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AUTOMOTIVE INDUSTRY FACES UNPRECEDENTED CHALLENGES AND NEEDS TO ACT TO COMPLY WITH LEGAL REQUIREMENTS RESULTING FROM COVID-19 PANDEMIC

Identifying and avoiding risks ("coronavirus crisis compliance") / Seizing opportunities

The COVID-19 pandemic has heavily impacted the automotive sector, posing unprecedented challenges for the industry as a whole. Direct effects include decreasing sales, massive losses, serious cash burn, existing or impending liquidity shortages and additional financing as well as a change in customer behaviour. This is compounded by the already rapidly advancing technology shift in a competitive global environment, forcing companies to pursue strategic realignment, and in the medium to long term jeopardizing the ability of companies or business units to continue as a going concern. Following the coronavirus lockdown in March, the German government responded by unveiling state-backed loan programmes and stimulus packages, and temporarily reducing the obligation to file insolvency petitions. These (temporary) remedies do nothing to change the basic challenges that companies face: They need to secure their financing and borrowing capacity and drive strategic realignment under changed circumstances. But when they do, their executive management in particular must observe the various legal requirements and take heed of the extensive liability risks, many of which are often not (widely) known. Tried-and-tested monitoring ("coronavirus crisis compliance") allows companies to identify and avoid risks. When conducting strategic realignment and related reorganisations and transactions they must also be aware of and avoid legal pitfalls in order to take best advantage of the opportunities that arise. This frequently requires early or timely action.

COVID-19 as an accelerant for an industry already undergoing radical changes

Recent studies show that approx. 40-45 million less vehicles are expected to be produced globally between 2020 and 2022. This means the industry will be hit **three times harder** by the coronavirus pandemic than the 2008/2009 financial crisis, which saw a decrease in production of only 12 million vehicles. In April 2020, vehicle sales in Europe dropped by **84%** compared to the same period in 2019. Whereas the Chinese market is showing signs of bouncing back quickly, experts anticipate recovery to be slow in Europe.

What's more, the **technology shift** in the automotive industry is in full swing. Manufacturers and suppliers are especially exposed to the rapid changes, particularly in the area of e-mobility and intelligent vehicles, as well as global competition and regulatory restrictions for combustion engines. This development is likely to **further accelerate** – an assessment that is also borne out by the weeks of COVID-19 related plant closures at virtually all European car manufacturers, weak new vehicle sales as well as uncertain backlog effects. There is also the risk of fresh production shutdowns in the event of a new wave of infections as well as additional cost pressure due to a drop in demand – amplifying the **disruptive effects** already felt before the COVID-19 outbreak and increasing the existing pressure to make changes. In this context, timely action can decide a company's fate.

Coronavirus crisis compliance: identifying and avoiding the risks

For maximum **legal certainty** in the critical phase during or following the COVID-19 pandemic, executive management needs to know the **duties that apply** in this kind of situation. It also needs to take into account the various adjustments to legislation introduced in response to the COVID-19 pandemic under the **COVID-19 Insolvency Suspension Act** (COVInsAG). The COVID-19 Insolvency Suspension Act allows companies experiencing financial difficulties as a result of the COVID-19 pandemic to remain a going concern under certain conditions, suspending the obligation to file for insolvency (for more, see our client update on Statutory relief in insolvency law and for restructurings). It does not, however, eliminate the associated liability risks. Quite the opposite: Executive management still faces extensive liability risks if it fails to monitor and document compliance with its duties using a proven **coronavirus crisis compliance programme**. Continuous monitoring of the conditions for suspension is required as long as the obligation to file for insolvency has been suspended – which is currently the case until 30 September 2020 and may even be extended until March 2021. The (restricted) prohibitions of payment also need to be complied with and documented while continuously monitoring the grounds for insolvency. **The COVID-19 Insolvency Suspension Act makes no change to any other civil or criminal obligations or liability risks**. Executive management remains generally obligated to take all measures necessary to overcome the crisis. It may be necessary to make use of government support measures – such as the liquidity assistance available under the KfW Special Programme 2020 – to secure liquidity; this must be applied for in a timely manner. However, there are a number of roadblocks to navigate here – especially for companies with structural problems (for more, see our Rescue by KfW Loans client update).

Plan B: Restructuring through well-prepared legal proceedings

Should it be likely that the conditions for the suspension of the obligation to file for insolvency will cease to apply, a "**plan B**" must be prepared in good time. But even while duties to file for insolvency remain suspended, grounds for insolvency and the rights to file continue to exist. Serious consideration – in consultation with the owners and any investors – should be given to whether reorganisation by way of court proceeding may be an option that offers advantages. As long as the German government has not implemented the EU Directive on **preventive restructuring frameworks** (which it must do by 17 July 2021 at the latest), **protective shield/self-administration proceedings** and insolvency plan procedures may be suitable alternatives.

Strategic realignment: Exploiting the opportunities afforded by a prompt "restart"

There will only be a short-term lapse in many companies' willingness to invest resulting from the coronavirus crisis. In the medium to long term, market experts expect both **M&A activities** around C.A.S.E. deals and strategic partnerships for electric vehicles to **increase**. Given the vastly accelerated shift caused by the COVID-19 pandemic, many automotive suppliers are being forced to **actively shape and secure their restart now**. That requires taking a host of measures:

- securing the company's medium- to long-term financing,
- strategic realignment,
- modifying personnel and cost structures,
- closing competency gaps,
- **separating business areas**, and
- acquiring companies and making (strategic) investments.

From a legal perspective, owners and management alike are advised to take action **without delay**. The sooner they do, the greater the legal certainty with which transactions, restructuring, or reorganisation can be conducted – for example, the separation of "old", at-risk business areas and innovative, promising business areas. That applies all the more now that the government has established a number of **temporary arrangements** in the COVID-19 Insolvency Suspension Act that, for example, can be used to separate business areas (carve out and M&A transactions) so as to protect (**ring-fence**) the transaction and the companies involved in the worst-case scenario – the subsequent insolvency of the company.

Keeping compliant through the coronavirus crisis – with an eye on the future

Companies in the automotive (supply) industry – companies that are already affected by shifts in that industry – now face additional challenges due to the COVID-19 pandemic. But by ensuring their coronavirus crisis compliance is sufficient, they can avoid the current liability risks. Even so, it is essential to both secure the financing to allow the company to remain a going concern and to pursue strategic realignment – including appropriate restructuring, reorganisation, and transactions. Owners and management can't afford to wait too long, but rather should take swift, decisive action to ensure their business is equipped to stand the test of time.

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