruptcies, Southeastern Bankruptcy Law Institute.

⁷² *Id.*

result the franchise agreement allows the franchisor more control over franchisee debtors in bankruptcy cases than mere creditors. In addition, normally the franchisor and franchisee relationship affords franchisor manufacturers much more information about the debtor dealer than other creditors. This information stems from the fact that franchise agreements mandate routine financial reporting, reporting on key employees, facility reporting, inventory reporting, training guidelines and a broad and often pervasive litany of other reporting requirements.

Although there are many profit centers in a new car dealership, it is not hard to see the value of the franchise agreement. One simply needs to imagine what a local Ford franchisee would be without the ability to hang a Ford sign, order new Ford automobiles, trucks and SUV's, order genuine Ford parts, or offer authorized Ford repair, warranty work and service. What would the aforementioned Ford dealership be without Ford? Although the answer depends on a host of operational specific elements, it is clear to say it would no longer be a Ford dealership and except for very few exceptions if it is no longer a Ford dealer, the value of the operation will be considerably lower and often will not even have ongoing concern value if the operation is stripped of the franchise agreement and ultimately the profit streams that flow from that agreement.

Typically, when new car dealerships are sold, the dealership's value is based on various balance sheet assets, which include very important items like the Real Estate, the Real Property improvements, Tools, Parts, Signs etc. Most buyers include new car inventory but it is not highly negotiated as new car inventory turns relatively often. Generally used car inventory is highly negotiated as buyer and

seller have differing opinions on the value of the assets and the assets are theoretically very liquid. In the end, the buyer and seller consider all of the dealership's assets and then all of the dealerships debts to arrive at what is generally termed the net tangible book value (book value) of the dealership. Although this number can be substantial especially in older, well-funded dealerships with little leverage, the book value is just one aspect of the dealerships value.

Generally the most valuable asset and the most important element of a buy/sell new car dealership transaction are termed "Blue Sky". Blue sky is the intangible value of a dealership, including goodwill and other intangibles such as customer lists and marketing materials.⁷³ Blue sky is calculated by multiplying the dealerships pretax income by some multiple the parties agree on. Generally multiples range from the very low side of 2 or 3 times pretax income to the higher side of 5 or 6 times pretax income. In the example of the Ford franchised dealer without the franchise agreement allowing them the benefits associated with being a Ford dealer it is clear that the blue sky value is dramatically reduced because the buyer has no reason to expect future earnings to equal past history. Even in poorly run franchise operations that produce no pretax income, willing buyers generally find value in the franchise albeit at lower multiples based on what the prospective operator deems they could produce with access to the franchise and their perceived ability to operate the dealership. As such it should also be clear that the asset that is generally most important to protect from the dealers stance is the franchise agreement. Therefore in the case of a bankruptcy proceeding, the DIP's most

⁷³ Larry Vellequette, *For Chrysler stores, blue sky is back*, Automotive News, June 3, 2013, <http://www.autonews.com/article/20130603/RETAIL07/306039956/for-chrysler-stores-blue-sky-is-back>.

important asset for the bankruptcy estate is very often the ability to assume and assign the franchise agreement.

Relatively recent transactions of dealerships that have experienced distress show that dealerships with good brands can demand premium prices even if those dealerships are in bankruptcy.⁷⁴ Take three examples. When Land Rover Jaguar Anaheim Hills was in bankruptcy, the trustee received a Blue Sky consideration of about \$4 million when the franchise was sold in September 2012 as an asset of the dealerships bankruptcy estate. In another transaction the bankruptcy estate of Land Rover Jaguar Cerritos received \$5 million for Blue Sky in November 2012.⁷⁵ In Florida, St. Augustine Toyota-Scion commanded a \$10 million dollar blue-sky value when it was sold during a bankruptcy sale.⁷⁶ It is very important for DIP's to assume and make sure that he/she has the ability to assign a franchised new car dealers franchise agreement because the value is so important to any new car dealerships attempt to reorganize.

Three Dealership Operational Issues that Often Result in Effective Dealership Reorganization.

While there are many pitfalls that dealers can accidentally fall into, and a host of dealership specific elements that make successful dealership reorganization extremely challenging, there are also some scenarios that bankruptcy provides a

⁷⁴ Jamie LaReu, Good news for sellers: Blue sky values appear strong, Automotive News, April 16, 2013, <http://www.autonews.com/article/20130416/BLOG06/130419933/good-news-for-sellers-blue-sky-values-appear-strong>

⁷⁵ *Id.*

⁷⁶ *Id.*

very viable solution for.⁷⁷ When dealers encounter scenarios that are outside of the normal operational issues or more succinctly non-recurring issues that throw the dealer into financial turmoil, the dealer may find bankruptcy is an exceptionally viable option to return the dealership to financial freedom via reorganization. There is not an exhaustive list of scenarios that make bankruptcy viable for dealers so instead I will consider three examples that most dealers can relate to: *litigation* and resulting judgment against a dealership, unbearable *mortgage debt* and *embezzlement* that cripples the dealership.

Litigation:

One of the key fears and financial drains that dealers have is confronting lawsuits. Litigation expenses can be daunting financially and in and of themselves without judgments they are often financially crippling to dealerships. In addition to the litigation expense(s) that can often last for years without relief if the dealer suffers from an adverse decision in the litigation, the creditor may end up with a judgment against the dealership. If the creditor has a judgment they can start to attach the assets of the dealership, which includes access to the dealership operational bank account. Even profitable dealers may be unable to weather the storm of multi-million dollar judgments. If the dealer cannot reach an amicable and consensual settlement, the dealer has the option of filing for Chapter 11 protection. The automatic stay that occurs when the dealer files for bankruptcy will prevent the

⁷⁷ Michael Issa & Kerry Krisher, Deconstructing Bankruptcy, Auto Dealer Monthly (Oct. 2013), <http://www.autodealermontly.com/channel/dps-office/article/story/2013/10/deconstructing-bankruptcy.aspx>

judgment creditor from collecting while the dealer is in bankruptcy. As a result of the automatic stay the dealer often is able to negotiate a more amicable consensual settlement with the judgment creditor via bankruptcy, reducing the claim, extending the terms for payment and ultimately allowing the dealer to keep the dealership and emerge as a functioning dealer. In cases that result from an adverse judgment dealers are generally not faced with all of the relational issues associated with financial turmoil with their lenders and franchisors but instead can stand united with their stakeholders in a mutual goal to reorganize with reasonable plan to pay back the judgment creditor. In this type scenario dealers are much more likely to successfully emerge from Chapter 11 reorganization.

Crippling Mortgage Debt or Lease:

Another very frequent issue that dealers face is mortgage debt or long term leases (typically only about a year's worth of lease is allowed as a claim in BK, not the same result under non-bankruptcy law, by rejecting the lease under 365) that are so onerous on the dealership operations that it cripples the operation and crushes the dealership. Often dealers overbuilt facilities in good times and when the loans mature, the lender is no longer willing to renew the loan. Often the loan-to-value ratio does not meet the lenders underwriting requirements or the regulatory burdens the lender faces. Unfortunately, often lenders may issue a default and in some cases foreclosure can occur very quickly. In cases like this, if the dealer's operation makes fiscal sense outside of the crippling mortgage, the dealer may be able to utilize a bankruptcy filing to impose a restructuring of the mortgage debt on

the lender. The bankruptcy court may be able to restructure the existing mortgage via bankruptcy by extending the maturity, revising the interest rate, changing the amortization period, etc. Bankruptcy courts can even do this over the objection of the lender. In these scenarios if the mortgage lender is a different lender than the floor plan provider, there is a very real possibility that the dealer will be able to use a Chapter 11 filing to restructure their mortgage debt and emerge a viable dealership.

Embezzlement:

Another albeit less common scenario is when a dealer suffers a major financial setback as a result of a dishonest employee(s). Often dealers operate profitably but as a result of embezzlement, a dealership may be thrown into financial insolvency overnight. In a case like this, bankruptcy protection gives the dealer who would be profitable but for the cash flow crisis of the employee fraud, a chance to regroup during the automatic stay and emerge from a chapter 11 filing as a profitable dealership once again.

Concluding thoughts

For new car dealers, the franchisor is the brand specific manufacturer of the automobiles the dealers sell, service and ultimately attain the majority of their income from. As such, the franchisor lends their good will to the franchisee in order to stimulate the dealer to sell more cars which in effect means the dealer will order more new cars from the franchisor/manufacturer and stimulate the franchisors sales

and profitability. As a result of the franchisors desire to sell more cars, the franchisor and the franchisee have a very strong mutual interest in seeing one another flourish. This mutual interest mandates that the franchisor and the franchisee work closely together to protect the brand and enhance one another's mutual interest(s). Similarly, since new car dealers are in an extremely capital intensive business that requires they buy inventory from their franchisor and as a result lending relationships are very important to dealers. Even though lenders are seldom more than providers of capital and they have no equity in dealerships, their relationship with car dealers is very important and must be thought of more akin to a partnership than a typical banking relationship. Dealers should protect their relationships with their lenders and work diligently to make lender and dealer interests mutually beneficial to each other.

When dealers are profitable, except for a specific issue(s), the previously profitable dealer has a very real chance of confirming a bankruptcy plan and retaining his or her dealership post-bankruptcy.⁷⁸ On the other hand, if a dealership is unprofitable and is relying on either “the market coming back” or “new products” or some change that is outside of their control, bankruptcy is generally not a very good alternative and the dealer will have little chance of emerging from the bankruptcy.

Bankruptcy does not necessarily mean that the dealer will have to liquidate or even lose their dealership. It may provide an opportunity to restructure the dealership through a process that enables the dealer to emerge from bankruptcy with a newly viable balance sheet. A fundamental goal of the federal bankruptcy

⁷⁸ id.

laws enacted by Congress is to give debtors a financial “fresh start” from burdensome debts. The Supreme Court made this point about the purpose of the bankruptcy law in a 1934 decision:

*It gives to the honest but unfortunate debtor... a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.*⁷⁹

When dealers desire an opportunity to continue operating their business and repay creditors through a court-approved plan of reorganization they stand a good chance of succeeding if the dealership is operationally viable and the stakeholders desire for the dealer to succeed.

In the end, there is no single solution to dealerships financial crisis nor is there one solution or ingredient to a successful dealership reorganization. Dealers in and out of financial crisis as well as dealers in and out of bankruptcy must successfully manage their operations and their relationships with their stakeholders to enjoy the rewards that a successful operation has to offer.

⁷⁹ *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).