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Supply Chain Instability and Disruption as a Key Source of Distress and Bankruptcy: A Long-Term Influence

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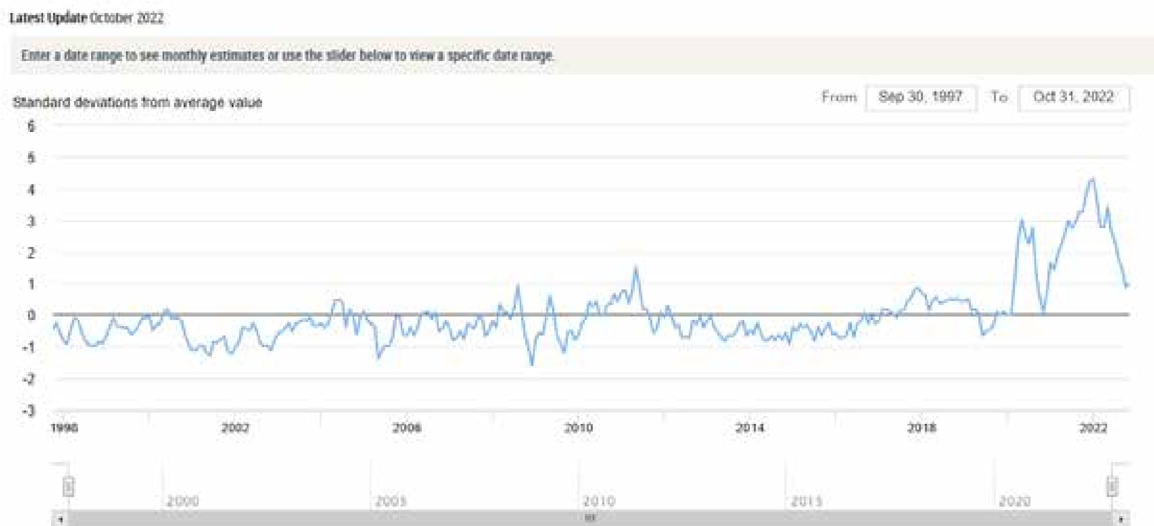
I. Supply Chain Crisis

Over the last two years, supply chain disruption has been the bane of many companies, suppliers, manufacturers and consumers whether shortfalls in semiconductor production, chemical supply, automotive production, and even silicon chips to name a few. On the heels of COVID shutdowns throughout 2020, the global supply driven crisis began in late 2020 and persists today. Reasons for supply shortages run the gambit, but the primary reasons include differences in COVID shutdown policies among global governments and the associated unevenness in reopening businesses and production lines, delays and seizures in global ports and freight compounded by labor shortages, the Russia-Ukraine conflict and resulting embargo against Russia impacting fuel costs (plus both countries are key commodities producers), and rising interest rates and inflation that put pressure on production inputs.

Supply chain pressures eased over the summer of 2022, but the Federal Reserve Bank of New York's Global Supply Chain Pressure Index (GSCPI) still stands near record highs:



The global supply chain pressures increased moderately in October after five consecutive months of easing. The Federal Reserve Bank of New York cites the cause for the October increase as "driven by upward pressures from Taiwan delivery times, Taiwan purchases, Asia outbound air freight, and U.K. backlogs. The GSCPI's year-to-date movements suggest that global supply chain pressures are falling back in line with historical levels."

The global supply chain crisis has impacted large global companies and domestic small business alike. For example, the automotive industry is facing disruption due to rising costs and the availability of key raw materials. Escalating Russia risks, complex automotive supply chains

and dependence on key raw materials may make the car production situation volatile through 2022. Another example is the airline industry, where "after retrenching at the start of the pandemic in 2020, airlines bounced back quickly and started placing large orders for new planes as they sought to upgrade and expand their fleets. But supply chain problems have hampered production, leading carriers to warn investors this month that plane deliveries might be delayed."[1]

Indeed, the global supply chain crisis has impacted large global companies and domestic small business alike.

> With no end in sight to delays and backlogs, building domestic supply chains from scratch is becoming more appealing and feasible. Small businesses are putting a priority on proximity to their customers so they can react to market demands in real time, and are leaning into a resurgent pride in "made in America" goods.
>
> . . .
>
> Challenges remain for small businesses, however, including labor availability and costs; a patchy, opaque system of suppliers and manufacturers that is reliant on word of mouth; and a lack of capital innovation, automation and sometimes just knowledge.[2]

So where do businesses go from here?

II. Who Bears the Risk of the Supply Chain Crisis?

Supply chain disruptions, inflation, fuel, labor and raw material cost increases have directly impacted both buyers and sellers of goods, particularly when it comes to pricing. The parties' contractual relationship will first dictate whether the buyer or seller must absorb the increased costs associated with the supply chain crisis. The parties should review and determine the following:

1. Do you have a contract?
2. Do the seller's or the buyer's terms and conditions apply? (*See* Section III)
3. Has one party accepted by performance (without even knowing it)?
4. Does the applicable contract have a price adjustment mechanism?
5. Are there raw material adjusters? (many adjusters are based on nationally recognized indexes and identify how much of the cost is shared by each party)
6. Does the buyer or seller absorb tariffs or other government-imposed fees? Is the contract silent?
7. How long is the seller required to sell at the original price (if no price adjustment provisions)?

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[1] THE NEW YORK TIMES, Airlines Need New Planes, but the Supply Chain Has Other Ideas, Oct. 26, 2022: https://www.nytimes.com/2022/10/26/business/boeing-alaska-airlines.html

[2] THE NEW YORK TIMES, Weary of Snarls, Small Businesses Build Their Own Supply Chains, Oct. 19, 2022: https://www.nytimes.com/2022/10/19/business/small-businesses-supply-chain.html

8. Can the seller simply reject any new purchase orders or is it bound by a long-term contract? (*See* Section V)
9. What are the termination provisions? Can the seller even terminate? If so, how much notice is required (how long does the seller bear the burden of increased costs without relief)?
10. Will the buyer negotiate price even if the contract doesn't require it? Consider the cost, timing, and practical implications of resourcing to an alternative supplier as compared to higher prices with a tested and known supplier.
11. Labor shortages and increase in costs are rarely, if ever, considered a "force majeure" or similar event that could excuse performance. (*See* Section VI)

III. What is the Contract?[3]

In the supply arena, the initial task is to collect and analyze the array of documents that could evidence a contract or contracts for the purchase and sale of goods, including purchase orders, invoices, requests for quotes, and any amendments (even correspondence showing modification of any of the foregoing). The goal is to divine the intent of the parties, even in circumstances when documents are on pre-printed forms.

Many commercial sales transactions are not covered by a signed contract, but rather by the exchange of "boilerplate" forms, which often remain unread — until there is a dispute. The "'[b]attle of the forms' refers to the not uncommon situation in which one business firm makes an offer in the form of a preprinted form contract and the offeree responds with its own form contract." *Northrop Corporation v. Litronic Industries*, 29 F.3d 1173, 1174 (7th Cir. 1994). Generally, sales contracts are formed through the exchange of purchase orders and invoices and/or by the conduct of the buyer and seller. For instance, the buyer issues a purchase order to the seller with its standard terms and conditions, and in response, the seller sends the buyer an invoice and/or a sales order acknowledgment with the seller's own standard terms and conditions. With the purchase order, invoice and/or sales order acknowledgment in place, the seller then ships the goods to the buyer and the buyer accepts the goods.

What happens if the seller needs to adjust its price to account for the supply chain disruptions (inflation, fuel, labor, raw material cost increases, etc.)? If the parties cannot negotiate new pricing, then the parties need to determine whether a contract exists between them and, if so, what the terms of their contract are.

Most states have adopted the Uniform Commercial Code (UCC) to help resolve the question of whether a contract exists and, if so, what terms should control the agreement between the contracting parties. What would have traditionally been considered a counteroffer at common law is now construed as an acceptance under the UCC. *See Tecumseh Intern. Corp. v. City of Springfield*, 70 Ill. App. 3d 101, 388 N.E.2d 460 (4th Dist. 1979). Under UCC Section 2-207, "a definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to

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[3] Credit to: Jillian Snider, "UCC Battle of the Forms: How to Minimize Contractual Disputes Using Sales Order Acknowledgements," *Iron & Steel Technology* (January 2019).

the additional or different terms." UCC Section 2-207 further provides that additional terms are construed as proposed additions to the contract. *Coosemans Specialties, Inc. v. Gargiulo*, 485 F.3d 701 (2d Cir. 2007). However, where both parties are merchants, additional terms become part of the contract unless: (a) the offer expressly limits acceptance to the terms of the offer; (b) the additional terms materially alter the contract; or (c) a notification of objection to the additional terms has already been given or is given within a reasonable time after notice of them is received. UCC 2-207(2); *Bayway Ref. Co. v. Oxygenated Mktg. & Trading A.G.*, 215 F.3d 219, 223 (2d Cir. 2000). What constitutes a material alteration to the contract is specific to each contract but, in general, if the additional or different terms propose to change the price, quantity, delivery, warranty disclaimer, limitation on liability, dispute resolution mechanism or attorney's fees provisions, they will be considered material alterations to the contract. *See Brass Reminders Co., Inc. v. RT Engineering Corp.*, 462 F. Supp. 3d 707 (E.D. Ky. 2020) (delivery timeline term in purchase order was an additional term and material alteration).

Additional terms that are not material will become part of the contract. Any material alterations that are not accepted and any contradictory terms will be knocked out under the "knock-out" rule. *Option Wireless, Ltd. v. OpenPeak, Inc.*, No. 12-80165-CIV, 2012 WL 6045936 (S.D. Fla. Dec. 5, 2012) (seller's term disclaiming consequential damages knocked out by purchase order silent on consequential damages). This rule is applied by a majority of courts to resolve a battle of the forms when forms contain conflicting terms. In the typical knock-out rule situation, a contract is still formed, but the rule will operate to discard the conflicting terms if there is a discrepancy between the contracts and replace those terms by the gap-filler provisions of Article 2 of the UCC. Article 2 of the UCC contains certain "gap fillers" that will substitute for certain missing terms, including: (1) open price terms;[4] (2) quantity terms;[5] (3) place of delivery;[6] (4) time for delivery;[7] and (5) time for payment.[8]

It is therefore no surprise that the buyer usually wins the battle of the forms because the buyer is the party who sends the first form, usually the purchase order, and is therefore the "master of the offer," and its initial terms will control subsequent transactions between the parties. However, sellers can protect themselves by using carefully crafted sales order acknowledgments and require that the buyer sign and accept the additional terms as set forth in the sales order acknowledgment. Sales order acknowledgments have two primary functions: (1) to confirm the buyer's offer; and (2) to confirm the acceptance of the seller's terms and conditions.

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[4] See UCC 2-305. If a contract is silent as to price, the price is a "reasonable price at the time of delivery."

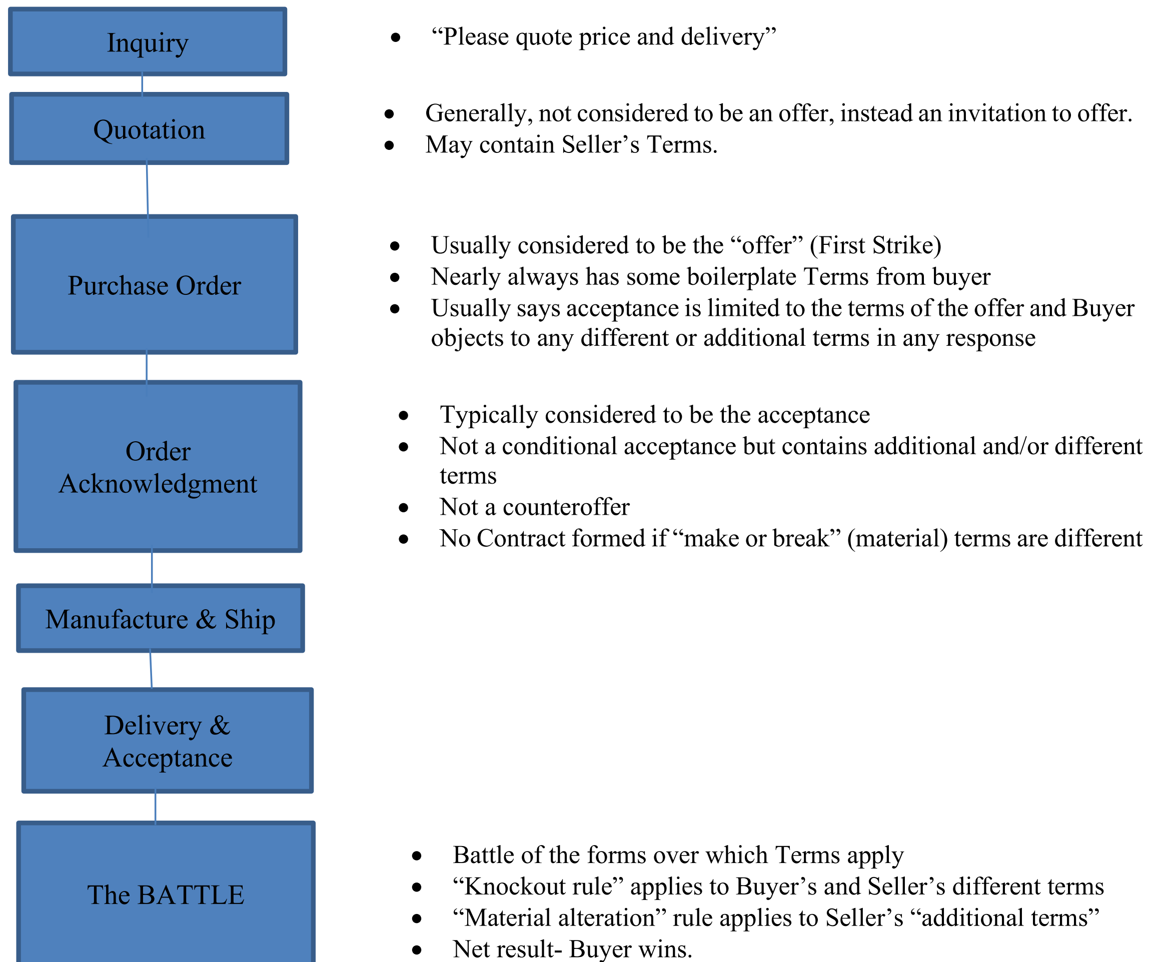
[5] See UCC 2-306. While UCC Article 2 does not substitute for a missing quantity term, it recognizes requirements contracts (buyer will buy all of its requirements from seller) and output contracts as enforceable measures of quantity. (*See* Section V).

[6] See UCC 2-308. If a contract is silent as to place for delivery, the place for delivery is the seller's place of business.

[7] See UCC 2-309. If a contract is silent as to the time for delivery, the time for delivery is "a reasonable time."

[8] See UCC 2-310. If a contract is silent as to the time for payment, payment is due at the time and place that the buyer is to receive the goods.

See an illustration of a typical battle of the forms transaction below:



IV. Battle of the Forms Considerations

A. Buyer

- Include protective language in purchase orders
  - Limit acceptance to Terms contained in the purchase order
    - Example: "Any additional or different terms in the seller's form are hereby deemed to be material alterations and notice of objection to them and rejection of them is hereby given."
- Incorporate all UCC terms providing protection to the buyer

- If the buyer has sufficient market power, it can refuse to accommodate any additional Terms from the seller

B. <u>Seller</u>

- Keep in mind that the UCC is buyer friendly when drafting forms
- Best protection for seller is a signed contract
- If the seller has leverage with the buyer, include in seller's form that acceptance is conditional on the buyer's consent to terms set forth solely in the seller's Terms
- If there is equal leverage in the transaction, the seller should negotiate an agreement that incorporates both parties' key Terms
- The seller may accept the buyer's Terms and then negotiate to add protective provisions for the seller, but it is important not to sign any of the buyer's documents until the negotiations are completed

C. <u>Result</u>

- The seller wins the battle of the forms either by using its market power to induce the buyer to sign the seller's Terms or to negotiate inclusion of seller's key protections
- Even though the UCC's provisions generally favor a buyer in transactions, the seller can contract its way out of compliance with a buyer's Terms, and hopefully avoid litigation altogether.

V. Is the Contract Enforceable under the Statute of Frauds as a Requirements Contract or Otherwise?

Contracts for the sale of goods[9] are governed by the Uniform Commercial Code. The UCC statute of frauds provision is in § 2-201:

> Except as otherwise provided in this section a contract for the sale of goods for the price of $500 or more is not enforceable by way of action or defense unless there is some writing sufficient to indicate that a contract for sale has been made between the parties and signed by the party against whom enforcement is sought or by his or her authorized agent or broker. A writing is not insufficient because it omits or incorrectly states a term agreed upon *but the contract is not enforceable under this subsection beyond the quantity of goods shown in such writing*.

Emphasis added. Comment 1 to § 2-201 further notes that, "[t]he only term which must appear is the quantity term which need not be accurately stated but recovery is limited to the amount stated."

[9] The term "goods" is defined in UCC § 2-105(1) to mean "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action."

Thus, a writing satisfies this section if it shows that a contract for the sale of goods has been made and the writing specifies a quantity.

To enforce a contract for the sale of goods, the court must be able to determine with certainty how many parts the buyer committed to buy and the seller to deliver. Contracts which measure quantity by the output of the seller or the requirements of the buyer are sufficiently specific to be enforced under § 2-201. *See* § 2-306. Section 2-306 provides, in relevant part:

> **Output, Requirements and Exclusive Dealings**
> (1) A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith, except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded.

Comment 2 to § 2-306 further illuminates why reference to the output of the seller or the requirements of the buyer is sufficiently definite to meet the UCC's quantity requirement:

> Under this Article, a contract for output or requirements is not too indefinite since it is held to mean the actual good faith output or requirements of the particular party. *Nor does such a contract lack mutuality of obligation since*, under this section, the party who will determine quantity is required to operate his plant or conduct his business in good faith and according to commercial standards of fair dealing in the trade so that *his output or requirements will approximate a reasonably foreseeable figure*.

Emphasis added. Thus, there are essentially three ways to state quantity under the UCC for a contract to be enforceable: a number, the output of the seller, or the requirements of the buyer. If a contract does not state a quantity, parol evidence is not permitted to add one. *See, e.g., Lorenz Supply Co. v. American Standard, Inc.,* 419 Mich. 610, 614-15, 358 N.W.2d 845, 847 (1984) ("The quantity term must, however, under § 2-201, be specifically stated."); *In re Estate of Frost*, 130 Mich. App. 556, 559, 344 N.W.2d 331, 333 (1983) ("The only term which must appear in the agreement is the quantity term.").

Most jurisdictions that have addressed the issue have found that, to be enforceable, an indefinite quantity supply contract must state a minimum quantity term. *See In re Anchor Glass Container Corp.*, 297 B.R. 887, 891-92 (Bankr. M.D. Fla. 2003) ("Absent a minimum quantity term, an indefinite quantity supply contact is an illusory and unenforceable contract.") (citing *Willard, Sutherland & Co. v. United States*, 262 U.S. 489, 494, 67 L. Ed. 1086, 43 S. Ct. 592 (1923) (indefinite quantity contract without quantity term is illusory and unenforceable until actual performance); *Mason v. United States*, 615 F.2d 1343, 1347 (Ct. Cl. 1980) (guaranteed minimum quantity required to enforce indefinite quantity contract). In the *In re Anchor Glass* case, the Court found that the agreement at issue was a classic indefinite quantity supply contract and was thus unenforceable. *Id*. Under the agreement at issue in *Anchor Glass*, the buyer had to place a

purchase order and seller then had to accept it. There was no requirement for the buyer to purchase a minimum quantity of goods. The Court held, "[f]or these reasons, the court concludes the Amended Agreement is an indefinite supply agreement that is unenforceable." *Id*.

As the court wrote in *Mason*, 615 F.2d at 1345, fn. 5, citing *Willard, Sutherland*, 262 U.S. at 493, and 1A Corbin, Contracts § 157 (1963 & Supp. 1971):

> An indefinite quantities contract is a contract under which the buyer agrees to purchase and the seller agrees to supply whatever quantity of goods the buyer chooses to purchase from the seller. It differs from a requirements contract in that under a requirements contract the buyer agrees to purchase all his requirements from the seller. Under an indefinite quantities contract, even if the buyer has requirements, he is not obligated to purchase from the seller. In an indefinite quantities contract, without more, the buyer's promise is illusory and the contract unenforceable against the seller.

Similarly, under Illinois law, "an essential element of a requirements contract is the promise by the buyer to purchase all of its requirements, or at least a minimum quantity, from the seller." *Brooklyn Bagel Boys v. Earthgrains Refrigerated Dough Prods*., 212 F.3d 373, 379 (7th Cir. 2000) (citing *Torres v. City of Chicago*, 261 Ill. App. 3d 499, 632 N.E.2d 54, 58 (Ill. App. Ct. 1994)).

Even Michigan courts, which are known for broadly construing contracts to be requirements contracts, find that for UCC § 2-306 to apply, "the buyer must agree to purchase a portion of its requirements from a seller." *Advanced Plastics Corp. v. White Consol. Indus., Inc.*, No. 92-76375, 1995 WL 19379, 1995 U.S. App. LEXIS 1047 *6-7 (6th Cir. 1995); *see also Cadillac Rubber & Plastics, Inc. v. Tubular Metal Sys.*, LLC 331 Mich. App. 416, 429, 952 N.W2d 576, 583 (2020) (contract providing that the buyer was required to purchase no less than one part and no more than 100% of its requirements from seller was sufficiently specific to be enforceable and obligated the seller to deliver the buyer's requirements).

An arrangement that leaves entirely to the buyer whether to buy any amounts from the seller, for example, "as released" or "blanket purchase order" without a minimum purchase requirement, lacks mutuality of obligation rendering it unenforceable. Mutuality of obligation is a prerequisite to contract formation and means that both parties to an agreement are bound or neither is bound. *Bancorp Group, Inc. v. Michigan Conf. of Teamsters Welfare Fund*, 231 Mich. App. 163, 171, 585 N.W.2d 777, 781 (1998). For example, a contract that failed to specify a quantity term sufficient to satisfy the UCC statute of frauds was unenforceable because, "[p]ursuant to the option addendum, the quantity, if any, that Eramet must supply MacSteel is conditioned entirely on the will, wish, or want of MacSteel." *MacSteel, Inc. v. Eramet N. Am.*, 2006 U.S. Dist. LEXIS 83339, *23 (E.D. Mich. 2006).

In cases where the arrangement lacks a specific quantity term, a buyer desiring parts would issue a release to the seller, which release the seller would be free to accept or reject. On acceptance, a contract would be formed for the quantity specified in the release. For example, a

release-by-release contract was found in *Advanced Plastics Corp.*, where the contract provided that "Seller agrees to furnish Buyer's requirements," but qualified that provision with the statement "*to the extent of and in accordance with . . . Buyer's written instructions*." 1995 U.S. App. LEXIS 1047 at *5 (emphasis added) (affirming district court's grant of summary judgment that contract was not a requirements contract).

Thus, the fact that the word "requirements" appears in a contract does not necessarily render the contract a requirements contract under the UCC. The quantity specified in the contract must be more than the whim of the buyer. A supplier's colorable argument that it is not bound by a requirements contract can provide significant leverage to the supplier to negotiate pricing and related concessions out of court.

VI. Potential Pandemic-ish Contract Defenses

UCC § 2-615 provides a statutory defense to nonperformance of a contract based on commercial impracticability:

> **Excuse by Failure of Presupposed Conditions**
> Except so far as a seller may have assumed a greater obligation and subject to the preceding section on substituted performance:
> (a) Delay in delivery or non-delivery in whole or in part by a seller . . . is not a breach of his duty under a contract for sale *if performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made* or by compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid.

Emphasis added. Comment 4 to this section makes clear that neither "[i]ncreased cost alone" nor "a rise or collapse in the market in itself" will justify an excuse of performance unless caused by some unforeseen contingency. The comment goes on to state that "a severe shortage of raw materials or of supplies due to a contingency such as war, embargo, local crop failure, unforeseen shutdown of major sources of supply or the like, which either causes a marked increase or altogether prevents the seller from securing supplies necessary to his performance, is within the contemplation of this section." Ongoing challenges from the COVID-19 pandemic including government-ordered shutdowns, Russia's war on Ukraine, and major weather-related disasters have led to increased commodity prices and shipping times, elevated freight costs, component shortages, and chronic labor constraints.

An impracticability argument is not easy to win, but a dramatic change in the contractual landscape from that envisioned at the time of contracting may provide a supplier a colorable defense to performance, opening a window for negotiations.

Additional potential performance defenses include a defense under the contract's force majeure clause, which is contract specific, as well as the doctrine of frustration of purpose which is similar to commercial impracticability under the UCC. For example, there are three elements to a frustration of purpose claim under Michigan law: (1) the contract must be at least partially

executory; (2) the frustrated party's purpose in making the contract must have been known to both parties when the contract was made; (3) this purpose must have been basically frustrated by an event not reasonably foreseeable at the time the contract was made, the occurrence of which has not been due to the fault of the frustrated party and the risk of which was not assumed by him. *Liggett Rest. Grp., Inc. v. City of Pontiac*, 260 Mich. App. 127, 676 N.W.2d 633, 637 (2003).

The Second Restatement of Contracts notes that "[t]he frustration must be so severe that it is not fairly to be regarded as within the risks that he assumed under the contract." Further, "the non-occurrence of the frustrating event must have been a basic assumption on which the contract was made." *Liggett Rest. Grp., Inc. v. City of Pontiac*, 260 Mich. App. 127, 676 N.W.2d 633, 637 (2003).

Neither the impracticability defense nor the frustration of purpose defense can be based "on an argument that the continuation of existing market conditions was a 'basic assumption' on which the contract was made." *Hemlock Semiconductor Operations, LLC v. SolarWorld Indus. Sachsen GmbH*, 867 F.3d 692, 704 (6th Cir. 2017). The District Court in Hemlock, applying Michigan law, stated the following when determining whether the doctrine was applicable to an automotive supplier:

> Under the third prong, the primary purpose must have been "basically frustrated by an event not reasonably foreseeable at the time the contract was made, the occurrence of which has not been due to the fault of the frustrated party and the risk of which was not assumed by him." *Molnar*, 313 N.W.2d at 173. In general, "[i]t is not enough that the transaction has become less profitable for the affected party or even that he will sustain a loss." *Seaboard Lumber Co. v. U.S.*, 41 Fed.Cl. 401, 417 (Fed.Cl.1998). "The frustration must be so severe that it is not fairly to be regarded as within the risks that he assumed under the contract." *Id*. (quoting Restatement (second) of Contracts § 265 (1981)). "[A] lack of profit is generally insufficient to frustrate the purpose of a contract." *Seaboard Lumber*, 41 Fed.Cl at 418.
>
> Regardless of any changes in the polysilicon market and regardless of the cause of those changes, Hemlock is still able to provide Kyocera with a stable supply of polysilicon at a predictable price. There is no allegation that Hemlock can no longer provide polysilicon to Kyocera, and there is no allegation that there is no longer an existing market for solar products. Kyocera simply claims that it can no longer act profitably in the international solar market if it must honor its supply agreements with Hemlock. A party's claim that it is unable to conduct business profitably is insufficient to state a claim of frustration of purpose.

Hemlock Semiconductor Corp. v. Kyocera Corp., No. 15-cv-11236, 2016 U.S. Dist. LEXIS 915, at *14-16 (E.D. Mich. Jan. 6, 2016, Ludington).

Where frustration or impracticability do provide a valid defense, the defense only applies as long as the frustration or impracticability exists. Therefore, the remedy is a temporary cessation of performance. *See* Restatement (Second) of Contract § 269, Comment a; *see also Bay City Realty, LLC v. Mattress Firm, Inc.*, No. 20-CV-11498, 2021 U.S. Dist. LEXIS 67054, at *30 (E.D. Mich. Apr. 7, 2021, Ludington) ("[e]ven though no Michigan court has referenced this specific provision of the Second Restatement of Contracts, the Michigan Court of Appeals referenced the Second Restatement of Contracts when it decided that frustration of purpose is a valid contractual defense. *Liggett*, 676 N.W.2d at 637. There is no reason to believe the Michigan courts would not adopt this related provision regarding temporary frustration"). Michigan courts do not permit rescission on the grounds of frustration of purpose or impracticability. *Bayagich v. Rose Twp.*, No. 273642, 2007 Mich. App. LEXIS 1289, at *17 n.4 (Ct. App. May 15, 2007) (citing *Liggett Restaurant Group, Inc v Pontiac*, 260 Mich. App. 127, 132-34; 676 N.W.2d 633 (2003)).

If these and other supplier defenses fail, the supplier may have to threaten rejection of the buyer's contract in a bankruptcy proceeding to force renegotiation.

VII. Executory Contracts[10]

Putting aside the glaring considerations of cash collateral, DIP financing, administrative expense claims and reclamation, and assuming a contract exists and is executory (generally there are obligations remaining on each side),[11] Section 365(a) of the Bankruptcy Code provides that a debtor, "subject to the court's approval, may assume or reject any executory contract or unexpired lease." 11 U.S.C. § 365(a). Assumption or rejection of executory contracts or unexpired leases by a debtor is subject to Court review under the business judgment standard. *See NLRB v. Bildisco and Bildisco*, 465 U.S. 513, 523 (1984). The bankruptcy court may approve a debtor's rejection of an unexpired lease if such rejection is made in the exercise of such debtor's sound business judgment, and if such rejection benefits its estate. *See, e.g., Matter of Tilco, Inc.*, 558 F.2d 1369, 1372 (10th Cir. 1977); (In re Bildisco, 682 F.2d 72, 79 (3rd Cir. 1982), aff'd, 465 U.S. 513 (1984); *see also Sharon Steel Corp. v. Nat'l Fuel Gas Distrib. Corp.*, 872 F.2d 36, 39 (3rd Cir. 1989). However, the bankruptcy court may reject the debtor's business judgment where it "is so manifestly unreasonable that it could not be based on sound business judgment, but only bad faith, or whim or caprice." *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043, 1047 (4th Cir. 1985).

Supply agreements in the bankruptcy context present the additional issue of severability. Generally speaking, a debtor cannot accept and reject individual contract terms or provisions – the debtor must address the contract as a whole. *W. Range Reclamation, LLC v. Scott's Co., LLC*, Civil Action No. 16-cv-02161-RM-KMT, 2018 U.S. Dist. LEXIS 32543, at *7 (D. Colo. Feb. 28, 2018) ("in order for a contract to be assumed or rejected under § 365 of the Bankruptcy Code, that contract must be assumed or rejected in its entirety."); *see Ellmann v. Dunivin* (*In re Ann Arbor*

[10] These materials assume familiarity with the assumption/rejection process effectuated by 11 U.S.C. § 365.

[11] The Countryman definition provides: "A contract is [executory if it is one] under which the obligations of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

Consultation Servs.), 614 B.R. 789, 796 (Bankr. E.D. Mich. 2020) ("Under § 365, a contract or lease must be assumed or rejected in its entirety."). The question, then, is what is an "entire contract," and

> bankruptcy courts have recognized that sometimes a single document may contain more than one agreement. In those circumstances, bankruptcy courts have allowed an agreement that is severable from the remainder of a contract or lease to be assumed or rejected without assuming or rejecting all other agreements contained within the same document.

Ellmann v. Dunivin (*In re Ann Arbor Consultation Servs.*), 614 B.R. 789, 796 (Bankr. E.D. Mich. 2020) (citations omitted); *In re Dickinson Theatres, Inc.*, No. 12-22602, 2012 Bankr. LEXIS 4798, at *5 (Bankr. D. Kan. Oct. 12, 2012) ("[W]here a contract, though contained in a single document, is divisible into several different agreements, some of the divisible agreements may be assumed or rejected under § 365 without assuming or rejecting the entire contract."); *see also In re Cutters, Inc.*, 104 B.R. 886, 889 (Bankr. M.D. Tenn. 1989) ("[I]f a document purports to contain a single contract but in reality contains separate severable agreements, then the debtor may reject a severable executory agreement.").

Whether a contract is severable, however, is an issue for state law: "[T]he Bankruptcy Code does not provide guidance for determining whether one agreement may be severed from other agreements contained in a single document. That is left to non-bankruptcy law, in this case, Michigan law." *Ellmann v. Dunivin* (*In re Ann Arbor Consultation Servs.*), 614 B.R. 789, 796 (Bankr. E.D. Mich. 2020) (citations omitted); *In re Dickinson Theatres, Inc.*, No. 12-22602, 2012 Bankr. LEXIS 4798, at *5 (Bankr. D. Kan. Oct. 12, 2012) ("Whether a contract or lease is divisible for purposes of assumption or rejection is determined by the state law governing the agreement."); *In re Teligent, Inc.*, 268 B.R. 723, 728 (Bankr. S.D.N.Y. 2001) ("Under general contract law, the parties' intentions determine whether two separately executed agreements are in reality one. The same rule applies to assumption and rejection issues under § 365."); *see also Weinman v. Allison Payment Sys., LLC* (*In re Centrix Fin., LLC*), 434 B.R. 880, 884 (Bankr. D. Colo. 2010) ("In construing and interpreting contracts, this Court must look to state law.").

A buyer of goods from a bankrupt seller must consider the following in connection with its executory supply contract:

- Buyer should require assumption or assumption/assignment of the supply contract in its entirety. *City of Covington v. Covington Landing Ltd. Partnership*, 71 F.3d 1221, 1226 (6th Cir. 1995) (debtor must assume both the benefits and burdens of the contract); *Stewart Title Guar. Co. v. Old Republic Nat. Title Ins. Co.*, 83 F.3d 735, 741 (5th Cir. 1996) (executory contract must be assumed or rejected in its entirety); *In re S.E. Nichols Inc.*, 120 B.R. 745, 747 (Bankr. S.D.N.Y. 1990) ("It is well-settled that a debtor cannot assume part of an [executory contract] while rejecting another part; the debtor must assume the [contract] *in toto* with both the benefits and burdens intact."); *see also Empire State Bldg. Co. L.L.C., et al. v. New York Skyline, Inc., et al. (In re New York Skyline, Inc.)*, 432 B.R. 66, 77 (Bankr. S.D.N.Y. 2010).

  - Seller will likely take the position each purchase order is a separate contract to avoid ongoing service part and warranty obligations.

- Even if there are no outstanding monetary obligations under the supply contract, buyers should be careful to assert cure objections to protect contingent, unliquidated obligations, such as warranty claims. If the seller/debtor assumes the supply contract with a $0 cure amount, buyer has waived its right to past warranty or other claims that have not yet arisen under the contract. *In re Cellnet Data Sys., Inc.*, 313 B.R. 604, 608-09 (Bankr. D. Del. 2004) (finding that "[w]here the nonbankrupt party has knowledge of facts sufficient to place the party on notice that a 'potential' pre-confirmation breach has occurred, res judicata bars that party from later asserting a claim based upon the pre-petition breach," following the assumption of an executory contract and payment of cure amounts); *In re Arriva Pharms., Inc.*, 456 B.R. 419, 424 (Bankr. N.D. Cal. 2011) (finding that the "burden is on the non-debtor party to assert any defaults prior to the debtor's assumption of the executory contract," meaning a that counterparty must object to cure amounts even based on unliquidated claims) (citing *In re Diamond Mfg. Co., Inc.*, 164 B.R. 189, 201 (Bkrtcy.S.D.Ga.1994)).

  - Seller will likely assign a $0 cure amount and take the position that there are no further warranty obligations as the contract was fully cured upon assumption.

- To the extent the seller is liquidating its assets (including the buyer's supply contract), carefully evaluate the purchaser's adequate assurance of future performance. 11 U.S.C. § 365(f)(2)(B); *In re Texas Health Enterprises Inc.*, 72 F. App'x 122, 126 (5th Cir. 2003) (a debtor may not assume an executory contract unless it provides adequate assurance of future performance); *In re PRK Enterprises, Inc.,* 235 B.R. 597, 603 (Bankr. E.D. Tex. 1999) (quoting *In re Prime Motor Inns, Inc.,* 166 B.R. 933, 997 (Bankr. S.D. Fla. 1994) (The requirement of adequate assurance of future performance should be given a "practical, pragmatic construction based on… the circumstances of [the] case."); *In re Huey's, Inc.*, No. 91-41391, 1992 WL 12004008, at *2 (Bankr. S.D. Ga. Aug. 11, 1992) (*quoting Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1310 (5th Cir.1985) (Although the Code does not define adequate assurance, courts have examined whether a debtor has "an income stream sufficient to meet its obligations, the general economic outlook in the debtor's industry, and the presence of a guarantee."); *see also In re Huey's, Inc.*, 1992 WL 12004008, at *2 ("Adequate assurance must be provided as to general performance and to each covenant within the agreement.").

  - Also be sure the buyer is not assuming only liabilities under the supply contract on a post-closing basis.

VIII. Alternatives to Chapter 11[12]

Following the COVID-19 pandemic, suppliers and manufacturers are facing the most difficult operating environment in recent memory, with disruption at every level of the supply chain. Despite the added stress of a strained supply chain, labor shortages, and the rising costs of raw materials, suppliers have largely avoided the chapter 11 process. In lieu of filing a bankruptcy petition, manufacturers and suppliers have sought out non-bankruptcy remedies, including out-of-court workouts, state law assignment for the benefit of creditors, and Article 9 of the Uniform Commercial Code (UCC) enforcement rights.

A. Out-of-Court Workouts or Wind Downs

A workout typically involves a debtor negotiating with creditors to develop a payment plan following a default. An out-of-court workout offers suppliers and manufacturers more flexibility and a quicker overall process than a bankruptcy filing. Similarly, an out-of-court wind-down allows a company to liquidate its assets outside the formal bankruptcy process, yielding cost-savings and subsequently a greater distribution to creditors. The wind-down or dissolution process allows a debtor to stay in control of the liquidation process, but requires more effort and direct involvement throughout the entire process.

However, these alternatives to bankruptcy do not come with the associated protections afforded by the Bankruptcy Code, such as the automatic stay and the ability to reject unprofitable contracts, and they may cause a debtor more difficulties obtaining financing.

B. State Law Assignment for the Benefit of Creditors

An assignment for the benefit of creditors offers another alternative to bankruptcy for those secured parties seeking relief following a default. This is a particularly attractive option for some businesses that may not be eligible for bankruptcy relief, but need some of the same protections to liquidate.

An assignment for the benefit of creditors is a remedy under state law that involves assigning "a debtor's property to another person in trust so as to consolidate and liquidate the debtor's assets for payment to creditors."[13] It may be particularly beneficial for suppliers to utilize assignment for the benefit of creditors where either (1) the company can no longer operate and is unable to find a buyer or (2) there is a purchaser for the failing company but the chapter 11 process

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[12] Credit to: Patricia Burgess, A.J. Webb, Matthew Higgins, Frost Brown Todd LLC, "Have Automotive Suppliers Traded in for a New Model? Alternatives to Chapter 11 Bankruptcy in the Post-COVID Era," *INSOL World* (Second Quarter 2022).

[13] Black's Law Dictionary (11th ed. 2019); *see also Assignment for Benefit of Creditors of Miami Perfume Junction, Inc. v. Osborne*, 314 So. 3d 604, 608 (Fla. Dist. Ct. App. 2020), review denied, No. SC21-312, 2021 WL 2065469 (Fla. May 21, 2021) (noting that assignments for the benefit of creditors offer a more cost-effective alternative to relief under the Bankruptcy Code).

is cost-prohibitive.[14] While this remedy does offer a viable alternative to bankruptcy for distressed suppliers, it does not provide the automatic stay or a discharge of debt that the Code affords.

C. State Law Receiverships

Appointment of a state court receiver is a viable alternative to seeking relief under the Bankruptcy Code. Receivers serve as the proverbial "arm of the court" and act as a fiduciary in a myriad of contexts (e.g., mismanagement of a business, deadlocked partners/members, domestic divorce, business divorce, trust disputes). Generally, there are two types of receivers – entity receivers appointed for the company itself and asset receivers appointed to administer, sell, liquidate or rehabilitate assets – but sometimes receivers may be appointed as both. Although most commercial Deeds of Trust provide for appointment of a receiver upon default, few asset-based loan documents do. Accordingly, creditors may seek appointment of a receiver under state law for cause when there is no other adequate remedy available. The appointment of a receiver creates a receivership estate subject to state court supervision, similar to a bankruptcy estate.

Bankruptcy laws are designed to afford a fresh start to honest but unfortunate debtors, while providing equal treatment to creditors. This is not so in the cannabis industry, where it is a commonly accepted rule across the country that if a debtor has direct connections with marijuana, whether cultivating or leasing space to a dispensary or grow facility, that debtor cannot seek relief under the bankruptcy court. While cannabis may be legal in many states, bankruptcy courts have turned to the Controlled Substances Act [21 U.S.C. §§ 801 *et seq.*] to determine whether a debtor's business operations conflict with federal law, thus making the debtor ineligible for the protections afforded by the Bankruptcy Code. State court appointed receivers provide an alternative path for debtors in financial distress when bankruptcy is not an available remedy.

D. Article 9 Sales Under the Uniform Commercial Code

Section 363 of the Bankruptcy Code offers companies the ability to sell assets free and clear of claims, liens, or encumbrances, the proceeds of which are then distributed to creditors. In contrast, Article 9 of the Uniform Commercial Code provides secured lenders with certain self-help remedies in the event of a default, with potential cost-saving advantages through its foreclosure process, which, in certain circumstances, can be completed within 45 days. Under Article 9, a secured lender may initiate a foreclosure, retain the collateral in full or partial satisfaction of the underlying debt, or collect payments from third parties where the collateral includes a right to payment.[15] However, it is important to keep in mind that each of these remedies requires cooperation between the secured party and the debtor in order to avoid the need for judicial intervention. If there is a likelihood of non-cooperation, the protections afforded by the Bankruptcy Code may be worth the additional time and up-front cost.

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[14] Carly Landon, *Making Assignments for the Benefit of Creditors As Easy As A-B-C*, 41 FORDHAM URB. L.J. 1451 (2014).

[15] UCC § 9-610 *et seq.*; § 9-620; § 9-607.

HAVE AUTOMOTIVE SUPPLIERS TRADED IN FOR A NEW MODEL? ALTERNATIVES TO CHAPTER 11 BANKRUPTCY IN THE POST-COVID ERA

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"the automotive industry continues to be challenged by supply chain issues, labor shortages, liquidity issues, rising costs of raw materials, strict lender standards, and a dwindling reserve of federal aid funds"

Market disruptions caused by the Covid-19 pandemic led many experts in the US financial and legal industries to predict record Chapter 11 bankruptcy filings[1]. However, outside of certain sectors, such as retail, Chapter 11 bankruptcy filings have continued to decrease since 2020.[2] Specifically, Chapter 11 business filings fell 27.9% from September 2020 to September 2021.[3] Although there have not been as many Chapter 11 bankruptcy filings as predicted, businesses and industries as a whole are still facing supply chain challenges, employment shortages, and general uncertainty in the markets.

For instance, the automotive industry continues to be challenged by supply chain issues, labour shortages, liquidity issues, rising costs of raw materials, strict lender standards, and a dwindling reserve of federal aid funds. Although many of these challenges would traditionally be factors leading to Chapter 11 bankruptcy filings, companies along the automotive supply chain are opting for alternatives to the traditional relief sought through Chapter 11 bankruptcy, such as:

- Article 9 of the Uniform Commercial Code;
- Assignments for the Benefit of Creditors; and
- Out-of-Court Wind-Downs (Structured Dissolutions) or Restructuring.

Original Equipment Manufacturers, suppliers, and lenders should seek to understand the benefits and risks associated with alternatives to Chapter 11 and how they can impact all parties involved in an insolvency or financially distressed situation.

Chapter 11 is not always the best option

The benefits of conducting a section 363 sale, liquidation, or restructuring under Chapter 11 of the Bankruptcy Code include the automatic stay, bankruptcy court supervision (and the transparency associated with that supervision), the Bankruptcy Code's priorities and protections for creditors, as well as the binding nature of orders entered by the bankruptcy court.

While Chapter 11 offers significant benefits and protections to both debtors and creditors alike, it comes with increased burdens and significant costs in the form of legal fees, filing fees, and fees to the Office of the United States Trustee, which reduce recoveries to creditors. Moreover, the requirements of the Bankruptcy Code and requirements of the bankruptcy court, such as seeking approval for various forms of relief by way of motion, can be strenuous and time-consuming.

Congress has attempted to address some of these challenges by enacting Subchapter V of Chapter 11 of the Bankruptcy Code, which allow businesses with debts less than $2,725,625[4] to file a streamlined Chapter 11 case. The goal of Subchapter V was to make small business bankruptcies faster and cheaper. However, due to certain limitations on the size of companies that are permitted to file under Subchapter V, as well as similar constraints from an ordinary Chapter 11 bankruptcy case still present in Subchapter V cases (*e.g.*, Bankruptcy Code and bankruptcy court requirements), many companies in the automotive industry are still opting for alternatives to bankruptcy.

Alternatives to Chapter 11 bankruptcy offer the benefits of being more time and cost efficient, and companies are given more control over the restructuring or liquidation processes. However, the bankruptcy alternatives are not without their issues. Below, we provide a brief and high-level explanation of certain alternatives to Chapter 11 bankruptcy that have been increasingly utilized by companies along the automotive supply chain. Of course, each company must carefully assess the pros and cons of filing Chapter 11 bankruptcy versus seeking an alternative to a bankruptcy filing by analyzing its specific facts, circumstances, and business goals, as well as speaking with professionals specializing in insolvency and financial distress.

1. Sales under Article 9 of the Uniform Commercial Code

Companies frequently utilize section 363 of the Bankruptcy Code to effectuate a sale of the company's assets pursuant to the provisions of the Bankruptcy Code and order of the bankruptcy court. Such sales generate funds for distribution to creditors, and so long as the sale is in good faith and certain other requirements are satisfied, purchasers obtain ownership of the debtor's assets free and clear of any lien or claim. Of note in the automotive context, in 2009, GM effectuated a section 363 sale during its bankruptcy case in the US Bankruptcy Court for the Southern District of New York.[5] More recently, in 2020, Dura Automotive Systems, LLC, a manufacturer of automotive components, effectuated a section 363 sale in the United States Bankruptcy Court for the District of Delaware.[6]

1 https://www.csbj.com/premier/businessnews/attorneys-say-a-wave-of-bankruptcies-is-coming/article_7d8e6af0-722a-11eb-9681-039563b99c3f.html.
2 https://www.uscourts.gov/news/2021/11/08/bankruptcy-filings-continue-fall-sharply.
3 https://www.uscourts.gov/news/2021/11/08/bankruptcy-filings-continue-fall-sharply.
4 During the Covid-19 pandemic, this amount was temporarily raised to $7.5 million. In addition, on April 7, 2022, the United States Senate passed S. 3823 by unanimous consent, which seeks to extend the $7.5 million debt cap for an additional two years. If S. 3823 is passed by the United States House of Representatives, it will then be sent to President Biden for signature before the increased debt cap becomes law.
5 https://dm.epiq11.com/case/mlc/dockets.
6 https://cases.ra.kroll.com/duraautomotive/Home-DocketInfo?DocAttribute=5323&DocAttrName=SALEDOCUMENTS&MenuID=13412.

Article 9 of the Uniform Commercial Code (the "UCC"), which has been adopted by all fifty states, offers an out-of-court alternative to a sale under section 363 of the Bankruptcy Code. A UCC Article 9 sale allows a secured creditor to utilize self-help remedies provided under the UCC to foreclose on and liquidate its collateral to satisfy its debt. Importantly, a UCC Article 9 sale requires some level of cooperation between the lender and borrower to effectuate the sale.

UCC Article 9 sale v. Chapter 11 sale

Benefits of a UCC Article 9 Sale Compared to Chapter 11	*Cons of a UCC Article 9 Sale Compared to Chapter 11*
• Less time consuming (section 363 of the Bankruptcy Code requires 60 days minimum) • Typically, fewer professional fees • Sale can be private or public • Allows easier transfer of assets with the benefit of stripping junior liens or interests in the collateral	• No claim mechanism for unsecured creditors, meaning unsecured creditors are less likely to receive payment • Lack of court involvement could lead to litigation over sale • Requires either cooperation by borrower or repossession without a "breach of the peace" • More robust bidding process in bankruptcy • More secured creditor control • Section 363 sale order offers broader buyer and lender protections and allows for assignment of certain contracts without consent

2. Assignment for the Benefit of Creditors

An Assignment for the Benefit of Creditors ("ABC") is a state-law insolvency proceeding, which assigns the debtor's assets to a third-party assignee to liquidate the assets for the benefit of the debtor's creditors. ABCs are typically a function of state statutes; however, in some states, such as Illinois, they are a function of common law. ABCs can be used as an alternative to either a Chapter 11 or Chapter 7 liquidation.

ABC v. Chapter 11

Benefits of ABC Compared to Chapter 11	*Cons of ABC Compared to Chapter 11*
• Faster than bankruptcy proceeding • More cost effective • Assignor can choose the assignee who oversees the liquidation • Typically, less court oversight	• Assignor does not receive discharge • No reorganization, just liquidation • No automatic stay • Fewer protections for unsecured creditors

3. Out-of-court wind-downs (structured dissolutions) or restructuring

An out-of-court wind-down typically involves the company seeking buyers for its assets, reducing its workforce, and formally dissolving its business according to state law guidelines. In an out-of-court restructuring, or "workout," a company seeks to work with its suppliers, lenders, landlords, etc. to infuse capital into the company and restructure its debts. Note that both a wind-down and a workout can be effectuated in conjunction with a UCC Article 9 sale. The pros and cons of each versus a Chapter 11 bankruptcy are similar.

Out-of-court process v. Chapter 11

Benefits Compared to Chapter 11	*Cons Compared to Chapter 11*
• More control over process and negotiations • Less time • Cost effective • No public filings or disclosures	• Requires creditor cooperation • Company needs to have enough liquidity to navigate windown or restructuring • No discharge • No automatic stay • For a restructuring, it may be more difficult to obtain financing comparable to debtor-in-possession financing without certain lender protections provided by Bankruptcy Code

Conclusion

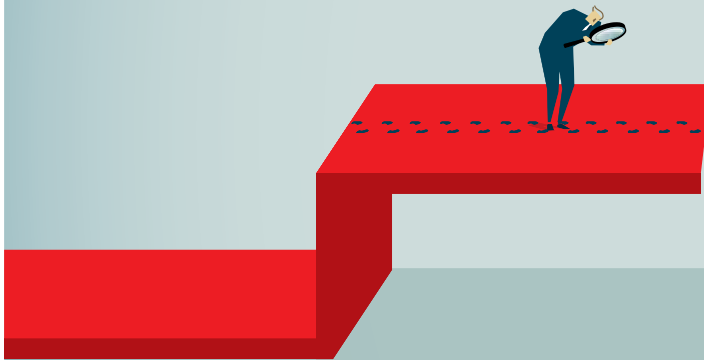
Chapter 11 bankruptcy is no longer the default option for financially distressed companies and suppliers in the automotive industry. Original Equipment Manufacturers, suppliers, lenders, and other interested parties need to understand how each bankruptcy alternate may impact their rights and interests. UCC Article 9 Sales, ABCs, Out-of-Court proceedings, and other alternatives[7] give insolvent companies more autonomy and can provide major cost savings compared to filing for Chapter 11 bankruptcy while still providing comparable benefits to the buyer and lender. If more companies continue to opt for bankruptcy alternatives, it remains to be seen how it could impact the ability of a company to successfully restructure or liquidate. Further, Congress could take note of the trends and propose changes to the Bankruptcy Code to reduce the costs and bureaucratic burdens associated with Chapter 11 bankruptcy, similar to Subchapter V.

Financially distressed companies assessing the above alternatives to bankruptcy, and other parties impacted by such companies, should speak to a restructuring professional to assess their options and evaluate their risks.

7 In addition to the alternatives discussed herein, receiverships appoint a third party under federal or state law to administer assets while a secured lender is assessing a possible liquidation.

The Challenges to and Strategies of Recalibration of the Asset Footprint Across International Platforms

By Frank Morton and Rafael Klotz



With the increasing globalization of markets and operations, the location and ownership of assets — inventory, brands, and other assets — has become an integral component of supply chain management. Calibrating the international asset footprint for a company or its secured lender allows for the maximization of asset values and the identification of areas of risk, but it comes with significant challenges.

Even a casual glance at the front page of most major financial publications spells the apparent doom of open markets and the inevitability of an impending global recession. Economic expansions do not last forever, of course, and what goes up must come down. We do not presume to know when, or how severe, the next downturn will be, but conventional wisdom suggests that it will eventually be upon us again. In fact, fears of an imminent recession were palpable at the time this piece was being finalized.[i]

To paraphrase Mark Twain, though, reports of the demise of global trade have been greatly exaggerated. The value of global merchandise trade and trade in commercial services in 2018 grew by 55% since the depths of the global economic crisis in 2008.[ii] In fact, global trade has grown 333-fold since the World Trade Organization started gathering data in 1948 through 2018.[iii] This, despite the dawn of the nuclear age, global recessions, conflicts and wars, the rise of worldwide terrorism, and multiple challenges to open markets during this 70-year time period.

Moreover, in today's age, the ubiquitous presence of the internet and relatively easy access to information for an increasingly broad swath of the world's population has had a profound, and perhaps irreversible, impact on the expansion of international trade, even in the face of growing protectionism and political trade barriers.[iv] As Børge Brende, president of the World Economic Forum, aptly stated in his opening remarks at the Annual Meeting of the Global Future Councils in Dubai last year: "Globalization's future is no longer about physical trade. It is about knowledge, information and technology. Digital trade already accounts for 12% of international trade, and data flows are predicted to increase another fivefold by 2022. The result will inevitably be not less globalization but more, different, globalization."[v] In the age of information, global trade may slow down or change, but it cannot be stopped.

Against this backdrop, many global businesses will continue to adapt and grow to meet the ebb and flow of global demand, while others, unable to manage the complexity of spread-out cross-border operations during uncertain times, will undoubtedly fail. The ones standing tall at the other end of the next downturn will probably be those companies that have mastered the art of skillfully managing their balance sheet and supply chain across disparate jurisdictions and cultures.

The challenge for secured lenders, and a differentiating factor to borrowers in today's harshly competitive asset-based lending environment, will be the capacity to provide increasing liquidity to growing or large-scale global operations in the face of economic uncertainty, differing legal enforcement environments, and most of all, widespread collateral locations. While some lenders' existing international operations will naturally afford them a measure of competitive advantage under these circumstances, no lenders, even multinational ones, are immune to the perils of multi-jurisdictional ABL underwriting.

So, what is a lender to do if one of its borrowers identifies a highly profitable opportunity to sell its goods or wares in far-flung locations from its main market, but lacks the capital to finance the production cycle from raw material to finished product delivered to its final destination? When it comes to pledging movable assets, inventory in particular, many developed and developing countries do not provide capital providers with the customary and time-tested predictability of, for example, the Uniform Commercial Code and Bankruptcy Code in the United States, the Insolvency Act in the United Kingdom, or the Personal Property Securities Act in Australia. While obtaining a local credit facility in some locations may be possible, there are virtually entire regions (e.g.: Latin America, Southern Europe), where lenders will provide little or no availability against inventory and most intangibles. This is largely due to the complications and, in some cases, the sheer impossibility, of enforcing a security interest in those types of assets without actual possession at all times, which generally defeats the purpose of a working capital loan.

On the flipside, a borrower may need to forego a potentially advantageous opportunity to expand its business outside of its and its lender's main jurisdiction due to the detrimental effect it would suffer in its core territory if it redeploys resources to a location where it will not be capable of obtaining the financing to conduct business. Without the necessary working capital financing, most companies would need to access the capital markets and confront the unsavory prospect of diluting equity ownership, or, find a local partner that can provide the necessary local funding and infrastructure. The latter, while advantageous, is easier to conceptualize in theory than to implement in practice, and it depends on the context. For example, a company that sells consumer products under a recognized brand may benefit by contracting with a licensing partner with existing local operations and the ability to place finished products in the appropriate sales channels. On the other hand, manufacturing or technology companies may view they lack direct control of their operations as an insurmountable barrier to entry. And even those companies who can find local partners or are willing to take the plunge will need to navigate the unique tax and dividend-repatriation peculiarities of each country, and how they dovetail with their own tax strategies.

When confronted with these circumstances, lenders have few choices. In certain narrow circumstances, some governments have agencies which promote the export of goods of services of local companies by providing guarantees to local lenders that are generally considered as safe as AAA-rated

government bonds (e.g.: EXIM Bank in the United States or EDC in Canada). The availability of these guarantees, however, is generally very limited and specific. There are often limitations based on the borrower's size (EXIM Bank's stated goal is to promote small and mid-size businesses). Furthermore, the application process can be very lengthy and approval uncertain, as EXIM Bank requires similar collateral enforcement assurances as any other secured lender would expect. Finally, these options often depend on political sentiment tides and are not permanent – EXIM Bank's charter, for example, has been left to expire by Congress several times, which resulted in lengthy periods during which it was not operational, and is currently set to expire again on September 30, 2019.[vi]

The alternative for secured lenders is to look at each country where the pledged assets are, or would be located, and engage in a case-by-case underwriting process for each of those jurisdictions. This requires a deep understanding of what is and is not possible under local commercial law and practice with respect to each individual asset class. The straightforward procedure in the United States of simply having to search one registry in the jurisdiction in which the borrower is organized for the existence of prior liens and, if the results are clear, then filing one ordinary all-asset UCC-1 financing statement to properly perfect its security interest, is a rare exception rather than the norm in most countries. The procedures and laws governing security interests are as diverse as there are countries, and the nuances relating to enforcement rights are equally germane to each separate jurisdiction (and some time they differ even within a country). Some countries, for instance, have very clear laws when it comes to taking a security interest in accounts receivable, while an enforceable consensual lien in inventory in that same country, even though embedded in its commercial laws, is practically useless from a secured lender's typical ABL underwriting criteria. The situation is sometimes the exact opposite in other countries, and somewhere in between in most other places. As a matter of fact, ABL underwriting is not unlike real estate: location, location, location.

In many places where typical lending is not possible, a liquidity provider must implement alternative structures that resemble asset-based lending by providing enhanced protection under local laws which would not be available if the infusion of funds was structured as a loan (such as, for example, inventory consignments with cash dominion or sale and leasebacks). Even so, the lender still needs to be fully aware of any restrictions relating to payments to a foreign lender, or that affect the transfer of the proceeds of sale of collateral post-enforcement outside of the jurisdiction. Often, there are registration steps that must be taken on the front end and, even when capital flows to offshore entities is permissible, it is not uncommon to encounter tax withholding requirements. All of this doesn't come without cost – in our experience, the price tag of many of these alternative structures is often prohibitive.

An additional, but essential, element of underwriting risk for a secured loan is, of course, a reliable valuation of the pledged collateral. At first glance, secured lenders may find comfort in the fact that typical ABL valuation metrics such as NOLV (Net Orderly Liquidation Value) or FLV (Forced Liquidation Value) have, on the whole, identical definitions around the world. This, however, can be misleading without a further examination of what the practical meaning of an "orderly" or "forced" liquidation truly means in the relevant country. In some jurisdictions, an "orderly" liquidation in a court-supervised insolvency process may take two or more years in the ordinary course of that country's judicial process. This is often the case in many jurisdictions, where a speedy auction is simply not feasible under the prescribed rules that govern sales of collateral by lenders. The rule of thumb, therefore, is for the underwriter to fully appreciate the underlying premise of the valuation in the context of local practice.

For example, in many civil law jurisdictions (mostly, but not solely, countries which operate under civil law systems), a lender cannot take the collateral in satisfaction of the debt without running an auction, and many jurisdictions have limitations on a secured lender's credit bid rights. Other countries essentially curtail any options to enforce rights against non-possessory collateral, such as retail inventory, or in the proceeds of sale of inventory which are not controlled by the lender. Furthermore, the party selected to undertake the valuation must have practical experience with disposition of the relevant assets in that specific jurisdiction, rather than a mere theoretical understanding of comparable sales and discount rates.

The final factors that complete the underwriting equation, once the legal and value considerations have been solved, are pricing and the advance rate. These are intertwined terms (particularly in countries with liquidity shortages and high prevailing interest rates) and contingent on specific country risks and expected volatility, as one size does not fit all jurisdictions. The risk factors to be considered include political turmoil or violence, transfers, expropriation, inflation and currency exchange risks. Some of these factors can be mitigated through hedging and others with insurance, but all such strategies involve significant additional costs on top of high risk-adjusted pricing. These could ultimately make the loan unattractive to the borrower because of the combination of low advance rate and very high costs.

A point worth emphasizing is the importance of understanding the art of the possible in a multi-jurisdictional workout in distress or bankruptcy.

This adds further layers of complexity to the structuring of cross-border secured loans. The implementation of more uniform protocols which address cross-border cooperation and conflicts of laws issues, such as Chapter 15 of the Bankruptcy Code in the United States, EU Insolvency Regulation, or UNCITRAL's Legislative Guide on Insolvency Law, have provided helpful guidance for lenders as they embark in cross-border lending. However, insolvency regimes are very dissimilar and many countries have not adopted laws that are in harmony with cross-border cooperation, especially when it comes to disposal of pledged collateral.[vii] The often-used strategy to restructure obligations through the sale of assets and business units is frequently hindered in cross-border workouts by the multiplicity of applicable laws (in many cases, not just commercial laws, but also labor, environmental, etc.). This topic warrants a separate follow-up piece, which the authors will address in an upcoming edition of *TSL*.

To sum up, global expansion is a key growth factor for many companies, particularly those whose home market share has peaked. Oftentimes, the biggest impediment for companies to pursue new markets is lack of adequate working capital, as many asset-based lenders are not comfortable or capable to lend against assets located in countries in which they do not have operations, even for longstanding clients. While the prospect of providing liquidity in non-core jurisdictions may seem daunting after reading this article, the authors can attest from direct personal experience in over a dozen "non-traditional ABL" jurisdictions that it is feasible for certain assets classes in specific countries, with the appropriate local expert legal and tax advice, a trustworthy valuation, the right structure (including the exit strategy), properly risk-adjusted pricing, and a meticulously-modelled advance rate. Fundamentally, it is a tailor-made process which requires a deep practical understanding of how to operate in each relevant jurisdiction within the established risk underwriting precepts of asset-based lending, sprinkled with some creative structuring dust. **TSL**

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[i] e.g.: Germany Nears Recession and Chinese Factories Slow in Trade War Fallout, By Jack Ewing, The New York Times, August 14, 2019; Opinion: When the unthinkable happens: U.S.-China trade negotiations break down for good, MarketWatch, August 12, 2019; Stocks slide after bond market warns again of recession, Associated Press, August 14, 2019, published in US Today; China and Germany fuel fears over global economy, Financial Times, August 14, 2019.

[ii] From US$12.6T in 2008 to US$19.5T in 2019. World Trade Organization OMC Data (https://data.wto.org/).

[iii] US$59B in 1948. Idem.

[iv] The Internet, Cross-Border Data Flows and International Trade, Joshua Meltzer, Fellow in Global Economy and Development at The Brookings Institution, February 2013 (https://www.brookings.edu/wp-content/uploads/2016/06/internet-data-and-trade-meltzer.pdf).

[v] https://www.weforum.org/events/annual-meeting-of-the-global-future-councils-2018/sessions/opening-plenary-cb9d6f83-df7a-426f-aeec-3d461c16efcc

[vi] https://fas.org/sgp/crs/misc/IF10017.pdf

[vii] Earlier this year, the EU council passed a directive aimed at harmonizing the many insolvency laws across the union (Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU (2016/0359)), but it remains to be seen if this can be fully implemented in a way that makes insolvency laws across Europe truly uniform.

Faculty

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