"Staying Safe" When Doing Business With Distressed Suppliers During The COVID-19 Pandemic

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State of the Industry

Automotive manufacturers appear to have weathered the COVID-19 pandemic and its impact on production, workforce availability, and sales to a greater extent than could have been anticipated in the spring of 2020. General Motors, Ford, and Fiat Chrysler all beat their earnings targets in the third quarter of 2020, although headwinds from ongoing uncertainty regarding the virus and containment countermeasures can be expected to persist for some time. Unfortunately, the picture for automotive suppliers is not as positive. Many suppliers were already in precarious financial situations prior to the pandemic and have so far avoided bankruptcy primarily through a combination of government assistance, reliance on cash reserves, and forbearance by lenders. None of these stopgap survival measures can last indefinitely. In the coming year, it is widely anticipated that many suppliers will file for bankruptcy and/or be acquired by other suppliers who have remained financially sound in the face of adverse circumstances.

Business relationships with distressed suppliers pose notable risks to customers and sub-suppliers. For customers, a distressed supplier ceasing operations or seeking bankruptcy protection can cut off the flow of essential parts and services. For sub-suppliers, bankruptcy filings by distressed customers can suspend or severely diminish the sub-supplier's ability to recover receivables for parts and services already provided. Automotive suppliers should be aware of how to identify a distressed sub-supplier or customer and how to mitigate the risks of that company going out of business or filing for bankruptcy.

At the same time, the prevalence of distressed and potentially distressed suppliers presents opportunities for automotive companies which have remained financially sound despite difficult market conditions. Consolidation in the automotive supplier industry was already a notable trend before the pandemic, and this trend should only accelerate under current market conditions. Suppliers whose balance sheets have remained strong may be able to use acquisitions of distressed suppliers to expand their product offerings and modernize their technology by purchasing distressed suppliers at attractive prices.

This bulletin summarizes: (1) means of identifying a distressed supplier; (2) risk mitigation strategies for doing business with a distressed supplier as a customer or sub-supplier; and (3) the rewards and risks of acquiring a distressed supplier.

How To Identify A Distressed Supplier

There is no formal cutoff point at which a supplier becomes formally "distressed," and most indicators of distress are not publicly disclosed or observable to anyone beyond that supplier's contractual counterparties. Essentially, there are three stages of warning signs indicating a distressed condition:

(1) increased machine downtime and turnover on the factory floor, combined with delays in new product launches and an extended cadence for launching new products;

(2) late, missed, expedited, incomplete, or poor-quality shipments;

(3) financial difficulties such as declining profits/revenue, recurring attempts to renegotiate payment terms, defaults on financing agreements, late or missed payments to lower-tier suppliers, and legal disputes with customers (regarding shipment deficiencies) and sub-suppliers (regarding payment).

Monitoring these warning signs on an ongoing basis is essential to identifying a distressed supplier in order to implement protective countermeasures. Even if a company itself is not seeing signs of concern from a customer or sub-supplier, it is important to stay in touch with other customers or sub-suppliers who also do business with that supplier who may be experiencing signs of distress in their own contractual relationships.

Ways To Protect Against Risks Of Doing Business With Distressed Suppliers

Risk mitigation steps for doing business with distressed suppliers differ depending on whether the distressed supplier is a customer or a sub-supplier of the contracting party.

When the distressed entity is a sub-supplier:

When a distressed sub-supplier faces failure or bankruptcy, the primary risk to a customer is disruption of operations, whether from that sub-supplier's decreased supply of shipments and services or its demands for price increases. A distressed supplier's customer can protect itself in some of the following ways:

- if available under the parties' purchase order terms, audit the supplier's finances and manufacturing operations to determine signs and levels of distress
- identify and/or implement alternative sources of supply
- obtain performance guarantees from the supplier's related entities to ensure supply even if the supplier itself goes bankrupt, because the supplier may reject its contract with you during bankruptcy proceedings
- inventory tooling, equipment, and other property provided to the supplier in the event ownership is disputed in the course of bankruptcy proceedings
- take set-offs against supplier payables

When the distressed entity is a customer:

Diminished ability to collect on receivables is the primary risk an entity runs when its customer is distressed. If shipments to the customer were not made within 20 days of the customer's bankruptcy filing, recovering payment becomes increasingly difficult. Some mitigating steps to take include:

- obtaining credit risk insurance or options on receivables to hedge against risk of nonpayment
- requesting payment guarantees from the customer's related companies
- holding the customer to strict payment terms that will be harder to unwind in bankruptcy
- closely tracking the customer's shipments and payments with other suppliers so that (i) you can make a bankruptcy claim for payments on shipments within 20 days of a bankruptcy filing, and (ii) you can potentially recover payments to other suppliers made within 90 days of bankruptcy filing as a preference
- track possible set-offs against customer receivables and take the setoffs before the customer files for bankruptcy

- reduce sales to the customer to lower outstanding receivables in the event of a bankruptcy filing
- prepare arguments for being deemed a "critical vendor" in bankruptcy court so as to obtain payment in full on receivables

Identifying And Benefiting From Acquisitions Of Distressed Suppliers

As market conditions worsen for many automotive suppliers, other suppliers who have remained financially sound can benefit by purchasing distressed suppliers at attractive prices. Financially-stable suppliers should be on the lookout for distressed acquisition targets whose technology can boost manufacturing processes and product offerings in increasingly "hot" areas such as autonomous driving systems, electrified vehicle systems, and fuel-efficient powertrains.

Some suppliers have also become distressed or will become distressed because OEM cost-control pressures have decreased their profitability. This has been an ongoing trend for years prior to the pandemic, and has pushed suppliers toward increasing vertical integration of their manufacturing operations and product offerings. The economic impact of COVID-19 should only increase these pressures, with the result that suppliers with strong balance sheets can acquire distressed suppliers with product lines which complement and integrate into existing product offerings.

As with any acquisition, purchasers must consider the attendant risks of a distressed supplier acquisition. Quality-control issues may result in increased warranty and recall cost liabilities, especially given the manufacturing problems that are often a leading indicator of supplier distress. Antitrust enforcement and related civil class actions are another risk that has become increasingly prominent in recent years: a distressed supplier may be at particular risk of antitrust enforcement actions if declining business led it to engage in alleged anti-competitive practices. A distressed supplier may also have pending or threatened litigation risk from sub-suppliers it has not paid, or from customers alleging breaches of existing supply agreements.

A distressed supplier's intellectual property issues also need to be taken into account when considering an acquisition. The purchaser should confirm that the acquisition target owns or licenses the intellectual property, has clear and transferable title to it without potential litigation risk, and that there are no other restrictions on the purchaser's use of that intellectual property following acquisition of the supplier.

Conclusion And Outlook

Although the challenges posed to suppliers by the COVID-19 pandemic are serious, they are by no means unprecedented or unmanageable. Lessons learned in the automotive industry from the crash of 2008-2009 can be adapted to present-day circumstances, and suppliers can not only protect themselves from the risks of business relationships with distressed counterparties but prosper by taking advantage of opportunities to acquire distressed suppliers whose technology and products will complement existing lines of business. VELN's attorneys are highly experienced in managing the ramifications of relationships with distressed suppliers and are ready and able to assist a wide range of automotive businesses in adapting to present and future market conditions.

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