Managing credit risk in the supply chain

David Conaway explains why companies should apply credit risk analysis to their supply chain

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A MANUFACTURER WHO IS A SIGNIFICANT CUSTOMER FOR THE SUPPLIER IS IN ESSENCE A CO-VENTURER OF THE SUPPLIER AND OF THE SUPPLIER'S FINANCIERS

Companies expend substantial resources managing the credit risk of customers, to protect the value of their sales. Many companies, however, do not always apply credit risk analysis to their supply chain, focusing instead on procurement at the lowest cost and compliance with a myriad of regulatory issues.

However, credit risk in the supply chain may actually pose a greater potential risk of loss. If a supplier fails to deliver the product on time, the manufacturing process can be interrupted or halted, potentially idling plants at a significant daily cost to the company.

In addition to diversity in the supply chain, companies can manage their supply chain "credit" risk, before and after financial distress or insolvency of a key supplier.

Early warnings of supply chain risk

The key to avoiding risk is identifying the primary sources of risk, including a supplier's key relationships with third parties. Is the supplier's lender providing working capital or term loans to provide necessary operating liquidity? Or, is the supplier funded by a 2nd or 3rd tier "asset based" lender who provides funding based on fluctuating inventory and accounts receivable, the advance rates for which are constricted and largely discretionary? Does the funding provide sufficient liquidity to operate? Note that lenders have a contractual advantage over the supplier, they can move quickly to restrict financing and recover collateral in the event of any business issues. A company dependent on such a supplier should seek early warnings of covenant violations or defaults under the loan agreements.

Companies should review their supplier's financial records, including operating performance, budgets and balance sheets. Does the supplier have long-term contracts with the component-parts suppliers? Is the supplier current with the vendors?

Suppliers may also receive funding from bond-holders who also have a contractual advantage over the supplier and second lien positions on the supplier's inventory and accounts receivable. In addition, many suppliers are funded by private "equity", which is increasingly not equity, but rather asset-based loans or convertible equity. These normally involve management participation or control through board majority or management contracts. As part of the C-suite, private equity has contractual and legal advantages over the supplier.

A manufacturer who is a significant customer for the supplier is in essence a co-venturer of the supplier and of the supplier's financiers. A material manufacturing company should assert its bargaining position to obtain information about the supplier's ongoing financial condition and notices from the supplier and the financiers of defaults or covenant violations.

Minimise supply chain risk after default

If a supplier defaults in the delivery of parts or products for the manufacturing company, the company should not hesitate to enforce its rights upon such default under the Uniform Commercial Code (UCC). In addition, companies should be aware of an available remedy when the supplier is not in default, but the company is concerned about the supplier's ability to continue performing as agreed. UCC Section 2-609, Right to Adequate Assurance of Performance *aka* "anticipatory default", allows the company to withhold performance (or, payment of outstanding accounts receivable), if the company has "reasonable grounds for insecurity … with respect to the performance" of the supplier. The company must demand in writing adequate assurances of performance and, until receipt of such assurances, may suspend performance if commercially reasonable.

Contract Tip: The supply agreement should specifically include UCC 2-609 (among other provisions) as a remedy, and provide that the company may suspend payment of any accounts receivable owed upon the failure of the supplier to timely deliver goods.

Practical Tip: If time is not critical, it is advisable to demand assurances and ask for a notice of suspension of performance prospectively, perhaps in five to ten days.

Note that the accounts receivable owed by the manufacturing company to its suppliers and the goods produced by the supplier to be sold to the company are also the collateral of the supplier's

lender. Upon the failure of early warning signals, the first notice of a problem may be the lender's notice to the company, to make payments owed for goods purchased, directly to the lender. This is a clear indication that the lender is in collateral recovery mode. The lender could attempt to extract non-ordinary course payment from the company in order to obtain uninterrupted delivery of the goods.

To the extent that the company has title or an ownership interest with respect to the goods produced, or has tools, equipment or other assets under bailment or consignment to the supplier, the lender could also attempt to assert its lien as superior when the parties' rights to title are not clear. The company may need to act quickly by asserting potential claims of tortuous interference with contract or conversion of assets in response.

Practical Tip: In addition to complying with the requirements of the UCC, the company should obtain a written acknowledgement by lenders, mentioning the company's superior title of owned property, and the agreement between the company and the supplier, both of which should reduce these risks.

Navigating risks upon a supplier's insolvency

Should the supplier file for Chapter 11, the company will face two primary issues. First, will the supplier successfully reorganise or will it liquidate assets, perhaps in the form of a Section 363 sale of all of the assets? The second issue facing the company will be the impact of the Chapter 11 filing on any sales or supply contract.

With respect to the ultimate outcome of the Chapter 11 case, the so-called "first day" motions filed by the supplier are an indicator of the eventual outcome of the Chapter 11 case. In particular, it is customary for a Chapter 11 debtor to secure "debtor-in-possession" (DIP) financing, usually from its pre-petition lenders. If the DIP financing is short-term, such as 60 or 90 days, and the budget associated with the DIP financing appears highly restricted, it is likely that the lender does not contemplate funding a reorganisation. Moreover, if milestones under the DIP financing agreement include securing a stalking horse bidder and filing a motion to sell assets, it is clear the lender is using the Chapter 11 proceedings to liquidate its collateral.

By contrast, if the DIP financing is long-term and milestones are tethered to filing a business plan or a plan of reorganisation, then it is more likely that the parties intend a successful Chapter 11 reorganisation plan. In either case, it is important for the company to determine whether it will have an uninterrupted flow of goods purchased during the Chapter 11 proceedings and thereafter. The company is entitled to understand the Chapter 11 debtor's ability to continue to supply goods in the ordinary course of business. The company is well advised to engage with the company and other stakeholders in the Chapter 11 proceedings, in order to obtain as much information as possible, including the supplier's Chapter 11 budget.

If the company and the supplier are doing business on a purchase order and invoice basis, it is more likely that the parties do not have an "executory contract", which is a Bankruptcy Code term for any contract where both parties owe material performance to the other. With no executory contract, the company is free to seek alternative suppliers to hedge the risks in the event that the supplier is not able to successfully reorganise. On the other hand, if the supplier and the company are doing business pursuant to a written sales or supply agreement, the Bankruptcy Code provides that the Chapter 11 debtor has the right to assume or reject the executory contract, which usually occurs in connection with the filing of a plan of reorganisation at the end of the Chapter 11

proceeding. Pending this decision, the parties are obligated to continue performing under the contract. If the supplier assumes the contract, the supplier is required to cure all pre-petition defaults, and the company will be obligated to continue doing business with the supplier. However, the company has the right to evaluate the supplier's ability to perform prospectively and the feasibility of any plan of reorganisation and to object to an assumption of the contract and any proposed plan of reorganisation.

In the event the Chapter 11 supplier seeks to sell substantially all of the assets to a third-party purchaser pursuant to Section 363 of the Bankruptcy Code, the Chapter 11 debtor also has the right to "assume and assign" executory contracts to the third party buyer. Similarly, the company would have an opportunity to evaluate a third-party purchaser and obtain assurances of the ability to perform prospectively. Also, to the extent of the company's intellectual property rights, the supplier may not be able to assume and assign a contract without the company's consent.

Contract Tip: The sales or supply agreement should expressly provide for termination of licenses or other use of the company's intellectual property rights upon default, change of control or assignment of the contract absent consent. ■

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