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Troubled Auto Part Suppliers Should Sidestep Chapter 11 Filings

By Sheryl L. Toby

Opinion

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Dykema member Sheryl Toby explains why Chapter 11 is not the best route for troubled auto parts suppliers. Responding to a previous Insight, she analyzes why out-of-court processes are preferred and provide better outcomes for all parties.

A Bloomberg Law Insight in December examined the automotive supply chain and anticipated distress during the transition from internal combustion engines to greater use of electrification.

I agree that more distress is coming. However, I respectfully disagree with the core premise that to “reorganize debtors and continue operations via existing management—debtor-in-possession—Chapter 11 is the ideal route for restructuring troubled auto parts suppliers.”

There are many reasons why the industry rarely turns to Chapter 11.

Having been involved for multiple decades on all sides of the table, including representing original equipment manufacturers, tier-one auto customers, suppliers, and lenders, I think Chapter 11 is usually the least desired route.

Figuring Out Best Option

For a minority of cases Chapter 11 may be the best option. These include cases involving large suppliers with complicated debt structures or a fragmented creditor base that can only be relieved through a sale of the organization’s assets under Section 363 of the Bankruptcy Code.

However, vast numbers of restructurings occur at the mid-market level and below where an out-of-court process is preferred and provides a better outcome for key constituents.

Traditional automotive production typically use a single source, and lean, supply method where interruption by one supplier will impact its customers and innumerable companies in the supply chain of the associated vehicles. Safety approval, tracing, part shelf life, and consumer affordability are key features of this type of inventory system.

While other industries use this supply system, the impact is often less immediate and dramatic. Hence, it's important to maintain a reliable quality supply base in traditional automotive manufacturing.

Challenges

Countless closely held mid-market and below size entities supply directly to original equipment manufacturers. Addressing troubled suppliers historically had been a multi-case daily routine, but consolidation has reduced the numbers of suppliers and daily matters.

However, thousands of closely held mid-market and below size supplier entities still exist in the supply chain, especially at the tier-two level, where most restructuring occurs and many of these entities also still supply directly to OEMs.

These restructurings can be more challenging for all involved than in a large tier-one case involving a limited OEM customer base where there are often broader sources of capital and potential buyers.

In addition, for these cases there may be increased means for incentivizing strategic purchasers. This contrasts with situations where the direct customers are predominantly tier-one entities that must meet production requirements of their multiple customer base.

On top of the costs associated with in-court processes the applicability of the absolute priority rule in Chapter 11 which makes it virtually impossible to accomplish a plan in which owners of the closely held company retain positions of ownership or management usually make Chapter 11 the least desired route of these suppliers. Consequently, for these and other reasons, closely-held suppliers and their customers typically attempt to avoid Chapter 11 and instead seek to resolve the distress through various out-of-court processes.

Similarly, unsecured vendor creditors are often more willing to work with the distressed entity out of bankruptcy process in order to maintain its customer and avoid potential claw back claims which occur in Chapter 11 and are inapplicable outside of bankruptcy.

Reputation Matters

Regardless of supplier size, there is always a limited number of repeat customers and a small number of traditional lenders in the closely held small to midmarket supplier space. It is a big, yet small, industry where reputation, management, and operational quality matter.

Similar to other repeat player industries, there is an established knowledge base of what is necessary from the parties—what goes around comes around can influence approach.

For all cases there are limited options for fixing distress. Usually one or more combinations of a sale process, debt restructuring, operational changes, or customer transition and liquidation occurs.

Agreements typically are entered into between the distressed supplier, customer, and lender, which includes specifying the process, timing, and support to be provided by each. This will also include standby customer protections in the event a meltdown occurs.

These agreements are entered into whether an in or out-of-court process occurs, and thus Chapter 11 is not necessary to accomplish the agreements.

Consequently, while Chapter 11 may be the right—or only course—for some auto supplier cases, in the context of the overall number of distressed supplier situations that occur, it is rarely the best or necessary route for most auto suppliers.

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Author Information

Sheryl L. Toby is a member at Dykema. She advises and guides manufacturers through novel and complex operational, procurement, and supply chain issues or protecting her clients' interests in bankruptcy and restructuring matters.

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