

Bankruptcy Court Holds that Postpetition Loan Participation Is Not a Form of Cover Under the Uniform Commercial Code (And Losses Related Thereto Cannot Be Set Off or Recouped Against Prepetition Receivables)

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A bankruptcy court decision will impact the way Tier 1 suppliers and original equipment manufacturers will structure the financing of automotive bankruptcies.

Customers dealing with troubled automotive suppliers often decide to resource production to other suppliers rather than facilitate a true restructuring of the troubled supplier's business. Such resourcing, however, generally cannot be done overnight. Tier 1 suppliers or original equipment manufacturers ("OEMs") often take months to resource production. Because of the "just in time" production process, Tier 1 suppliers and OEMs often cannot afford to be without component parts or tooling for the period of time that it may take to resource.

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Accordingly, Tier 1 suppliers and OEMs often must make financial accommodations to troubled suppliers to ensure production during transition periods.

This process follows a familiar pattern to those with experience in automotive restructurings. Indeed, practitioners in automotive restructurings generally are familiar with form accommodation agreements, access and security agreements and related documents used by Tier 1 suppliers and OEMs to ensure the stable supply of component parts from financially troubled suppliers. In bankruptcy, Tier 1 suppliers and OEMs often agree to advance funds either directly or indirectly to bankrupt suppliers in order to ensure production until they are able to resource production.

A recent decision by the United States Bankruptcy Court for the Eastern District of Michigan involving funding provided by the customers of Mayco Plastics, Inc. (“Mayco”) may impact the way loans to bankrupt suppliers are structured and the expectations of customers who make such loans. In this case, as discussed below, the bankruptcy court held that TRW could not set off or recoup the unpaid balance of its participation in Mayco’s debtor in possession financing facility as a form of cover damages.¹ This decision prevented TRW from reducing its liability for parts and tooling delivered to TRW prior to Mayco’s bankruptcy by TRW’s investment loss as a loan participant.

FACTUAL BACKGROUND

TRW is a Tier 1 supplier to various original equipment manufacturers. TRW purchased parts and specialized tooling, molds, patterns and equipment from Mayco pursuant to the terms of purchase orders. Prior to its bankruptcy, Mayco sought financial assistance from TRW and its other key customers. Specifically, Mayco sought accelerated payment terms and price increases from its customers, including TRW. Mayco stated that it would not be able to continue production without such accommodations.

In response to Mayco’s request, and to ensure the continued production of parts, TRW and Mayco’s other customers agreed to provide Mayco with certain financial accommodations. These accommodations, however, did not solve Mayco’s financial problems and, on September

12, 2006, Mayco filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. As of the petition date, TRW owed Mayco approximately \$4 million for parts and approximately \$2 million for tooling produced prior to the petition date. With an acknowledged setoff, the net balance owed by TRW to Mayco on the petition date was approximately \$5.3 million.

Mayco's prepetition lender, PNC Bank, refused to provide any debtor in possession financing. Mayco ultimately obtained debtor in possession financing from Citizens Bank. Citizens Bank's willingness to make postpetition advances to Mayco was dependent upon Mayco's customers purchasing participations in the loan. Citizens Bank provided Mayco with a working capital line of credit of \$14.5 million, together with an out-of-formula advance up to \$6.5 million. Because Mayco's customers purchased participations in the loan made by Citizens, Mayco's customers, including TRW, bore the economic risk that the advances made by Citizens would not be fully repaid.

After filing for bankruptcy, Mayco sold substantially all of its assets in a Section 363 sale. While certain of the Mayco customers chose to keep their business with the buyer, TRW and the majority of Mayco's customers opted to resource production to alternative suppliers of their own choosing. After Mayco's assets were sold and the proceeds were distributed to PNC Bank and Citizens Bank in accordance with their relative priorities in Mayco's prepetition and postpetition assets, Mayco attempted to confirm a plan of liquidation.

Mayco, however, failed to confirm its plan, in part, because its estate was administratively insolvent. Mayco's postpetition production was facilitated by the postpetition loan from Citizens Bank. Mayco's postpetition production was insufficient to cover administrative expense claims and repay Citizens Bank in full, as was likely anticipated by Mayco's customers and Citizens Bank at the beginning of Mayco's case. Mayco's customers effectively brought participations in a loan that was unlikely to be repaid in order to ensure the production of their parts and tooling.

After the court denied plan confirmation and TRW resourced production, Mayco commenced a turnover proceeding against TRW in order to recover the \$5.3 million receivable due and owing to Mayco for pre-

petition parts and tooling. TRW defended the action by asserting the right to set off and/or recoup its losses under the Citizens Bank loan as a form of cover damages. TRW argued that Mayco had breached its purchase orders prepetition when it sought financial accommodations from TRW and Mayco's other customers. As a result of such breach, TRW claimed that it has a right to cover under the Uniform Commercial Code. According to TRW, TRW "covered" by participating in the loan made by Citizens Bank because such loan facilitated Mayco's production of parts and tooling. Both Mayco and TRW filed motions for partial summary judgment regarding TRW's right to cover by participating in the Citizens Bank loan.

THE BANKRUPTCY COURT'S OPINION

The bankruptcy court held that TRW's purchase of a participation in the Citizens Bank loan to Mayco did not constitute cover or a measure of cover damages for Mayco's prepetition breach of the purchase orders. The opinion initially concluded that Mayco repudiated its purchase orders with TRW prepetition by failing to provide TRW with adequate assurance of performance upon TRW's request. The bankruptcy court also found that TRW had several remedies available to it under the Michigan Uniform Commercial Code, including cover or damages for non-delivery. The key issues, however, were whether TRW had the right to "cover" by purchasing a participation in the Citizens Bank loan and whether TRW's related loss could be considered a measure of cover damages.

The bankruptcy court rejected TRW's attempts to fit its loan participation as a form of cover. After considering the debtor in possession financing order and related documents, the bankruptcy court found that TRW's loan participation could not reasonably be viewed as a measure of cover damages or cover, which in most instances generally consists of the purchase of substitute goods from another vendor. The bankruptcy court further found that the amount paid by TRW for the loan participation could not be viewed as a measure of incidental or consequential damages occasioned by the prepetition repudiation by Mayco.

Having rejected TRW's cover damage theory, the bankruptcy court

then considered whether TRW had the right to set off or recoup its postpetition loan participation against the prepetition receivables owed to Mayco. The bankruptcy court found that TRW's loan participation did not arise out of the same transaction or occurrence as the prepetition receivables owing to Mayco under prepetition purchase orders. The obligations did not arise under the same contract and there was no provision in the purchase orders of general terms related thereto that contemplated TRW's participation in debtor in possession financing. The bankruptcy court also rejected TRW's argument that the obligations were part of the same transaction because the funds advanced by Citizens enabled Mayco to produce parts and tooling for TRW.

The bankruptcy court further found that TRW could not set off the unpaid balance owing on its postpetition loan participation against the prepetition receivables owing to Mayco. The bankruptcy court found that the debts were not mutual because Citizens Bank made the postpetition loan and not TRW. Additionally, the Citizens Bank loan was made postpetition, whereas the receivables at issue were prepetition. Accordingly, there was no mutuality under Michigan law or Section 553 of the Bankruptcy Code.

The bankruptcy court did not preclude TRW from asserting that Mayco's prepetition repudiation of its purchase orders caused other damages that could be used for setoff and/or recoupment. The bankruptcy court, however, did reject TRW's attempt to characterize its loan participation as a form of cover or a claim that could be used for the purpose of setoff and/or recoupment against a prepetition receivable.

CONCLUSION

This decision will impact the way Tier 1 suppliers and OEMs structure the financing of automotive bankruptcies. The bankruptcy court's decision forecloses customers from setting off or recouping losses related to postpetition loan participations against prepetition receivables due and owing to the supplier. This decision also may foreclose customers from loaning money directly to troubled suppliers under a debtor in possession financing order and then using the losses related thereto to avoid

the payment of prepetition receivables. This decision merits careful consideration by all parties involved in automotive restructurings.

NOTE

¹ See *Mayco Plastics, Inc. v. TRW Vehicle Safety Systems, Inc. (In re Mayco Plastics, Inc.)*, 389 B.R. 7 (Bankr. E.D. Mich. 2008).