full disclosure

Fall 2010 | A publication of Benesch Friedlander Coplan & Aronoff LLP

In this issue:

Can The Automotive Bankruptcy Financing Model Provide An Alternative To Debtor-In-Possession Financing? *Key Customer Pre-Paid Purchases Replace Post-Filing Lenders*

In Memory

We're Still Growing For It.

Opening your morning mail you find the following: Bankruptcy Preference Demand Immediate Attention Required.

Lemisch Named Partner-in-Charge of Wilmington Office and Chair of Business Reorganization Group

Speaking Engagements

Recent Transactions

News About Us

BENESCH
Attorneys at Law

Can The Automotive Bankruptcy Financing Model Provide An Alternative To Debtor-In-Possession Financing?

Key Customer Pre-Paid Purchases Replace Post-Filing Lenders

By William I. Kohn and Scott B. Lepene

Will Kohn was someone who thrived in providing clients with creative solutions to their business issues. This article is an example of his creativity.

The Disappearing D-I-P Lender

Bankruptcy practitioners have seen the practice repeated for decades-companies that are insolvent and in need of a fresh start, especially during a recession, will seriously contemplate filing a chapter 11 bankruptcy and reorganize the company while receiving bankruptcy protection. But we are not living in normal times. One surprising aspect of this historic period of economic instability is the lack of bankruptcy filings throughout the country.

Although we have seen DIP Financing made available in the most recent Chrysler and GM bankruptcies, these filings were unique, in part, because the Federal Government opted to provide DIP Financing so that one of America's largest industries would continue. The government's generosity, however, will not find its way to every industry. In fact, fewer bankruptcies are being filed because fewer banks amidst the current credit crisis are inclined to fund a fledgling company that attempts to reorganize in a chapter 11 bankruptcy.

Because lenders are increasingly more risk averse during the current economic downturn, troubled companies that file Chapter 11 petitions may need alternative solutions to obtain DIP Financing under Section 364(c) of the Bankruptcy Code.

Section 364 Standard of Lending

Before addressing some of these alternative solutions, we must first examine the Bankruptcy Code's standard of lending to a debtor. Pursuant to Section 364(c), a debtor who has filed a bankruptcy may obtain credit by offering a creditor:

a. Superpriority over any or all administrative expenses;

b. Security in the form of a lien on free assets; or

c. Security in the form of a junior lien on assets that is currently subject to a lien.

Before a debtor can offer such a form of superpriority, the debtor must obtain court approval. Some courts also will apply a three-part test to assess requests under Section 364(c). This test requires a showing that (1) the debtor cannot obtain credit without superpriority status; (2) the credit

(continued on page 2)

Can The Automotive Bankruptcy Financing Model ProvideAn Alternative To Debtor-In-Possession Financing? (continued from page 1)

transactions are necessary to preserve assets of the estate; and (3) the terms of the credit agreements are fair, reasonable and adequate.

Key Customer Funding Alternatives

In two Northeast Ohio automotive industry bankruptcies, chapter 11 debtors (Blackhawk Automotive Plastics, Inc. and Johnson Rubber Company, Inc.), who served as just-in-time suppliers (producing necessary items in necessary quantities at necessary times) to Original Equipment Manufacturers (OEMs) such as Ford Motor Company and Toyota Manufacturing Company obtained debtor in possession financing from these OEMs. In connection with this DIP Financing, these customers received the type of superpriority described above. Moreover, the DIP Financing secured by these debtors essentially froze the position of their pre-petition lenders, the traditional banking institutions, during the DIP Financing period. Most importantly, in exchange for the DIP Financing to the bankrupt entities, the automotive customers required the execution of accommodation and access agreements to protect the automotive supply chain from disruption.

While this method of obtaining financing in the automotive industry has proven successful, the automotive industry is not the only industry that can look to a troubled company's customers as a means for obtaining DIP Financing. This article examines this method of DIP Financing in the automotive industry and applies it to other industries who have benefitted from this type of financing.

The Accommodation Agreement

To ensure that production will continue, OEMs may request that a supplier facing financial difficulties execute an Accommodation Agreement. An Accommodation Agreement is essentially a forbearance agreement that involves several parties: (1) the OEMs, (2) the sole-source supplier, and (3) the secured lenders and/or lessors. This agreement is implemented when a troubled supplier lacks funds to purchase materials to manufacture products for the OEM. In connection with the execution of the Accommodation Agreement, the OEM will commit to provide financing to the troubled supplier to manufacture product and thus obtain adequate assurances that the product will be manufactured. The Accommodation Agreement also enables the OEM to find a replacement sole source supplier if the current supplier's financial condition does not improve. This agreement further provides reasonable compensation to the secured lenders and lessors of the troubled supplier for forbearing their rights as the OEMs take possession of the operating assets, the collateral of these secured parties.

An Accommodation Agreement ensures that all parties involved receive a benefit. Not only does the debtor receive funding, but the OEM is assured of supplier delivery, and the troubled suppliers' traditional lenders receive full value for the cost of inventory as well as receiving expedited payment, without setoff, of the OEM receivables, and sale at above liquidation value of OEM dedicated equipment without the costs and risks of an auction process.

The Access Agreement

The Access Agreement is the second part to a two-part arrangement between the OEMs and troubled supplier. This mechanism is typically utilized when the supplier is not expected to survive. The Access Agreement permits an OEM to step in and fund a manager of its troubled supplier's facility to maintain production of the OEM's parts when an act of anticipated default occurs. From the OEM's perspective, this process is very expensive and something of a last resort. Parties to the Access Agreement must include any secured creditor or lessor of the troubled supplier with an interest in the plant, equipment or inventory related to the OEMs production.

At the end of the Access Period, the facilities are returned to the supplier who generally has wound down its business so that the assets can be sold to satisfy creditors of the supplier.

Applying the Auto-Industry Approach

In many workouts and reorganization proceedings the critical interest of a troubled company's customers are over looked as an important potential source of working capital. Borrowing from the auto-industry approach, a Kansas-based elevator company financed its Chapter 11 proceeding and reorganized its operation successfully by gaining the support of its most critical customer. Wittur Inc. supplied entrances and operational motors to several international commercial elevator system manufacturers. KONE was its largest customer and, in fact, Wittur Inc. had several years previously been a division of KONE, a Denmark-based company. Wittur had suffered several years of declining sales, experienced increasing price increases for its metal inventory without the ability to adjust pricing as a result of long term supply contracts with its customers. The local regional bank which provided Wittur's working capital needs secured by accounts receivable, inventory, equipment and operating facilities had grown disenchanted by the history of losses and had given notice of an intent not to continue to provide the company's financing needs.

In analyzing Wittur's predicament, bankruptcy counsel viewed the long term supply contract with KONE for which Wittur was a sole source supplier as an opportunity for post-filing funding. Following the Detroit model, Wittur negotiated a new six month purchase order with KONE, half of the intended aggregate purchase price of which was prepaid to permit Wittur to fund the commencement of its reorganization proceeding and cover initial operating expenses. Negotiations with the bank included a significant pay down of the debt and conversion of the unpaid balance of Wittur's working capital line to a term loan secured only by equipment and the operating plant. By eliminating the bank's lien on the accounts receivable and inventory, Wittur could focus on meeting the purchase order requirements of KONE and other customers without borrowing base formula constraints.

During the six months of operations under the purchase order, new management was brought in and new customers came on line. As anticipated by Wittur, KONE was only able to shift part of its production to other sources and agreed to extend the relationship with Wittur as the initial purchase order neared completion on schedule and within projected pricing. KONE's agreement for additional production and the building volume of new work laid the groundwork for a successful confirmed Plan of Reorganization.

Conclusion

Adopting the Detroit model of having dependent customers become the source of a financially troubled manufacturer's working capital has become a reasonable tool for consideration beyond the automotive sector. It has been used in out-of-court composition agreements encompassing such diverse industries as a national assembler of mass market computer systems to a national supplier of private label consumer products. Taking time to study the Motor City model of preserving production of key suppliers for the benefit of OEMs is a creative tool in enabling a debtor to obtain DIP Financing.

In Memory

This issue of *Full Disclosure* is dedicated to William I. Kohn.

William I. Kohn
(1951–2010)

A Partner and Group Chair of the Bankruptcy and Business Reorganization Department at Benesch, Will was a nationally-recognized attorney with more than 30 years of experience. He was the Chair of the American Board of Certification for the ABA's Business and Consumer Bankruptcy Practice and was a former adjunct professor of Bankruptcy and Banking Law at the University of Notre Dame College of Law.

A very private and generous man, Will gave back to the communities in which he lived and worked and endowed two scholarships at the Michael E. Moritz College of Law, Ohio State – the Dean John "Jack" Henderson Scholarship and The James H. Williams Scholarship Fund. He also endowed a scholarship at the University of Cincinnati – The E. Edward Herman-Howard R. Leftwich Scholarship for Organizational Leadership. In 2006, he was presented the Excellence in Public Interest Service Award by the Northern District of Illinois District Court and the Federal Bar Association for creating a program for the disabled and financially disadvantaged to avoid bankruptcy. He helped to create a similar program through the Legal Aid Society in Cleveland. His involvement in the philanthropic area was never done for self recognition or gain – he did it because he truly believed in helping others and he set an example for all professionals to follow.

He will be truly missed.

WE'RE STILL GROWING FOR IT.

MY BENESCH MY TEAM

Benesch/Dann Pecar is pleased to announce further expansion of our Indianapolis office with the addition of three attorneys. We are excited to better serve our clients through enhanced depth in our Business Reorganization Practice Group.

WENDY D. BREWER, Business Reorganization Partner

Ms. Brewer will serve as Vice-Chair of the firm's Business Reorganization Practice Group. She focuses her practice on commercial litigation, bankruptcy and restructuring. She is also experienced in the representation of creditors and debtors in bankruptcy cases and adversary proceedings, as well as the representation of corporate and bank clients in commercial litigation. Ms. Brewer received her B.A. from Florida State University and her J.D. from Florida State University College of Law. Ms. Brewer has been certified by the American Board of Certification as a Business Bankruptcy Specialist, and previously chaired the Commercial and Bankruptcy Law section of the Indianapolis Bar Association.

wbrewer@beneschlaw.com | 317.685.6160

SAMUEL D. HODSON, Business Reorganization Partner

Mr. Hodson's practice is centered around commercial litigation, bankruptcy, finance, insolvency and restructuring. He has represented creditors and debtors in proceedings under Chapters 7, 11, 12 and 13 of the Bankruptcy Code, state and federal court commercial litigation and receiverships, out-of-court workouts and administrative collection matters with state and federal tax authorities. Mr. Hodson received his B.A. from Indiana University, his M.B.A. from the Indiana University Kelley School of Business and his J.D. from Indiana University School of Law. Mr. Hodson has been certified by the American Board of Certification as a Business Bankruptcy Specialist.

shodson@beneschlaw.com | 317.685.6125

KRISTA S. ZORILLA, Business Reorganization Associate

Ms. Zorilla focuses her practice primarily on state and federal court commercial litigation involving creditor/debtor issues and the Uniform Commercial Code. She is also experienced in bankruptcy court representations, adversary proceedings, receiverships and out-of-court workouts. Ms. Zorilla received her B.A. from Franklin and Marshall College and her J.D. from Notre Dame University Law School.

kzorilla@beneschlaw.com | 317.685.6133

For full profiles, please visit www.beneschlaw.com

Opening your morning mail you find the following: Bankruptcy Preference Demand Immediate Attention Required.

There follows a lengthy letter "explaining" bankruptcy preferences and concluding with a demand for repayment of payments received by your Company in the 90 days preceding bankruptcy. The letter usually agrees to a nominal discount if paid within ten (10) days. The letter should, but does not, state: UPON RECEIPT CONSULT YOUR BENESCH ATTORNEY.

The reason is that the letter does not explain a number of potential defenses available to your company. Some of the more prominent defenses are:

- **Substantially Contemporaneous Exchange.** This is a flexible concept calling for a case by case inquiry. For example, one case held that a lien granted in exchange for a loan may be substantially contemporaneous even though the lien was not perfected for 16 days.
- **Ordinary Course of Business.** This is probably the most useful defense. If the payments are received in the ordinary course of business, the trustee cannot require repayment. Although the term ordinary course of business is not defined in the Bankruptcy Code, case law is reasonably clear as to its meaning. Determination as to ordinary course generally requires an analysis of the credit relationship between the parties for an extended period.
- **Subsequent Advance Rule.** Another useful defense is the subsequent advance of unsecured credit following receipt of the payment. In situations where there is an ongoing credit relationship, the analysis as to deliveries and application of payments can be quite complicated. Some cases require the subsequent advance to remain unpaid while others do not. The subsequent advance rule applies to both goods and services.
- **Small Transfers.** In business cases, transfers of an aggregate value of less than $5,475.00 cannot be recovered.
- **Delivery of Goods Within 20 Days of Bankruptcy.** Unpaid deliveries of goods within 20 days are entitled to payment as administrative (higher priority) claims. Creditors should always assert these claims as soon as they learn of the bankruptcy filing. However, in some cases where that has not been done, it may not be too late to do so toward the end of the case when the preference demand is received.

The key point is that all of these defenses must be asserted by the creditor. If not asserted, the trustee can recover the total of all payments made within 90 days.

The attorneys in the Benesch Reorganization Practice Group can assist you in asserting these defenses, and if not eliminating, at least substantially reducing potential repayments in most cases.

Lemisch Named Partner-in-Charge of Wilmington Office and Chair of Business Reorganization Group

Raymond H. Lemisch has been named Partner-in-Charge of the firm's Wilmington office and Chair of the Business Reorganization Practice Group.

Ray oversees the operations and expansion of the Wilmington office, along with the firm's Business Reorganization Practice Group. Ray stated, "This is not only an exciting time for the firm, but it is also a very exciting time for the Business Reorganization Practice Group as we continue to grow with the addition of three new Business Reorganization attorneys in our Indianapolis office." He continued, "In the future we look forward to continuing the expansion of our group both in Cleveland and Wilmington."

For over 25 years, Ray has represented clients in matters relating to bankruptcy and insolvency, litigation and general business issues. He has substantial experience assisting high net worth individuals through complicated business transactions and contractual negotiations, as well as representing business entities in out-of-court restructurings. He also regularly represents unsecured creditors' committees, equity security holders' committees, debtors in Chapter 11 bankruptcy proceedings, landlords, Chapter 11 and Chapter 7 trustees, and has an active transaction practice in which he represents both buyers and sellers of businesses and businesses seeking equity or debt financing.

For more information about our Business Reorganization Practice Group, please contact any of the following:

JON B. ABELS
(317) 685-6148 | jabels@beneschlaw.com

MICHAEL BARRIE
(302) 442-7068 | mbarrie@beneschlaw.com

WENDY BREWER
(317) 685-6160 | wbrewer@beneschlaw.com

FRED L. CLINE
(317) 685-6121 | fcline@beneschlaw.com

KARI CONIGLIO
(216) 363-4690 | kconiglio@beneschlaw.com

SAMUEL D. HODSON
(317) 632-3232 | shodson@beneschlaw.com

JENNIFER R. HOOVER
(302) 442-7006 | jhoover@beneschlaw.com

DAVID H. KLEIMAN
(317) 615-6151 | dkleiman@beneschlaw.com

STUART A. LAVEN, JR.
(216) 363-4493 | slaven@beneschlaw.com

RAYMOND H. LEMISCH
(302) 442-7005 | rlemisch@beneschlaw.com

SCOTT B. LEPENE
(216) 363-4428 | slepene@beneschlaw.com

DAVID M. NEUMANN
(216) 363-4584 | dneumann@beneschlaw.com

MARK A. PHILLIPS
(216) 363-4153 | markphillips@beneschlaw.com

CYNTHIA REESE
(317) 685-6158 | creese@beneschlaw.com

MATTHEW SAMSA
(216) 363-4409 | msamsa@beneschlaw.com

WILLIAM E. SCHONBERG
(216) 363-4634 | wschonberg@beneschlaw.com

JENNIFER E. SMITH
(302) 442-7011 | jsmith@beneschlaw.com

KRISTA ZORILLA
(317) 632-3232 | kzorilla@beneschlaw.com

Recent Transactions

- Represented large Midwest regional bank in the sale of its middle market borrower under Article 9
- Represented automotive dealer in successful workout with a large Midwest regional bank and assisted automotive dealer in obtaining additional financing with an Ohio bank
- Filed chapter 7 bankruptcy cases for Hudson & Keyse, LLC and its corporate parent, with $60 plus million of indebtedness

News About Us

- Our Business Reorganization Practice Group was ranked within the top tiers of the U.S. News—Best Lawyers "Best Law Firm" Survey in the Cleveland, Indianapolis and Wilmington offices.
- **Jon Abels**, **Wendy Brewer**, **David Kleiman**, **Ray Lemisch** and **Bill Schonberg** were named 2011 Best Lawyers in America in the area of Bankruptcy and Creditor-Debtor Rights Law.
- **Scott Lepene** was named a 2010 Ohio Super Lawyer Rising Star.
- **Bill Schonberg** presented on two panels at the ABI Mid-Atlantic Bankruptcy Workshop on August 6 and 7, on "Creative Alternatives to Bankruptcy; Effective use of Alternative Restructuring Techniques."
- **Sam Hodson** and **Wendy Brewer** presented at the "Complex Bankruptcy Issues" seminar on September 17, presented by NBI (National Business Institute) on the topic of: "When a Debtor Owns a Small Business."
- **Kari Coniglio** is speaking on a panel on October 27 at the Cleveland Metropolitan Bar Association in a program sponsored with the Legal Aid Society of Cleveland. The program is the CHLAP CLE program on "Common Issues and Resources for Homeless or At-Risk Individuals." Kari will be presenting on Debtor/Consumer Law.

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Pass this copy of *Full Disclosure* on to a colleague, or email jgurney@beneschlaw.com to add someone to the mailing list.

Cleveland 200 Public Square, Suite 2300 | Cleveland, OH 44114-2378
Phone: (216) 363-4500 | Fax: (216) 363-4588

Columbus 41 South High Street, Suite 2600 | Columbus, OH 43215-6164
Phone: (614) 223-9300 | Fax: (614) 223-9330

Indianapolis One American Square, Suite 2300 | Indianapolis, IN 46282
Phone: (317) 632-3232 | Fax: (317) 632-2962

Philadelphia One Liberty Place | 1650 Market Street, 36th Floor
Philadelphia, PA 19103-7301
Phone: (267) 207-2947 | Fax: (267) 207-2949

Shanghai Kerry Centre, Suite 1802 | 1515 W. Nanjing Road
Shanghai, P.R. China 200040
Phone: (86) 21-3222-0388 | Fax: (86) 21-5298-5955

White Plains White Plains Center | 50 Main Street, Suite 1000
White Plains, NY 10606
Phone: (914) 682-6812 | Fax: (914) 682-2600

Wilmington 222 Delaware Avenue, Suite 801 | Wilmington, DE 19801-1611
Phone: (302) 442-7010 | Fax: (302) 442-7012

www.beneschlaw.com

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