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MEMORANDUM

UNDERSTANDING AND SAFEGUARDING YOUR POSITION IN DEALINGS WITH FINANCIALLY TROUBLED CUSTOMERS AND SUPPLIERS IN THE U.S.

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DATE: January 2009

Companies operating in today's economically challenging environment are assessing their financial exposure to customers and suppliers in the U.S. market, and how best to position themselves, especially with respect to (a) pre-petition unpaid receivables; (b) post-petition ongoing business relationships, and (c) pitfalls/opportunities arising from the restructuring in the market generally.

Unsecured suppliers dealing with financially troubled customers may have difficulty collecting their invoices. If a customer becomes a debtor in bankruptcy, its creditors are generally prohibited from taking further efforts to collect their claims unless permitted by the bankruptcy court to take action. Instead the creditors will have the right to file a proof of claim with the bankruptcy court. Unfortunately, most likely, unsecured creditors will only recover a fraction of the claim and only after significant delay.

This briefing is intended to provide a general overview of some of the main tools which clients should keep in mind in their efforts to reclaim from, stop delivery of goods to and otherwise increase recovery on their unsecured claims against a financially troubled customer. For more information and specific advice on any of these or related matters, we encourage you to contact us.

- **Demand for Adequate Assurance.** Under §2-609 of the Uniform Commercial Code ("UCC"), once a supplier has reasonable grounds to doubt a customer's ability to fully perform its contractual obligations to the supplier, the supplier may in writing demand adequate assurances of due performance from the customer. Importantly, the supplier may suspend its performance of its obligations until such time as the adequate assurances are provided. Since the "old" contract is suspended, if the supplier so desires it may agree to continue its performance but only on new terms, such as the imposition of Cash in Advance ("CIA"), Cash Before Delivery ("CBD") or Cash on Delivery ("COD") terms.

- **Pre-Petition Claims for Amounts Owing**. After a customer files a petition of bankruptcy, a supplier's claims for unpaid amounts which arose prior to a bankruptcy filing (pre-petition) are now included in the pool of debt. The status of a claim depends on the type of claim and whether it is a secured or unsecured obligation. To preserve its rights as a claimant, the supplier should file a proof of claim within the deadline set by the bankruptcy court. An attempt by a creditor to obtain payment of the pre-petition debt or to otherwise seek any remedy against the debtor with respect to the pre-petition claim absent court order may result in a violation of the "automatic stay," which protects the debtor during its reorganization or liquidation efforts.

However, under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), in addition to the expanded reclamation rights addressed below, suppliers have an administrative priority expense claim for goods the supplier had delivered to the customer shortly before the commencement of the customer's bankruptcy case. This administrative priority expense claim applies whether or not the supplier complied with the requirements for reclamation or is not otherwise entitled to relief on its reclamation claims. This administrative priority expense claim is for the value of the goods delivered to the customer within 20 days of the commencement of the bankruptcy case.

- **Reclamation Claims**. In addition to the administrative priority expense claim, suppliers can demand reclamation (demand the return of) goods delivered on credit terms to an insolvent customer. Additionally, a supplier may reclaim goods sold and delivered on a COD, CBD or CIA basis where the customer's check in payment for the goods was dishonored. Importantly, the customer does not have to be in bankruptcy for the supplier to assert its right to reclaim its goods. However, the Bankruptcy Code does limit the supplier's reclamation right once the customer is in bankruptcy.

A creditor's right of reclamation arises under state law, specifically §2-702(2) of the UCC, under which the following requirements must be met:

(1) Customer must be insolvent when it received the goods;
(2) Supplier must demand return of the goods;
(3) Demand for reclamation must be sent to the customer within 10 days after the customer physically receives the goods;
(4) Goods must have been sold to the customer on credit terms or dishonored check; and (5) customer must still possess the goods when the demand is made.

Under Bankruptcy Code §546(c), the reclamation reach-back period is expanded to 45 days. Thus, an unpaid supplier can reclaim goods it had sold to on credit to a customer in the ordinary course of the supplier's business that the customer had received within 45 days of the customer's bankruptcy filing. The supplier is also given up to 20 days after the bankruptcy filing to send its reclamation demand as long as the 45 day reclamation period expires after the bankruptcy filing (i.e., for goods received within 45 days of bankruptcy).

There are certain defenses to a supplier's reclamation claim. The most important of which is under UCC §2-702(3) whereby a supplier's rights are subject to the rights of a customer in the ordinary course or a good-faith purchaser, including a secured creditor with a perfected floating security interest in all of the customer's existing and future inventory. Additionally, a number of courts have held that a supplier's knowledge of the customer's insolvency is a defense to the supplier's reclamation claims. The courts have concluded that a supplier who knowing sells to an insolvent customer does so at its own risk and should lose its reclamation and stoppage of delivery rights.

- **Preferences.** The U.S. Bankruptcy Code is designed to protect two distinct interests, namely, the debtor obtaining a fresh start and the creditors being treated fairly. The Bankruptcy Code attempts to provide equal treatment among creditors through §547 of the Code, which allows the bankruptcy trustee or the debtor-in-possession ("DIP") to avoid or recover certain payments made to creditors during the 90 days prior to the bankruptcy petition. The 90 period was established under the presumption that the debtor was insolvent 90 days prior to filing. However, the possibility of recovery of the payments exists only if the supplier cannot assert and prove certain statutory defenses which would entitle it to keep the payments. The defenses are designed to protect suppliers that continue to sell on credit to a potential debtor during the 90 days before a bankruptcy case is filed.

The most common defenses under §547 are the following:

(1) Ordinary Course. To prevail under this defense the supplier must demonstrate that the payments were made on an ordinary debt and made according to ordinary terms between the parties.

(2) Contemporaneous Exchange. To the extent that the transfer was intended by the debtor and the supplier to be contemporaneous for a new shipment of inventory or provision of services and was, in fact contemporaneous, the payments may be protected.

(3) New Value. To the extent that, after each transfer is made, the supplier supplied new value to the debtor, the supplier is able to assert the value of the new inventory or services supplied as a credit against the transfer.

(4) Aggregate Value. If the aggregate value of all property that constitutes the transfer is less than $5,000, then the payment will be protected.

- **Tools and Molds**. Although enforcement of tooling liens arising under state law would normally be subject to the automatic stay, bankruptcy courts often enter an order permitting the debtor to pay tool and mold builders and the debtor's suppliers that user tooling to make parts, subject to certain conditions. Several states, including Michigan and Ohio, also grant special statutory liens on such molds and tools and provide toolmakers and tool users with certain rights.

- **Continuing to Do Business with Debtor.** After a bankruptcy filing, it is useful for a supplier to examine whether it has an existing supply or customer contract with the debtor. Given most standard terms and conditions, the answer to this question may not be as simple as one would think. Even if a contract is still in effect, the debtor will generally have a certain amount of time to assume or reject contracts not yet fully performed. In the meantime, if the supplier is not able to continue performing absent payment by the debtor of the amounts owing, or if the debtor does not continue to perform, the supplier may have options. However, those options must be evaluated in light of applicable bankruptcy restrictions. In any case, it will be important to ensure that any post-petition work performed will be given priority as an "administrative expense" and will be paid for prior to any pre-petition unsecured claims.

- **Long-Term Contracting with Debtor**. Future contract negotiations with a debtor should be handled with care. Issues such as tooling ownership, payment terms and capital expenditures need to be considered carefully and negotiated individually.

- **Essential Supplier Program and Continuation of Troubled Supplier Program**. Bankruptcy courts will often grant a debtor permission to preserve its "essential suppliers" and to assist troubled suppliers. Up to a specified cap, a debtor may be authorized to pay the pre-bankruptcy claims of certain of its "essential suppliers" subject to such suppliers agreeing to certain terms. Debtors are often authorized to continue pre-bankruptcy vendor rescue programs, including such support as purchasing raw materials on behalf of troubled suppliers or making payments on an accelerated basis.

- **Doing Business with Debtor's Foreign Operations.** While a bankruptcy court generally will not bother foreign subsidiaries that are not a part of the Chapter 11 filing, creditors can sometimes reach the assets of subsidiaries that are not a part of the bankruptcy filing in situations where they can convince the court that the corporate separateness of the subsidiaries is a sham and that the corporate veil of the affiliate should be pierced. If the bankruptcy court determines that the parent and subsidiary do not have a separate identity, then the foreign subsidiary's assets may be attached in the bankruptcy proceedings. A court may also attach the assets of a foreign subsidiary in the case of fraud. Accordingly, you should take this into account in doing business with any debtor subsidiary, even if it is not now involved in the bankruptcy proceeding.

- **Supplier Claims under Insurance Policies.** Some countries provide government-supported export insurance programs for goods delivered to the U.S., and guaranteeing their accounts receivable. Such insurance generally does not cover goods shipped to the debtor in the U.S. post-bankruptcy, but such shipments may be granted administrative expense status.

- **Restructuring Operations**. Debtors often announce that it plans to radically restructure their U.S. operations, selling off or closing down certain operations and facilities. This may provide an opportunity for existing suppliers as well as new entrants looking to acquire an established business and customer relationship in the U.S. Assets purchased out of bankruptcy are subject to specific legal procedures which offer certain protections not otherwise afforded in a general business acquisition.