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AUTO DEALERS MAY BE IN FOR A BUMPY RIDE

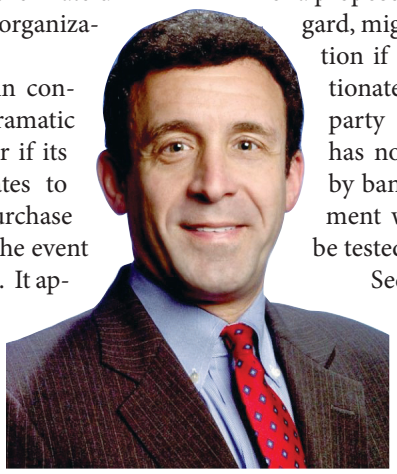
By IRVE J. GOLDMAN

A panel of experts who spoke in late February to the Heritage Foundation in Washington, D.C., offered the view that bankruptcy is a better solution for General Motors Corp.'s financial crisis than another federal bailout. As the possibility of a GM bankruptcy filing looms larger, it is important for automobile dealers to consider what can happen to their contracts with GM if that doomsday scenario occurs.

They should start with awareness that one of the most potent reorganization tools given to a Chapter 11 "debtor in possession" (DIP) – which would be GM in this case – is the ability to "assume" or "reject" what are called "executory contracts." In plain terms, an "executory contract" is a contract between the DIP and another party under which material performance by both sides is still due. This definition would most certainly capture automobile dealer contracts with GM or one of its companies.

CONNECTICUT LAW REQUIRES A CAR MANUFACTURER TO PAY 'FAIR AND REASONABLE COMPENSATION' TO THE DEALER FOR ITS CURRENT MODEL AND PRIOR MODEL YEAR INVENTORY IF THE MANUFACTURER CANCELS THE DEALER AGREEMENT.

If a DIP opts to reject an executory contract, a decision which must be approved by the bankruptcy court, it is relieved of all of the obligations under that contract, while the non-debtor is relegated to filing a claim for damages in the bankruptcy case. This claim is based on a legal fiction that views the rejection as a breach of the contract immediately before the bankruptcy filing date. This makes the rejection claim an unsecured claim that is in the same line with all other general unsecured creditors of the DIP, who typically await their fate under an eventual plan of reorganization.



To put this dynamic in context, one of the most dramatic consequences for a dealer if its contract is rejected relates to GM's obligation to repurchase the dealer's inventory in the event the contract is terminated. It appears that in some contracts, this "obligation" is simply optional on GM's part, but even if it were not, the rejection of the contract would transform the obligation to an unsecured claim for damages in GM's bankruptcy case. This would be of little solace to the spurned dealer, who will continue to be obligated to its floor plan financier.

AVENUES OF RELIEF

There are, however, several legal arguments that can be used to prevent this seemingly unfair scenario. Although they have never been tested in a case of the size and magnitude of a potential GM bankruptcy, it is certainly worth identifying these potential avenues of relief.

First, as mentioned, the bankruptcy court must approve a DIP's decision to reject a contract. The prevailing rule is that this decision will be approved as long as it based on sound business judgment and not bad faith or whim. In other words, if rejection will result in a greater benefit for the DIP's general unsecured creditors, it will be approved. There are, however, a minority of courts which will also balance the equities of a proposed rejection, and in that regard, might consider denying rejection if it would cause disproportionate harm to the non-debtor party to the contract. Since it has not gained wide acceptance by bankruptcy courts, this argument would most likely have to be tested at the appellate level.

Second, there is some support in case law for application of a higher standard for rejection when the contract is of the type that implicates broad public interests. This higher standard was applied by the U.S. Supreme Court in *National Labor Relations Board v. Bildisco and Bildisco* (1984), when a DIP attempted to reject a collective bargaining agreement, and it would appear to allow a bankruptcy court to consider the impact that rejection would have on the public interest, as well as to balance the equities involved. The *Bildisco* decision led to the 1984 amendments to the Bankruptcy Code, which established a

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specific procedure and higher standards for rejection of a collective bargaining agreement. It is unclear whether the public interest in preventing scores of automobile dealers from themselves going into bankruptcy will be considered by the courts of similar public importance as preventing easy rejection of collective bargaining agreements.

Third, the laws of some states may require an automobile manufacturer to pay reasonable compensation to a dealer for its inventory and new parts if the manufacturer cancels the dealer agreement. For example, Connecticut law requires a car manufacturer to pay "fair and reasonable compensation" to the dealer for its current model and prior model year inventory, as well as its new parts inventory, if the manufacturer cancels the dealer agreement. There are significant issues in getting this law to apply to a bankrupt car manufacturer that is looking to reject its dealer agreements, however.

FEDERAL PREEMPTION

The biggest issue is federal preemption, which generally holds that if a state law interferes with the operation or objective of a federal law, the federal law will control or "preempt" the conflicting state law. It can be expected that GM would argue that the bankruptcy law which allows rejection of contracts and affords the non-debtor party an unsecured claim for damages should preempt any state law requiring a buy-out of a dealer's inventory.

On the other hand, there is a federal statute which specifically requires a DIP to operate its business in compliance with the valid laws of the states in which it does business. How the obvious tension between the two laws will be resolved is not clear.

Finally, if GM files for Chapter 11, it is virtually certain that the federal government would provide it with so-called "debtor in possession financing," which simply means providing financing to a DIP on agreed terms that are approved by the bankruptcy court. It would certainly be within the prerogative of the federal government to insist on some type of relief for automobile dealers whose contracts might be targeted for rejection.

It is readily acknowledged that there are no easy answers for automobile dealers in the event of a GM bankruptcy filing. Nonetheless, they are not without valid legal arguments to protect their interests if that unprecedented event occurs. ■