Pratt's Journal of Bankruptcy Law

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JULY/AUGUST 2020

LexisNexis

Pratt's Journal of Bankruptcy Law

VOLUME 16 NUMBER 5 July/August 2020

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Library of Congress Card Number: 80-68780

ISBN: 978-0-7698-7846-1 (print)
ISBN: 978-0-7698-7988-8 (eBook)
ISSN: 1931-6992

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT'S JOURNAL OF BANKRUPTCY LAW [page number] ([year])

Example: Patrick E. Mears, *The Winds of Change Intensify over Europe: Recent European Union Actions Firmly Embrace the "Rescue and Recovery" Culture for Business Recovery*, 10 PRATT'S JOURNAL OF BANKRUPTCY LAW 349 (2014)

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(2020–Pub.4789)

Editor-in-Chief, Editor & Board of Editors

POSTMASTER: Send address changes to *Pratt's Journal of Bankruptcy Law*, LexisNexis Matthew Bender, 230 Park Ave. 7th Floor, New York NY 10169.

Dealing with Customers in Financial Distress During COVID-19

By Jennifer L. Marines and Andrew Kissner*

The authors suggest steps that suppliers of goods and services can take that can help to place themselves in a more favorable position in the event that a customer files for bankruptcy.

The COVID-19 pandemic is a public health crisis unprecedented in modern history, and the resulting economic dislocation has caused financial distress across supply chains worldwide. In light of this extraordinary crisis—and in anticipation of a wave of defaults by businesses large and small in the months to come—shippers, vendors, and other suppliers are assessing their potential exposures in the event of a customer failure. And while suppliers will no doubt consider reasonable accommodations to assist their customers in weathering these challenging times, prudent actors may still be wondering what can be done to prepare for the worst.

Although the suggestions outlined below are by no means exhaustive, suppliers of goods and services that take proactive steps such as these will often find themselves in a more favorable position in the event that a customer files for bankruptcy.

HOW TO MONITOR CUSTOMERS FOR DISTRESS

The first step is to monitor customers for early signs of potential distress, so that a supplier can take proactive steps before it is too late. The scope and frequency of this review will depend upon the size and importance of each customer to the supplier's business. Larger customers, for instance, may be reviewed frequently or on an ongoing basis, while a less frequent, periodic review may suffice for smaller customers.

There are many ways to monitor customers' financial health, and the exact means of doing so will largely depend upon whether they are publicly traded companies or are otherwise subject to regulations that mandate public disclosures.

The review process will be considerably easier for publicly traded companies,

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which are required under federal securities laws to file both annual and quarterly financial reports (Securities and Exchange Commission ("SEC") Forms 10-K and 10-Q, respectively) and to publicly disclose other material events on an ongoing basis (generally on a form 8-K). These documents are available free to the public on the SEC's Electronic Data Gathering, Analysis, and Retrieval system ("EDGAR") page.[1] To the extent that one does business with state or local government units, those entities might be required to make similar disclosures under municipal securities laws, which are also made publicly available on the Municipal Securities Rulemaking Board's Electronic Municipal Market Access ("EMMA") website.[2] Companies based overseas may also be subject to financial disclosure requirements by the laws of their home jurisdiction.

Although it can be more challenging to obtain the same degree of information on privately held companies—which are generally not subject to public disclosure requirements—there are still ways to obtain valuable information in the public domain. For example, with respect to larger customers that have issued debt such as bonds or bank loans traded on the open market, that debt might be rated by one of the major credit rating agencies (Fitch, Moody's, Kroll, or Standard & Poor's). These agencies will often make certain reports available to the general public (with more detailed information available to paid subscribers). To the extent available, suppliers should review these reports for all of their customers, whether publicly traded or privately owned. However, these reports can be especially valuable for private companies, as they often contain information on such companies' financial health (including compliance with debt covenants and other metrics) that private companies are not otherwise required to disclose publicly.

For smaller businesses or companies without widely traded debt, there are several credit bureaus that offer "business credit reports" similar in nature to the personal reports used in consumer lending (although these business credit reports may contain out-of-date or inaccurate information).

In addition to these sources of information, it may be worth considering whether to require periodic financial reporting from customers as a condition to providing trade terms or when negotiating the next supply contract.

WHAT TO LOOK FOR

In reviewing a customer's financial disclosures, credit reports, and other

[1] https://www.sec.gov/edgar/searchedgar/companysearch.html.

[2] https://emma.msrb.org/.

relevant documents, a supplier should be on the lookout for anything that suggests a customer's inability to continue to operate or otherwise pay its obligations in full when due. Some of these indicators are obvious—for instance, a missed interest payment—while others are less intuitive. Although the below list is far from exhaustive, some common signs of distress include the following:

- Disclosure of missed interest payments, events of default on loans or other credit facilities, or entry into forbearance agreements with lenders or bondholders;
- Public filings that discuss increased risk factors or that include a qualified or adverse opinion on the business's ability to continue as a going concern (i.e., in the auditor's opinion, the business cannot continue operating unless certain events occur);
- Entry into new financing facilities on onerous terms (e.g., high interest rates, paid-in-kind or capitalized interest, high amounts of original issue discount) or into alternative credit arrangements such as receivables-factoring or merchant cash advance facilities (which may indicate a loss of liquidity);
- Downgrades of the customer's corporate debt by one of the major ratings agencies, or placement onto a "credit watchlist"; and
- Hiring of restructuring advisors or appointment of a chief restructuring officer, which will often be accompanied by a securities filing, press release, or other disclosure that the customer is considering a restructuring or reorganization, "exploring strategic alternatives," or other euphemisms.

Of course, one of the most important signs of distress can be identified without any diligence on the supplier's part at all: when a customer requests an extension of (or other deviation from) their customary payment terms.

For example, a customer that had been paying cash upon delivery may seek to pay 30 days in arrears; similarly, customers currently paying in arrears may seek to extend the payment time to 45 or 60 days (or seek alternative payment arrangements such as consignment). Other times customers do not request an extension, but instead begin to "stretch" payments of their own accord, either because they are planning to file for bankruptcy or because they simply need to triage payments. In either case, this is a key sign of distress; although there are a number of reasons a customer may seek to alter payment terms—many of which are benign—this is often an early sign of more serious financial difficulties down the road.

Accordingly, suppliers should develop and implement internal mechanisms to alert them when payments are being made outside of normal trade terms. And to the extent that a customer affirmatively requests an alteration of payment terms, such a request provides a supplier with the opportunity to obtain some of the protections described below.

PROTECT YOURSELF

Once the signs of potential distress have been identified, there are a number of actions that can be taken to minimize (or at least mitigate) exposure in the event of a more serious adverse event down the road, such as a bankruptcy filing, foreclosure, or similar scenario.

Some of the most common protective actions are identified below; these actions are not mutually exclusive, and may be more effective when combined. Conversely, not all of these will be available or appropriate to address a given scenario. A vendor or supplier considering taking action should consult with counsel to determine which of these will be most effective to suit its specific needs.

In addition, this list is geared towards customers that, while experiencing financial distress, have not filed for bankruptcy. Once a customer has filed for bankruptcy (which is discussed briefly below), one should not do anything without consulting with counsel first, as there may be significant penalties for taking certain actions with respect to a debtor in bankruptcy absent leave of the bankruptcy court.

- *Truncate Trade Terms*. One of the simplest steps that can be taken is to seek truncated trade terms, such as cash in advance or cash on delivery. Not only does this provide suppliers with certainty of payment, but it also mitigates preference risk (that is, the risk that a bankruptcy trustee will seek to claw back any payments as avoidable preferences). Tightening of trade terms may require revisions to existing contracts; in consideration for shortening the payment periods, however, a supplier could offer the customer discounts or other incentives. To the extent that a supplier negotiates new contracts with at-risk customers, those contracts could permit the supplier to change payment terms either at will or, in its sole discretion, upon certain triggering events (such as hiring of restructuring advisors, a missed interest payment, or defaults under other contracts).
- *Obtain Credit Support*. To the extent available, one might seek guarantees of payment from a customer's parent corporation, an equity sponsor/majority shareholder, or an affiliated company, special purpose entity, or joint venture. These entities may be less likely to default on their obligations or file for bankruptcy, whether due to reputational

risks or, in the case of special purpose entities, because they are prohibited by their governing documents from seeking bankruptcy protection. Credit support may also be obtained through a letter of credit.

- *Seek Guarantees from Related Entities*. If the customer is part of a larger corporate family, it may be possible to obtain guarantees from the customer's affiliates—ideally, those that are operating entities or that hold substantial assets. In the event of a subsequent insolvency, claims against guarantor entities will be structurally senior; that is, they will need be satisfied before creditors of the corporate parent can obtain a recovery on the guarantor's assets. To the extent that the customer is the corporate parent, then a supplier could instead seek guarantees from the customer's subsidiaries or modify its contracts such that the obligor is the operating entity.
- *Impose a Credit Limit*. For high-volume customers that purchase on credit, suppliers may also consider imposing an aggregate credit limit to reduce exposure. Once that limit is reached, then truncated payment terms may take effect (e.g., five- or 10-day payments in arrears, cash on delivery) or future shipments may cease until any outstanding balances have been paid.
- *Obtain a Security Interest*. Obtaining a security interest in customer assets—such as on accounts receivable—provides very strong protections to a supplier, as those security interests are property rights that must be respected in bankruptcy. Any such security interest would have to comply with the contracts that govern a customer's bank loans or bond indebtedness, which often restrict the property that a customer may pledge to secure obligations to other creditors; a failure to comply with these restrictions could trigger a default, leading to serious adverse consequences (e.g., commencement of bankruptcy or foreclosure proceedings). Further, the supplier should consult with counsel to ensure that any security interest agreed to by the customer is properly perfected. This is necessary to ensure the supplier has priority with respect to the relevant assets vis-à-vis all other creditors, and is often as simple as filing a financing statement with the secretary of state.
- *Explore Availability of Setoff*. Finally, to the extent that it has outstanding monetary obligations owed to a customer, a supplier may be entitled to offset those liabilities against any amounts owed by the customer. Parties should consult with counsel before exercising any right of set-off or recoupment, as these may occasionally be the subject of litigation by a trustee in bankruptcy; however, generally speaking, a

valid setoff right that is exercised prior to a bankruptcy filing will be respected under the Bankruptcy Code.

WHAT TO DO IF A CUSTOMER FILES FOR BANKRUPTCY

A supplier that takes one or more of the steps outlined above should (hopefully) be well positioned in the event that a customer ends up filing for bankruptcy. However, there are additional protections that may be available once the bankruptcy has commenced.

Many debtors, for instance, seek approval via "first day motion" to pay the prepetition claims of so-called "critical vendors" at the outset of the case; to the extent that a supplier provides a good or service that is crucial to the customer's operations, it is possible that the debtor will grant such supplier critical vendor status. To the extent one has shipped goods to the debtor within 20 days prior to the bankruptcy filing (and has not yet received payment), those claims are generally entitled to priority of payment ahead of other unsecured claims. In addition, mechanics' or materialmen's liens that could be asserted by a supplier under state law will generally be enforceable in the bankruptcy (increasing the chance that associated claims will be paid).

Suppliers should consult with counsel to determine whether one or more of these are available and appropriate for the particular situation.

CONCLUSION

Although the failure of a key customer or other contractual counterparty may be out of a supplier's control, the proactive measures outlined above may help to mitigate the negative impact of such a failure on the supplier's business. These tips are to an extent evergreen, and are prudent actions to take at any stage of the business cycle. They are made all the more important, however, in light of the extraordinary economic dislocation that has occurred as a result of the ongoing COVID-19 pandemic.