Polymer Advisory

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You are only as Strong as Your Weakest Link

The supply chain for many manufacturers, especially that of original equipment manufacturers ("OEMs"), consists of multiple tiers of suppliers with each supplier using another to supply and produce component parts that are eventually delivered to the manufacturer or the OEMs. The costs associated with carrying inventory on the books makes a supply chain that relies on frequent shipments or 'just-in-time' delivery attractive.

Each supplier in the chain receives its supplies on an as-needed basis from the supplier further along the chain, and so forth. Any disruption in the supply chain can cripple production. To make matters worse, often the component parts for many OEMs are manufactured with specialized tooling or machinery that limits a tier one supplier's or OEM's ability to procure substitute products. Also, because of the costs associated with having more than one supplier for a given component part, OEMs often rely on a limited number of sole source suppliers. Efficient, dependable suppliers with the ability to supply parts and product to a plant when needed are key to the just-in-time supply chain.

A just-in-time delivery model will not work without trusted suppliers to deliver the goods. The impact felt by customers and suppliers of Delphi Corporation and its subsidiaries, in the wake of its bankruptcy petition, illuminates the symbiotic relationship a supplier has with its customers. Unfortunately, as evidenced by the Delphi bankruptcy petition, no supplier is immune to financial difficulties. Since substitutes are not readily available in the marketplace, customers are sometimes forced to make tough decisions when a supplier hits financial difficulty. Sometimes the customer is forced to provide financial support to the supplier to keep them out of bankruptcy while alternative suppliers are found. Financial support may include accepting temporary price increases, procuring raw materials for suppliers, accelerating payment to suppliers, and making payments to vendors of suppliers. When the foregoing approaches do not work, a customer may take a more drastic approach and enter into an access agreement with its supplier.

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In an access agreement, the supplier gives the customer the right to enter the supplier's plant and use the tooling, machinery and raw materials located within to produce the component parts themselves. A typical access agreement may require the customer to pay for the employee expenses of the troubled supplier, maintain the assets of the supplier, pay use and occupancy fees, and, in many cases, allow the troubled supplier to produce products for other customers. These types of arrangements may need to be worked out in conjunction with the supplier's lender. The lender and the supplier typically enter into a forbearance agreement whereby the lender agrees to forbear from exercising its rights under the loan agreements following a default by the supplier. Often a lender may require the customer to agree not to set-off claims against accounts payable owed to the supplier. These types of arrangements, however, are only temporary and bridge the gap in the supply chain while alternative supply channels are found.

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A customer can take a number of steps to identify problem suppliers before entering any relationship. The customer should conduct extensive due diligence on the potential supplier. Due diligence should, at a minimum, include: (1) reviewing the most recent financial statements of the supplier, (2) analyzing the adequacy of the working capital needs of the supplier by reviewing its current asset to current liability ratios, (3) determining the supplier's customer base and concentration of customers (a broader customer base spread over a number of different industries may help the supplier deal with the market highs and lows in a particular industry), (4) determining who is supplying materials or products to the potential supplier, (5) analyzing the outstanding payables and the average number of days payables are unpaid, (6) visiting the plant to determine if it is well maintained and efficiently run, and (7) obtaining the available credit reports of the supplier and references.

The diligence process should not end once the parties enter into the supply agreement. The customer should require the supplier to periodically provide the same information supplied during the diligence process and to notify the customer of any material changes that take place in the supply chain. This information should be analyzed by the customer to look for disturbing trends. It is equally important for the customer to conduct internal training to assist purchasing agents, quality control, accounts payable, and plant managers to recognize some of the early warning signs of a troubled supplier. There should be a mechanism in place for such individuals to report potential trouble to senior management immediately.

Some indications of trouble include: (1) requesting price increases, (2) altering the payment terms, (3) delivering products late, (4) delivering poor quality product, or (5) failing to pay other creditors, including the Internal Revenue Service, on a timely basis.

As a customer, you cannot expect suppliers to willingly announce they are in financial trouble. Be proactive and try to identify problems with the supplier before it impacts production.

For additional information on this topic, contact Rob Marchant at 216.363.4489 or rmarchant@bfca.com.

Dealing with Preference Claims under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

Editor's Note: This article was first published in our May 2005 issue. The article has been modified to reflect recent changes resulting from the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).

Most suppliers in the polymer industry today are all too familiar with preference claims. As you learn of customer bankruptcy filings or become aware of customers in financial distress, understanding the fundamentals of a valid preference claim becomes important. Financial officers, credit managers and sales people should be aware of what actions might help to avoid a valid preference claim and what actions might strengthen the bankruptcy estate's claim that a payment was a preference. Understanding the definition of a preference claim and the exceptions outlined in the U.S. Bankruptcy Code is a good starting point.

The U.S. Bankruptcy Code allows a trustee or a debtor in possession ("DIP") to "avoid" and recover certain prepetition payments. These avoidable transfers are known as preferences, which are defined in the Bankruptcy code as:

- a transfer
- of an interest of the debtor in property
- to or for the benefit of a creditor
- for or on account of an antecedent debt
- made while the debtor was insolvent
- on or within 90 days (one year for "insiders") before the petition filing date
- that enables the creditor to receive more than it would receive in a chapter 7 liquidation case if the transfer had not been made and the creditor received payment on its claim as provided in the Bankruptcy Code.

The trustee or DIP must establish each element before a valid preference claim can arise.

What is a Transfer?

A transfer is broadly defined to be any method of disposing of any interest in property, including possession, custody or control. The Bankruptcy Code does not distinguish between voluntary or involuntary transfers nor does it care if the transfer is direct or indirect. Almost all transfers are avoidable if the remaining elements of Section 547 are satisfied. A "transfer" takes place when the cash is received by the creditor (in the case of a cash payment), when the check clears the creditor's bank (in the case of a check), and when the deed is recorded (in the case of a mortgage).

What is the Interest of the Debtor in Property?

To be a preference, the debtor must have had an interest in the property transferred. That is to say, the transfer diminished or depleted the debtor's estate. Generally this is not a problem since most potential preferential transfers involve cash payments by a debtor to a creditor. However, situations involving earmarking of funds for payment of specific obligations, constructive trusts, payments of previously escrowed funds, and drawings upon letters of credit should be reviewed with care as under certain circumstances this element of a preference may not exist.

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What is "To or For the Benefits of a Creditor"?

Transfers made directly to a creditor and also those made for the creditor's benefit are preferential.

For or On Account of an Antecedent Debt?

To be eligible for preference avoidance, a transfer must have been made for or on account of an antecedent debt, i.e., the debt must have preceded the transfer. A few courts have held that payment within terms is not a payment on an antecedent debt.

Made While the Debtor Was Insolvent?

The fifth element of a preference requires the insolvency of the debtor at the time of the transfer. Debtors are usually deemed insolvent if the sum of their debts exceeds a fair valuation of their non-fraudulently transferred property. The Bankruptcy Code includes a rebuttable presumption that a debtor is insolvent on and during the 90 days immediately preceding the date of the bankruptcy.

The Preference Period?

Unless the recipient of the transfer is an insider, the transfer must have been made within 90 days before the bankruptcy to be subject to possible avoidance under section 547 of the Bankruptcy Code. If the creditor is an insider, the reach-back period is extended to one year.

The Transfer Enables the Creditor to Receive More Than in a Case Under Chapter 7 of the Bankruptcy Code?

The court must determine what the creditor would have received as of the date of bankruptcy in a hypothetical liquidation had the alleged preferential transfer not been made. Unless unsecured creditors will receive a 100% distribution in this hypothetical liquidation, all payments to unsecured creditors during the preference period will satisfy this final element of a preference. Special attention should be given to this element if the transferee has a secured interest, such as a filed financing statement, a mortgage, or a statutory or common law lien.

Exceptions to Avoidance

Even if all of the elements of a preference are proven, the transfer is not avoidable if it falls into one of these statutory exceptions:

1. a substantially contemporaneous exchange for new value;
2. a payment on a debt incurred in the ordinary course of business;
3. collateral given for certain enabling loans;
4. followed by subsequent new value to or for the benefit of the debtor;
5. resulted from a floating lien on inventory and receivables and there was no "improvement" in position during the preference period;
6. the fixing of a statutory lien not avoidable under Bankruptcy Code section 545;
7. a payment for alimony, maintenance or support; or
8. less than $600 in a consumer case or less than $5,000 in a non-consumer case.

A few of the exceptions most often applicable are discussed in greater detail below.

Contemporaneous Exchange

A transfer is insulated from avoidance if it was intended by the debtor and the creditor to be a contemporaneous exchange for new value and the transfer was in fact a substantially contemporaneous exchange. The defense is applicable only to the extent of the new value given. Examples of such exchanges are either delivery of a check (not postdated) to a seller at the time of sale so long as the check is honored within a reasonable time; or cash in advance, cash on delivery, or within a short period thereafter.

Ordinary Course of Business

For all bankruptcy cases filed after October 17, 2005, a transfer may also be excluded from avoidance if (1) it was made in the ordinary course of business or financial affairs of the debtor and the transferee or (2) it was made according to ordinary business terms.

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As a general matter, the inquiry under this provision tends to focus on the relationship between the debtor and the creditor, examining the timeliness of the payments under the terms of the invoices generated by the creditor or by examining the similarity or deviance of the alleged preferential transfer to or from prior transactions between the debtor and the preferred creditor. Alternatively, the creditor may show that the payments are within industry standards. Courts have held that transfers made in response to extreme economic pressure applied by a creditor or payments made in settlement of a lawsuit filed by the creditor to collect an outstanding debt do not fall within the ordinary course of business exception.

Enabling Loans

If a debtor needs to buy a new piece of equipment and takes out a loan from a bank to pay for the equipment, the debtor granting a security interest in the equipment to the bank in the preference period is a preferential transfer. This type of loan is commonly known as an enabling loan. A trustee or DIP may not avoid enabling loans if certain requirements are met. The value given by the party receiving a security interest must be intended and in fact used to acquire the property that is the subject of the security interest. The value must be given under a signed security agreement describing the property and perfected on or before 30 days after the debtor receives possession of the property.

Subsequent New Value

The subsequent new value defense is designed to protect a creditor who after receiving payment, (that otherwise would be avoidable as a preference) extends unsecured credit to the Debtor that either remains unpaid as of the Petition Date or, in some jurisdictions, is merely unsecured credit as to which the debtor did not make an otherwise unavoidable transfer. Delivery of goods or the performance of services generally constitutes new value.

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Floating Liens

A creditor with a security interest on the debtor's inventory or receivables is said to have a "floating lien" on the collateral. A preferential transfer can occur when a creditor holds a floating lien prior to the preference period and there is an increase in the value of the collateral or the creditor acquires a lien on after-acquired collateral during the 90 day preference period. The statutory exception is meant to protect secured creditors from preference actions resulting from fluctuations in the value of the debtor's inventory or receivables during the 90 day period. However, the exception does not permit any creditor to improve its position relative to other creditors. Ultimately, a floating lien will not result in an avoidable preference unless and only to the extent that the lienholder's position improves during the 90 days before bankruptcy.

Multiple Defenses

Defendants in preference actions typically are allowed to assert two or more statutory exceptions to reduce potential liability for any alleged preferential transfer. For example, the defendant could assert that part of a payment was made in the ordinary course and the remainder of the payment is not avoidable because the defendant provided subsequent new value. In addition to the exceptions to avoidance noted above, there are defenses that can be asserted in certain circumstances.

For additional information, please contact David Neumann (216.363.4584 or dneumann@bfca.com) or Michael Zaverton (216.363.4690 or mzaverton@bfca.com).

Commercial Impracticability May Work in Absence of Force Majeure

In the October 2005 issue of *Polymer Advisory*, we discussed how the supplier impacted by Hurricane Katrina may invoke the force majeure clause contained in its agreement to be excused from its performance of the contract. In the absence of a force majeure clause, the supplier may be able to assert a commercial impracticability defense under Uniform Commercial Code § 2-615.

To establish the defense of commercial impracticability under Uniform Commercial Code § 2-615, the supplier must prove that: (1) the parties' contract was for the sale of goods; (2) a contingency causing the supplier's nonperformance occurred; (3) the occurrence of the contingency rendered the supplier's performance commercially impracticable; (4) the nonoccurrence of the contingency was a basic assumption of the contract; (5) the supplier did not obligate itself to perform despite the occurrence of the contingency; and (6) the supplier gave the buyer timely notice of the supplier's inability to perform.

Successful assertion of the commercial impracticability defense will excuse the supplier from the performance of the contract. However, if it was practical for the supplier to partially perform its contract with the buyer and the contracts it had with other parties, the supplier must show that it made a fair and reasonable allocation of the goods to the buyer.

"Fair and reasonable allocation" is also determined by reference to the UCC in the absence of any specific requirements in the parties' agreement. Many supply agreements contain force majeure provisions, but do not address allocation requirements in the event that the force majeure only partially impacts a supplier's ability to perform.

With respect to the reasonableness of the supplier's allocation, it will be sufficient to show that the chosen formula for determining allocation was fair to the supplier's customers taken as a whole. A fair amount of latitude is given to the supplier in making this determination. In making its allocation, the supplier may consider such factors as customer profitability, past performance, needs, and the relationship between the supplier and its customers. Suppliers may also consider projections of potential future sales to the customer. In the absence of an express contract term to the contrary, the supplier is not required to allocate its supply equally among its customers. The supplier may be included in the allocation system, although there are certain limits on a supplier's ability to do so.

For more information on this topic, contact Yanping Wang at 216.363.4664 or ywang@bfca.com or Megan Mehalko at 216.363.4487 or mmehalko@bfca.com.

Upcoming Events

February 1, 2006
Cleveland, Ohio
Doing the Deal®
This half-day conference will cover recent global issues taking place in the Private Equity industry.

March 5-8, 2006
Tampa, Florida
Plastics News Executive Forum 2006
This executive-level conference features top-name speakers from the industry's leading companies. Benesch and Plante & Moran will present at a 3-hour bonus strategy session.

April 27, 2006
Chicago, Illinois
Benesch Polymer Seminar
Sponsored by Benesch's Polymer Group, Plante & Moran PLLC, and the Society of the Plastics Industry, this conference will focus on identifying, protecting and maximizing value in a business.

May 23, 2006
Columbus, Ohio
2006 Ohio Polymer Summit
Save the date for this annual meeting that brings together leaders from Ohio's government and the plastics industry to discuss the state's polymer industry.

For more information on events, contact Megan Thomas at 216.363.4174 or mthomas@bfca.com.

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