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# Mid-Atlantic Bankruptcy Workshop

## Supply Chain Disruptions

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# Supply Chain Disruptions

## Preparing for the Next Stage

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## Please Allow Me To Introduce Myself...

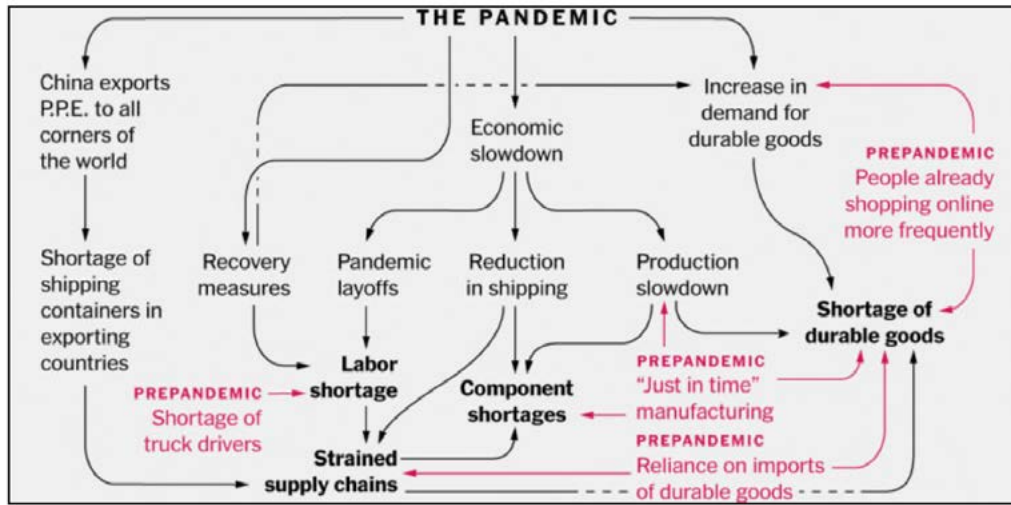
**Supply chains have been pushed to the brink over the past two years by the pandemic, current economic conditions, rising inflation, and global tensions resulting from the Ukraine Conflict.**

1. Industries most effected
  - a. Computer Chips and downstream effects, *e.g.*, Automotive
  - b. Logistics: Domestic and International Freight
  - c. Goods
    - i. Home Improvement
    - ii. Consumer goods
  - d. Energy related
  - e. Other Industries
2. What types of Turnaround Consulting engagements have resulted from supply chain issues?
3. Outlook for continuation, resolution, or new supply chain issues



## Where It All Began....

The New York Times analyzed the origins of the supply chain problem and concluded it was too complex to describe in words, so it used a flow chart.



## The Root of the Problem

Logistics is the common thread in this nightmare



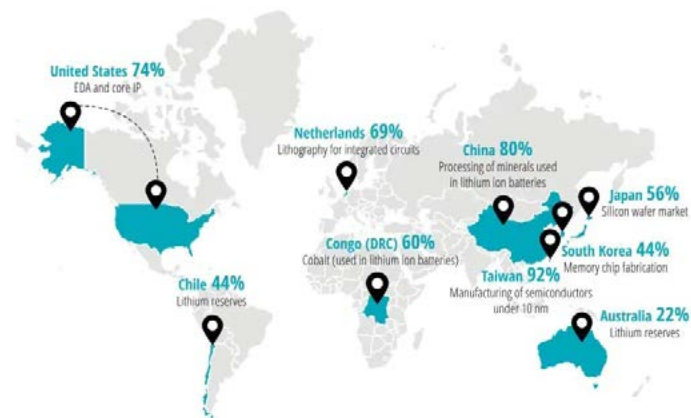
1. Empty Containers/full containers stranded – caused a ripple effect down entire supply chains, disrupting trade on a global scale.
2. There is a worker shortages at all levels.
3. Transportation links are dysfunctional or broken: air/water, rail/trucking, pickup and delivery.
4. E-Commerce has changed traditional models of delivery:
  - A. Traditionally: ship goods from factories around the world to central warehouses that supply retail outlets, consumers purchase goods from brick-and-mortar stores.
  - B. Today: produce, sort and deliver individual orders directly to homes and businesses.
5. Significant need for new storage, warehousing, and logistic mechanisms – this is production and sorting problem and then a mass delivery issue.

## Drivers of Supply Chain Vulnerability

- **Insufficient U.S. Manufacturing capacity:** U.S. manufacturing capabilities have declined over the past several decades. Between 2000 and 2010, the U.S. lost one-third of its manufacturing jobs, mostly in small and medium enterprises. Some of the decline is attributable to competition from low wage nations (China). Counter to popular beliefs that the “robots are coming,” many SMEs are underinvesting in new technology to increase their productivity.
- **Misaligned Incentives and short-termism in private markets:** Current structure fails to reward firms for investing in quality, sustainability, or long-term productivity.
- **Industrial Policies Adopted by Allied, Partnered, and Competitor Nations:** While U.S. investment in the domestic industrial base has declined, our allies, partners, and competitors have adopted strategic programs to advance their own domestic competitiveness.
- **Geographic Concentration in Global Sourcing:** The search for low-cost production, combined with the effective industrial policy of key nations, has led to geographic concentrations of key supply chains in a few nations, increasing vulnerabilities for U.S. and global producers. Such concentration leaves companies vulnerable to disruption, whether caused by a natural disaster, a geopolitical event, or a global pandemic. The U.S. is dangerously dependent on specific countries for parts of the value chain. For example, global economy depends on Taiwanese firms for 92 percent of leading-edge semiconductor production. China has over 75 percent of global cell fabrication capacity for advanced batteries.

FIGURE 2

### High concentrations in the global tech supply chain



Sources: The White House, *Building resilient supply chains, revitalizing American manufacturing, and fostering broad-based growth*, June 2021; Boston Consulting Group and Semiconductor Industry Association, *2021 state of the us semiconductor industry*, April 2021.

Deloitte Insights | [deloitte.com/insights](https://deloitte.com/insights)

1. **Semiconductors** – Affected by shortages in talent, raw materials, manufacturing and shipping as well as shifts in new product uses (5G) – localization of productions is beginning to come online with increasing CAPEX. Semiconductor shortages the past 2 years are expected to have resulted in revenue misses of more than \$500 billion worldwide for suppliers and customers.
2. **Aluminum** – Affected by Chinese production decisions to reduce carbon emissions, natural gas prices in Europe, and delays in new CAPEX in the U.S. (Ball Corporation just announced it would build a \$290 million packaging plant in Nevada).
3. **Food** – Largest cost item: energy, affected by labor shortages, shipping, and shortages in fertilizer and pesticides. Curbs on exports from Russia and China are expected to keep fertilizer demand high beyond 2023.
4. **Plastics** – Driven by resin shortages, power outages in Texas and Southern US. Everything from plastic straws to industrial pipes, car parts, and heart valves are facing higher prices. Virgin resin prices are up 30-50% from a year ago.
5. **Building Materials** – Inflation risks in all areas driven by price and availability of labor (manufactures don't have enough labor on the plant floors), materials and shipping costs, long lead times that cannot meet increased demand.

According to: <https://www.supplychaindive.com/news/shortages-2022-outlook-supply-semiconductors-aluminum-food/617537/>

## 5 Key Supply Chain Shortages

## Supply Chain Issues in Turnarounds and Bankruptcy

### Key Issues are Driven by Uncertainty

- **Projections:** The key tool used in turnarounds is uncertain – cash flow projections (13/26 week, 5-year) – not just a revenue/expense or cash flow timing problem. Major risks and uneven cash flows are making it difficult to anticipate needs and to project meeting obligations.
- **Values:** EBITDA multiples continue to be high.
- **Terms:** Lending terms are still lax and too much money is still chasing deals.
- **Post-Closing Issues:** Significant risks for M&A post-closing adjustments to receivables, inventory, other working capital.
- **Recession Risks:** Ukraine War shocks (shorter/longer term), inflation.
- **Litigation:** Significant uncertainty for key litigation tests that rely on value, solvency, damages or other cash flow projections and dependability of transaction comparisons.

## How to Address Supply Chain Issues in Turnaround Negotiations

### Lean Into the Complications Involved in Dealing with Financial Projections and Business Values

- **Projections:** focus on pressure points, *e.g.*, inflation, labor, sources/capacity, product deliver (units and money), timing issues until stability can be achieved.
- **Develop and Test Scenarios:** short/long term until reach stability state, base case versus scenarios, modelling impact on working capital, capex, timing issues.
- **Weighting:** avoid using simple averages of projected outcomes in cash flows or implied values, focus on both base case and scenario tests, consider presenting multiple models.
- **Supply Chain Specific Analysis:** If you want/need to blame external forces for client's failures, work with your management team to evaluate strategies, costs, and investment in managing supply chains and inventory. Consider supply chain mapping analysis, try to optimize product line SKUs and sources of components as well as transportation modes and strategies.
- **Communication:** communicate and partner/work with stakeholders (employees, vendors, customers, lenders), educate, realign to solve key issues, realign both vendors and customers, work with lenders.

## Case Studies

## *Situation #1 – Commercial Bakery*

- Macro Dynamic:
  - Avian Flu
  - ~ 40.1 million birds impacted
  - ~ 30.0 million hens culled (12.0% to 13.0% of the population)
- Company Situation:
  - ~ 2.5% decline in national egg supply, a key raw material
  - National whole egg prices increased from \$1.60/dozen to \$2.50/dozen (~ 56.3%)
  - Revenue and EBITDA had been under pressure but not classically distressed
- Aftereffect:
  - Short term expense impact mitigated due to proactive risk management (e.g. hedging)
  - Specific key suppliers weren't as impacted relative to the industry
  - Some instances where suppliers invoked force majeure due to haywire spot market

## *Situation #2 – Pre-Formed Concrete Manufacturing*

- Macro Dynamic:
  - Russian invasion of Ukraine
  - Ships not wanting to go through the Bosphorus into the Black Sea
  - Rising labor costs
- Company Situation:
  - Transportation of critical raw materials originating from Black Sea ports blocked
  - On going projects had to be delayed (~7.0% revenue miss to initial budget)
  - Contract labor costs expanded substantially (~1,228.1% y/y and ~18.3% q/q)
- Aftereffect:
  - EBITDA suffered (88.3% miss to initial budget)
  - Created too much projection uncertainty for a covenant reset
  - Amendment and facility upsize negotiations in statis

## *Situation #3 – Commercial & Residential Alarm Monitoring*

- Macro Dynamic:
  - Sunset of 3G cell tower
  - Lockdowns in China impacting manufacturing
  - Shortage of LTE alarm radios
- Company Situation:
  - Company winding down operations
  - Had purchased LTE radios for its own conversion project prior to supply chain issues
  - Excess raw inventory which is in high demand by industry peers
- Aftereffect:
  - Relatively disintermediated liquidation process
  - Recovery has been close to initial cost
  - Upside to the wind-down budget

## Commodity Pricing and Availability Provides Both a Case Study and a Source of Supply Chain Disruption in Various Other Industries

- Commodity prices have been unpredictable in recent years, and many business deals and contracts are based on a reality that no longer exists.
- Tradingeconomics.com
  - It has become one of the most watched websites
  - Find the cost of commodities
  - Multimillion dollar fluctuations within the day and at times 20% or more swings within a 30 to 60 day period.



## Limited Supplies – Could be an Opportunity

- Limited supplies has become an opportunity for many businesses.
- For the first time in many years businesses are consistently turning away revenue, unless they can achieve significant price increases.
- Automatically saying yes to revenue growth is being rethought.
- Has enabled certain clients to achieve 15 to 20% price increases.
- Moral (Irony) of the Story:
  - ✓ Empowered Companies to be bolder
  - ✓ Improve focus, cash flow and operating performance – talk about making the most out of challenging times

## E-Commerce/Online Challenges

- Continues to be one of the largest growing components
- Challenge Clients/Customers
  - Have they outlined the challenges and opportunities?
  - What % of their supply channel is impacted or are impacting?
  - Is E-Commerce a difference maker? Positive? Negative?

## Vendor Specific Considerations: 503(b)(9) Claims & Reclamation

- Section 503(b)(9) generally allows for an administrative claim for goods delivered to the debtor in the 20 days prior to the petition date:
  - Even with 503(b)(9)– there are so many challenges to ultimate recovery, in particular where the business arrangement does not follow the narrow delivery paradigm. For example, drop ship arrangements where there was no delivery to the debtor may cause disallowance of 503(b)(9) priority.
  - Think early and often: Keep your guard up.
- Domestic or International – Need to employ an exceptionally different approach.
- Reclamation processes under the UCC are generally not useful in a chapter 11, due to secured lenders who may have a blanket security interest in inventory.

## Representation Strategies

- Different strategies must be employed for representation of the entity experiencing financial distress due to supply chain problems, rather than a secured lender, creditor, contract counterparty, supplier or customer of the entity in question. To analyze the strategy to be employed:
  - Quantify Exposure
  - Stakeholder Temperament & Attitude – Maybe the most critical consideration
  - Timeline & Path
  - Obtuse & Opportunistic Consideration
    - Hang on Sloopy: Is it worth it

## Impact of Market Conditions Depends on Client/Debtor's Role in the Supply Chain

- **Debtor as manufacturer** – supply chain could prevent crucial materials from reaching the Debtor, shipping delays and pricing could impact margins and timing of supply and revenue cycle, increased inventory of unused materials or finished goods could prevent realization of profit. All of these issues could result in contractual defaults with customers and potential lender defaults or failure to pay other suppliers.
- **Debtor as retailer** – supply chain could prevent finished goods from reaching the retailer or cause the retailer to be left with an oversupply of unmarketable goods, or empty shelves with unchangeable rent and employee costs.
- **Debtor as supplier of raw materials** – supply scarcity could be beneficial or detrimental to supplier depending on whether the debtor has contracts it can't fulfill. A debtor may be using the bankruptcy process to eliminate unfavorable contract terms or pricing through contract rejection. Shipping and transport of raw materials may also impact a raw materials supplier's ability to remain profitable.

## Supply Chain Disruption in Chapter 11

- Unexpected supply chain issues may cause a cash flow crisis or cause an entity to default on its contractual obligations.
- To avoid contract termination and possible resulting litigation or an action by a secured lender, or in order to reject burdensome contracts, a company may choose to commence a chapter 11 proceeding.
- In addition to serving as a contributing factor to a company's decision to file a chapter 11 petition, supply chain complications factor into a number of additional phases of a chapter 11 case, including:
  - Contract assumption and rejection
  - Critical vendor payments
  - Preference and fraudulent conveyance liability
  - Plan feasibility considerations

## Assumption of Executory Contracts

- To assume an executory contract in bankruptcy pursuant to section 365, a debtor must cure any financial defaults and give adequate assurance of future performance
- Also demand for adequate assurance of performance under 2-609 of the UCC upon reasonable grounds for insecurity concerning a contract party's willingness or ability to perform a future obligation under a contract for goods
- Under the UCC, counterparty can suspend or modify performance if assurance not provided, negotiate concerns before a breach occurs and modify contract including guaranties, liens, or letters of credit

## Rejection of Executory Contracts and Leases

- Rejection is an extremely powerful tool for an entity looking to take advantage of limited supply and increased market demand that allows for increased price of goods and profit.
- Alternatively, if a company can't perform under a supply contract, rejection limits damages to a prepetition unsecured claim, cuts off contract breach litigation, and may allow a reorganization around remaining contracts and assets.
- Perfect recent example in energy filings – rejection of commodities contracts has occurred where pricing was based on prior years. Underpriced and unfavorable supply contracts can be rejected in chapter 11.
- Reducing operations may require rejection of contracts for a certain business division, or the need to reject a lease of real property.
- Damages calculated for rejection of executory contracts become prepetition unsecured claims, whereas lease rejection damages require payment of outstanding amount in addition to a capped rejection damages claim.
- Analyze contract terms to determine which contracts are unfavorable and must be rejected
  - Pricing of materials
  - Pricing of finished goods
  - Status of demand
  - Availability of quantity required

## Critical Vendor Issues

- Critical vendors, to the extent they can be paid prepetition amounts owed by the debtor pursuant to a court order, must maintain prior contract terms. The primary concern for most courts in determining whether to grant this relief is whether there are potential alternative suppliers of the required goods or services.
- Some courts are extremely reluctant to grant this relief. The Seventh Circuit in its 2004 *In re Kmart Corp.*, 359 F.3d 866 (7<sup>th</sup> Cir. 2004) decision began to turn the tide away from the widespread availability of critical vendor relief in the initial stages of a chapter 11 case.
- Courts have applied a three-factor test: “the vendor must be necessary to successful reorganization; the transaction must be in the debtor's sound business judgment; and other unsecured creditors must not be prejudiced by payment to those critical vendors.” *In re Windstream Holdings Inc.*, 614 B.R. 441, 458 (S.D.N.Y. 2020), citing *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989).
- With a limited supply of goods due to the breakdown of supply in certain industries, these requests could increase. Suppliers, acting in their own best interest, could reasonably send their limited supply to an entity that is not in a financially precarious position or subject to bankruptcy court oversight. Without the ability to compensate critical suppliers for pre-petition amounts owed, in the current economic climate, the initial weeks and months of a chapter 11 case may be complicated for some debtors.
- Critical vendor orders also may not insulate these vendors from preference claims. See *Insys Liquidation Trust v. McKesson Corporation (In re Insys Therapeutics, Inc.)*, No. 21-50176 (JTD), 2021 WL 3083325 (Bankr. D. Del July 21, 2021).

## Preference and Fraudulent Transfer Risks

- With a limited supply of goods, or an unanticipated value/pricing structure, suppliers may put pressure on purchasers to pay on tighter terms.
- Pressure from a supplier to reduce credit extended in the days preceding a chapter 11 filing may impact that supplier's new value and ordinary course defenses for payments received from the debtor within 90 days prior to the bankruptcy filing.
- Further, a lender may seek to perfect liens within 90 days of filing, which could subject that lien position to preference exposure.
- A lender may seek to take additional collateral to secure their position if the inventory is depleted or the collateral loses its value for another reason. Without additional lending or consideration, this could be considered a fraudulent transfer pursuant to section 548 of the Bankruptcy Code, or applicable state law.

## Plan Feasibility

- Detailed projections generally form the basis of a chapter 11 plan feasibility analysis.
- Section 1129(a)(11) requires that the debtor can show that confirmation of a plan is not likely to be followed by a liquidation or need for further reorganization.
- Without a firm handle on commodity pricing, raw material availability or a reliable supply of goods, chapter 11 debtors seeking plan confirmation will face an uphill battle.
- Courts may have to approve plans based on current or expected market conditions, and we may see further repeat filings, or fewer chapter 11 plans that do not simply follow a 363 sale.

# Faculty

**Robert D. Katz, CPA, CTP** is managing director of Eisner Advisory Group LLC in Philadelphia and has more 25 years of experience working with public and private middle-market companies, both in and out of bankruptcy. In a leadership capacity, he acts as interim president, CFO, COO, CRO or treasurer. He also acts as plan administrator, distribution trustee and receiver. In addition, Mr. Katz advises U.S. Trustees, creditors' committees, company management, lenders and private-equity funds. He pursues substantial litigation claims and avoidance actions, and serves as an expert witness. Mr. Katz is an advisor and board member for public companies, private family-owned businesses, and many nonprofit organizations. He was recently named Distressed M&A Dealmaker of the Year by The M&A Advisor. In addition, Mr. Katz prepares statements and schedules, forecasts and projections, and negotiates with secured and unsecured creditors. He assists companies planning for, going through and emerging from a § 363 sales process, and he has turned around, operated and improved the performance of companies in the pharmaceutical, health care, manufacturing, wholesale distribution, high tech, retail, hotel/casino, publishing, printing, service industries and nonprofit sectors. Mr. Katz helps companies raise capital, including refinancing debt, securing debtor-in-possession financing, and adding lines of credit and term loans. He also has guided clients through strategic acquisitions, raising equity capital and divestitures. Mr. Katz is a member of ABI and the American Institute of Certified Public Accountants, Pennsylvania Institute of Certified Public Accountants, Turnaround Management Association and Commercial Finance Association. He also is an adjunct professor at Temple University. Mr. Katz received his B.S.E. in accounting and business management from the University of Pennsylvania Wharton School of Business and his M.B.A. from Temple University.

**Michael Sicari, CFA** is a manager with CR3 Partners LLC in its New York office. He is a finance professional with a background in portfolio valuation and portfolio management. Prior to joining CR3 Partners, Mr. Sicari valued complex debt and equity securities, primarily in the oil and gas sector. He has experience performing due diligence, analyzing and building financial models, and examining legal documentation. He also has worked in high-net-worth portfolio management and investment consulting. Mr. Sicari is a member of the CFA Society New York and the Turnaround Management Association (TMA). He received his B.A. from Franklin and Marshall College.

**Hon. J. Kate Stickles** is a U.S. Bankruptcy Judge for the District of Delaware in Wilmington, appointed on April 6, 2021. Previously, she was member of Cole Schotz P.C.'s Bankruptcy and Corporate Restructuring Department in its Wilmington, Del., office and practiced in the areas of corporate bankruptcy, insolvency and creditors' rights, having represented debtors, official committees, creditors, examiners and trustees in chapter 11 cases. Judge Stickles has been named in *Chambers USA: America's Leading Lawyers for Business* since 2010 and has been listed in *The Best Lawyers in America* and in *Delaware Super Lawyers* in the area of Bankruptcy and Creditor-Debtor Rights Law. She served as counsel to chapter 11 debtors in a variety of industries, including manufacturing and distribution, telecommunications, health care and media, in some of Delaware's most significant bankruptcy cases. Judge Stickles has published in, and served as a contributing editor for, the *ABI Journal* and has also published in *The Americas Restructuring and Insolvency Guide*, the ABI Bankruptcy Litigation Committee eNewsletter and the ABI Commercial Fraud Committee eNewsletter.

Judge Stickles is active in the Bankruptcy Section of the Delaware State Bar Association, having served as the Section's chair (2010-11), vice chair Commercial Bankruptcy (2009-10) and secretary (2008-09). She is also a member of the Delaware Views from the Bench Advisory Board and the International Women's Insolvency & Restructuring Confederation (IWIRC), for which she served as director-at-large from 2010-11. Judge Stickles received her B.A. in political science and communications from Western Maryland College and her J.D. from Temple University School of Law.

**Sara C. Temes** is a member of Bond Schoeneck & King, PLLC in its Syracuse, N.Y., office, where she focuses her practice on a wide range of restructuring matters throughout New York State, including out-of-court workouts, cross-border insolvency cases and representations of debtors, creditors, creditors' committees, landlords, lenders and purchasers in litigation and insolvency matters. She also advises senior managers and boards of directors of financially troubled companies with respect to turnaround strategies. Ms. Temes has been recognized in *Super Lawyers* as a "Rising Star" in the area of business bankruptcy for 2019-21 and as a "Rising Star" for 2017 and 2018. She also serves on the Local Bankruptcy Rules Standing Committee for the U.S. Bankruptcy Court for the Northern District of New York. Prior to joining Bond, Schoeneck & King, she was an associate at Weil, Gotshal & Manges LLP in New York. Ms. Temes received her B.A. from Wellesley College and her J.D. from the University of Pennsylvania Law School.

**Christopher B. Wick** is a corporate restructuring and bankruptcy partner with Hahn Loeser and Parks LLP in Cleveland, where he focuses his practice on corporate reorganizations, workouts, debtors' and creditors' rights, and corporate transactions across the U.S. He has represented parties in the restructuring, reorganization or sale of complex business in an array of industries, including energy, automotive, agriculture, telecommunications, logistics, manufacturing, real estate and steel. He also has a broad range of transactional experience and has advised clients in connection with a variety of DIP financing facilities, recapitalization transactions, and asset dispositions and acquisitions. Mr. Wick has substantial experience representing and advising companies, buyers and investors in all aspects of distressed and insolvency situations. He also counsels boards of directors, chief executive offices and other members of senior management with respect to their duties and obligations to, and exposures in connection with, financially challenged companies. Mr. Wick received his J.D. in 2000 from Washington & Lee University School of Law.