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Dealing with Preference Claims

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.

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).

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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To or For the Benefit 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 and the case is a 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

Transfers may also be excluded from avoidance if they satisfy all of the following elements:

1. the transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the creditor;
2. the transfer was made in the ordinary course of business or financial affairs of the debtor and the creditor; and
3. the transfer was made according to ordinary business terms, i.e., the payment was made in accordance with practices and customs common to the industry or business in which the debtor and creditor are engaged.

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. The creditor may also be required to 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 20 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 remains unpaid as of the Petition Date. Delivery of goods or the performance of services generally constitutes new value.

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 receivable 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 more information on this topic, please contact David Neumann (216.363.4584 or dneumann@bfca.com) or Michael Zaverton (216.363.4690 or mzaverton@bfca.com).

Polymers Help Deliver Medicine

Imagine if a close friend or family member was diagnosed with cancer. Now imagine that person could go to the hospital and be cured with one injection. This scenario may not be out of the realm of possibility for long, thanks to a rapidly growing new field of medicine known as nanomedicine.

Nanomedicine is an emerging new field within nanotechnology. The term "nanotechnology" generally refers to engineering and manufacturing at the molecular or nanometer length scale. A nanometer is one-billionth of a meter, about the width of six bonded carbon atoms. Nanomedicine is the process of diagnosing, treating, and preventing disease and traumatic injury; relieving pain; and preserving and improving human health using molecular tools and molecular knowledge of the human body.

Future potential medicinal applications of nanotechnology are so promising that this country's Federal investment in nanoscale

science, engineering and technology for fiscal year 2005 is about \$982 million (source: National Science Foundation). This money is divided between the NSF and various other federal government institutions that provide research and development grants to various universities, national science and engineering centers, exploratory research, and education projects for high schools and public outreach programs.

Polymer technology is an integral part of nanomedicine. Applied on the nanoscale level, polymer technology has a strong potential for use in the field of drug delivery. Nanoscale polymeric drug carriers can now facilitate the transport of drugs to some of the smallest capillaries in the body. These nanospheres are designed to travel to specific sites within the body, release their contents of drug molecules and then degrade. Their degradation by-

products are non-toxic and will ultimately be excreted by the body. For example, chemotherapy treatment of cancer usually involves saturating the body with toxic drugs, which can often result in harmful side effects such as reduced immune response to infection. With the use of polymeric drug carriers, it is possible to direct the drug molecules specifically to the site of a tumor so that a reduced quantity of drug would be required. Consequentially, this reduces the toxic effect of the drug on the body.

Developments in polymer science have had a great influence on drug delivery. It is now possible to synthesize a wide variety of biocompatible polymers that will release entrained drugs at a rate determined by the chemistry and physical form of the polymer.

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The nanopolymeric drug delivery systems are produced involving a method known as emulsion polymerization, in which molecules self-assemble themselves during a chemical process. In an emulsion polymerization, molecules known as surfactants perform the self-assembly by virtue of their amphiphilic nature. Amphiphilic molecules are composed of two or more parts with each part being soluble in a different medium. Generally, a surfactant molecule may have a hydrophilic end and a hydrophobic end.

The surfactant molecules are dissolved in water until the critical micelle concentration ("CMC") is reached. At the CMC, the molecules arrange themselves so as to minimize the interaction of their hydrophobic end with a water molecule. In order to accomplish this, the hydrophobic ends align along side each other to form spherical structure called a micelle. The interior of the micelle provides the site necessary for polymerization.

Once there are millions of micelles in the aqueous medium, a hydrophobic reactive monomer is introduced and travels to the interior of the micelles where it is stable. The micelles then swell to accommodate

the monomer. The final part of the preparation of the nanoparticles involves the addition of initiator molecules that trigger a chain reaction within the micelle's core leading to a polymerization. Once the cores of the micelles have been converted to solid polymer spheres, the spheres may be removed from the emulsion. Drug molecules either attach to the sphere surface or can be absorbed into the core. The specific site within the body to which the nanoparticles will travel is controlled by the surface chemistry of the nanoparticle. Molecules can be tethered to the particle's surface which will cause selective uptake by various organs of the body.

Medicinal treatment of diseases using nanoparticle drug delivery systems is possible. Through their unique structure and capability to carry drugs on the molecular level throughout the body to specific targets, it is easy to see how polymers help deliver medicine.

For additional information on this topic, please contact Rita Kline at 216.363.4466 or rkline@bfca.com.

Ohio Polymer Industry Legislative Luncheon

Benesch is pleased to be a sponsor of this event.

May 24, 2005

Ohio Statehouse Atrium, Columbus

Growth or Decline: It is Our Choice

With 142,000 Ohio jobs, Ohio's polymer industry has the potential, according to a recent Battelle study, to favorably affect 40,000 jobs over the next 5-10 years.

The polymer industry is at a crossroads. Unprecedented opportunity is contending with unprecedented global competition. New technology is being introduced at a record pace, while newspapers report continued job losses in the manufacturing sector. Such mixed signals cause confusion at a time when decisive action is required to succeed.

Polymer materials continue to replace traditional materials like glass, metal, wood, and paper in diverse markets from medical to automotive to packaging and building products. New polymer technologies in nanocomposites and photonics are compounding polymer industry growth with brand new products to improve the quality of life for everyone.

As the world's competitive playing field has grown, new coalitions between businesses and universities are emerging on an increasingly fertile landscape of cooperation and collaboration nurtured by government actions. This teamwork is becoming the benchmark for tomorrow's economic health. The challenge in Ohio is to choose innovative actions that will result in growth.

This program will focus on Ohio's efforts to grow and strengthen the polymer industry. Meet Ohio's elected officials as well as William Cardeaux, president of the Society of the Plastics Industry.

For more information and tickets, call (614) 901-8866.

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