

Dealing with Distressed Vendors & Customers

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Chip Ford, Partner



Ashley Edwards, Partner

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Today's Presenters



Chip Ford

704.335.9840

Chipford@parkerpoe.com



Ashley Edwards

704.335.6632

ashleyedwards@parkerpoe.com

Agenda

- Why you should care.
- Warning signs of financial distress.
- Strategies to mitigate risk.
- Pre-bankruptcy rights and remedies.
- Bankruptcy considerations and next steps.



Why You Should Care

- Add value to the organization.
- Proactive versus reactive approach (especially important in the current times).
- Save legal fees.

PRE-BANKRUPTCY



WARNING SIGNS OF FINANCIAL DISTRESS

- Slowing payment.
- Industry-wide distress.
- Bankruptcy filing rumors.
- Delay or refusal to provide financial information.
- Unanswered phone calls and emails.
- Post-dated checks (or request to hold checks).
- Confirmation that other vendors/factors have withdrawn trade credit.
- Unusual turnover in executive ranks.

STRATEGIES TO MITIGATE RISK

- Tighten credit terms – cash-in-advance (CIA) or cash-on-delivery (COD).
- For past due receivables, negotiate lump-sum payment or payment plan (but be aware of potential preference risk).
- File lawsuit to reduce claim to judgment (but courts are backlogged due to the pandemic).
- Require a pledge of collateral (also involves potential preference risk).
- Third-party credit enhancement, e.g., a letter of credit or a personal guaranty from a solvent individual or entity.



STRATEGIES TO MITIGATE RISK

- Exercise *setoff* or *recoupment* rights (setoff involves potential preference risk).
- If there is an existing contract:
 - Review to see if any terms (e.g. credit terms) need to be amended.
 - Consider terminating (or use threat of termination to negotiate more favorable terms) if there are grounds to do so.
- Consider filing an involuntary bankruptcy.

RIGHTS AND REMEDIES UNDER THE UNIFORM COMMERCIAL CODE

UCC ARTICLE 2: Rights of a Seller of Goods

- **Reclamation** (UCC Section 2-702)
 - Requirements:
 - i. Buyer must have been insolvent when it received the goods; and
 - ii. Demand must be sent within 10 days of buyer's receipt of the goods.
 - Reclamation rights are subordinate to rights of a buyer in ordinary course or other good faith purchaser (e.g., the holder of a blanket lien on the buyer's inventory).
 - Reclamation rights can be enforced by filing a lawsuit, which should include a request for a temporary restraining order that prevents the debtor from moving, selling, or altering the goods.

RIGHTS AND REMEDIES UNDER THE UNIFORM COMMERCIAL CODE

UCC ARTICLE 2: Rights of a Seller of Goods

- Right to stop delivery of goods (UCC Sections 2-702, 2-703, and 2-705)
 - If the seller has not yet shipped goods that the buyer ordered on credit and the seller discovers that the buyer is insolvent, the seller may refuse to deliver the goods unless the buyer pays for them.
 - A seller also has the right to stop delivery of goods in the possession of a carrier, warehouse, or other third party bailee. This right continues until the buyer takes physical possession or control of the goods.

RIGHTS AND REMEDIES UNDER THE UNIFORM COMMERCIAL CODE

UCC ARTICLE 2: Rights of a Seller of Goods

- Right to stop delivery of goods (UCC Sections 2-702, 2-703, and 2-705).
 - A seller exercising this right is liable to the bailee for any charges or damages resulting from the stoppage (e.g. storage and demurrage charges).
 - After delivery is stopped, seller can either:
 - i. convert the credit sale into a COD sale; or
 - ii. arrange for the return of the goods.

RIGHTS AND REMEDIES UNDER THE UNIFORM COMMERCIAL CODE

UCC ARTICLE 9: Sale of Collateral

- Secured creditor with a valid UCC Financing Statement may sell the collateral.
- Sale must be “commercially reasonable.”
- Must provide 10 days notice (if non-consumer transactions) prior to disposition of collateral.
- Required contents of a notification of disposition.
- Prepare Bill of Sale to demonstrate change in ownership.

BANKRUPTCY



REVIEW THE BUSINESS RELATIONSHIP

- If there is an unexpired contract or lease with the debtor, review it to determine whether:
 - all of the entities liable for the debt actually filed for bankruptcy; or
 - the contract or lease permits payment on a CIA/COD basis, or a cash deposit.
- If there is no ongoing contract or lease with the debtor, consider whether to continue doing business with the debtor and, if so, determine ways to ensure payment for post-petition deliveries.

GATHER INFORMATION AND MONITOR THE BANKRUPTCY

- Find out what chapter the debtor filed under. The debtor's operations generally continue under Chapter 11 (reorganization), but terminate under Chapter 7 (liquidation).
- Obtain copies of key filings to understand the facts and circumstances and identify any important deadlines. Sources:
 - PACER (official court records)
 - Noticing and claims agent website

GATHER INFORMATION AND MONITOR THE BANKRUPTCY

- Key filings include:
 - Notice of commencement of case;
 - **Cash collateral** or **DIP financing** motions/orders;
 - Routine **“first day” motions/orders** and supporting declarations;
 - Notice of proof of claim bar dates; and
 - Schedules and Statement of Financial Affairs.

GATHER INFORMATION AND MONITOR THE BANKRUPTCY

- Have your attorney file a notice of appearance to receive all pleadings and other documents filed in the case.
- Attend the first meeting of creditors required by Section 341 of the Bankruptcy Code.

FILING A PROOF OF CLAIM

- ***Proof of claim*** form is generally available through the bankruptcy court's or the noticing agent's website. There is a standard form, but the court may prescribe a customized form.
- Include relevant attachments to demonstrate the basis for your claim. Make sure to redact all personal identifiers.
- Monitor the case docket for:
 - any objections to the claim;
 - the deadline for responding to any objections; and
 - the date of the hearing on the objection.

SERVING ON THE CREDITORS' COMMITTEE

- Advantages include greater access to information and control over the proceedings. Main disadvantage is the time commitment. Must also be wary of potential conflicts of interest resulting from fiduciary duties imposed on committee members.
- If interested, promptly complete and mail back the questionnaire sent by the **US Trustee** or **Bankruptcy Administrator** and either:
 - attend the organizational meeting where the UST/BA interviews and appoints committee members; or
 - if live participation at the meeting is not possible, call the UST/BA's office to reaffirm interest in serving and act through a proxy, if permitted in the particular jurisdiction.

AVOID VIOLATING THE AUTOMATIC STAY

- The ***automatic stay*** is an injunction that becomes effective immediately upon the commencement of a bankruptcy case. It bars substantially all collection and enforcement actions by creditors; including:
 - the commencement or continuation of any legal action against the debtor;
 - any action to collect a pre-petition debt;
 - enforcement of any judgment previously obtained against the debtor; or
 - any act to obtain possession or control over property of the debtor.
- Stop all collection activities and inform all employees handling the debtor's account of the debtor's bankruptcy to avoid inadvertent stay violations.

AVOID VIOLATING THE AUTOMATIC STAY

- Separate prepetition and post-petition obligations in correspondence and invoices, and apply post-petition payments to post-petition invoices only.
- If there is any pending litigation, stop all activity and notify the court of the bankruptcy.
- Consider filing a motion requesting relief from the stay to:
 - continue with any pending litigation if there is a reason that the action, or some portion of it, must proceed immediately;
 - exercise setoff rights; or
 - exercise termination rights under any contract to supply goods or services to the debtor.

LEASES AND EXECUTORY CONTRACTS

- An ***executory contract*** is a contract with material, unperformed obligations on both sides as of the petition date.
- Debtor may assume, assume and assign, or reject an unexpired lease or executory contract. Rejection gives rise to an unsecured claim for damages. Assumption requires the debtor to cure all defaults and provide adequate assurance of future performance.

LEASES AND EXECUTORY CONTRACTS

- Generally speaking, the debtor in a Chapter 11 case can assume or reject an unexpired lease or executory contract at any time prior to confirmation of a plan, but the court can set an earlier deadline at the request of the non-debtor counterparty.
- A commercial real estate lease is deemed rejected if it is not assumed or rejected within 120 days after the petition is filed (this time period can be extended for 90 days).

LEASES AND EXECUTORY CONTRACTS

- A debtor must timely perform all obligations arising from and after the petition date under an unexpired commercial real estate lease until the lease is assumed or rejected (this time can be extended for up to 60 days).
- A debtor must timely perform all obligations arising from and after 60 days after the petition date under an unexpired lease of personal property until the lease is assumed or rejected.
- Special rules dealing with consequences of rejection of certain types of real estate leases and IP licenses.

CRITICAL VENDOR ORDERS

- In larger Chapter 11 cases, debtors sometimes file a motion early in the proceedings seeking authority to pay the prepetition claims of ***critical vendors*** (key suppliers that are essential to the success of the debtor's continued business operations and reorganization).
- A critical vendor order may specifically designate certain suppliers, or it may give the debtor some amount of flexibility in determining (1) which vendors are critical, and (2) how much to pay those vendors.

CRITICAL VENDOR ORDERS

- Critical vendors are usually required to sign a ***critical vendor agreement***, which is a contract governing the post-petition relationship and stating the terms under which the debtor will pay the vendor's prepetition claims.
- Be wary of terms that:
 - place open-ended obligations on the seller to extend unreasonably favorable credit terms;
 - prohibit the seller from raising prices during the term of the agreement; and
 - prohibit the seller from suspending the agreement if the debtor defaults on its obligations or if there are other indications that the debtor's financial condition is deteriorating.

RECLAMATION RIGHTS IN BANKRUPTCY

- Seller of goods must make a reclamation demand within:
 - 45 days of the debtor’s receipt of the goods; or
 - 20 days from the petition date, if the debtor filed for bankruptcy within 45 days of receiving the goods.
- Reclamation rights are subordinate to existing liens, so they may be of limited value.
- Determine whether the bankruptcy court has entered an order approving global procedures for resolving reclamation claims.
- If receiving critical vendor treatment, check whether the critical vendor order prohibits asserting reclamation claims.

PREFERENCES

- A **preference** is a transfer made by an insolvent debtor to a creditor in payment of a preexisting debt within 90 days before the petition date (or, if the creditor is an insider, within one year before the petition date) that allows the transferee to receive more than it would have otherwise received in a Chapter 7 liquidation.
- If you received any potentially preferential payments, gather the necessary facts to show that:
 - all of the elements of a preference are not satisfied; or
 - one or more defenses apply (for example, the payment was made in the ordinary course of business, or your company gave new value after the transfer in question).

PREFERENCES

- If all of the elements of a preference are satisfied and no defenses apply, you will likely have to negotiate a settlement with the debtor or trustee.
- Two year statute of limitations (from the bankruptcy filing date).
- Claim may be disallowed until preference claim is resolved.

SECTION 503(b)(9) ADMINISTRATIVE EXPENSES

- Section 503(b)(9) of the Bankruptcy Code entitles a seller of goods to an ***administrative expense*** claim for the value of any goods received by the debtor within 20 days of bankruptcy, if sold to the debtor in the ordinary course of business.
- Bankruptcy courts often enter procedural orders requiring 503(b)(9) creditors to:
 - use a particular form different from the standard proof of claim form;
 - provide specific supporting documents; and/or
 - file section 503(b)(9) claims by a deadline separate from (and often earlier than) the general bar date for asserting all other claims.

SETOFF AND RECOUPMENT

- **Setoff** rights are recognized in bankruptcy, but a creditor must obtain relief from the automatic stay in order to exercise them.
- **Recoupment** is not prohibited by the automatic stay.
- A claim subject to a right of setoff is treated as a secured claim.
- If the debtor obtains court approval to sell its assets outside of the ordinary course of business in a **Section 363 sale**, insist on **adequate protection** for any sale of property against which there are setoff rights (e.g., accounts receivable).

SELLING YOUR CLAIM IN BANKRUPTCY

- Claim trading has become prevalent, especially in the larger cases.
- Weigh the benefits of selling your claim (cash now) against the costs (a lower recovery and possible indemnification obligations).
- Remember that claim traders buy case risk, not claim risk.

DISCLOSURE STATEMENT AND PLAN OF REORGANIZATION

- Review the *Disclosure Statement* and proposed *Plan of Reorganization* to determine:
 - whether your claim is classified appropriately under the plan; and
 - the proposed treatment for that class of claims.
- File appropriate and timely objections, and vote to reject the plan if dissatisfied with how the plan treats and classifies your claim.

MECHANIC'S LIENS

- Perfect any mechanic's liens within the time period established by applicable non-bankruptcy law.
- If legal action is required in order to continue perfection, file a timely notice under Section 546(b)(2) of the Bankruptcy Code.

Contact Us



Chip Ford

704.335.9840

Chipford@parkerpoe.com



Ashley Edwards

704.335.6632

ashleyedwards@parkerpoe.com