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Managing Distressed Customer Relationships

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In the wake of the COVID-19 pandemic, we often are asked what our clients should do if a business counterparty (such as a vendor, customer or other contract counterparty) is suffering distress and may be contemplating filing for bankruptcy. It is, of course, impossible to anticipate every potential scenario, but here are several general "do's and don'ts" to consider. Recognizing that the facts and circumstances differ as to each situation, as always, it is best to consult your restructuring advisors as soon as possible if you believe a business counterparty is suffering financial distress and may be close to bankruptcy. They will be able to tailor the advice to fit the specifics of the circumstance.

Before Bankruptcy

Stay on top of on payment terms. Distressed companies often fall behind on payables. If you believe a customer or other counterparty is suffering distress, then you should monitor collections carefully to avoid slippage in payment. We frequently hear of client concerns regarding accepting late payments that might be subject to clawback as a preference if there is a subsequent bankruptcy. We generally recommend that you not be overly concerned whether a payment may be a preferential transfer. While it is true that a payment from a distressed party may be a preferential transfer, that transfer can be clawed back only *if* the company making the payment files for bankruptcy within a specified time period, *if* the statutory elements of a preference are met and *if* the estate seeks to avoid the transfer as a preference. There are a number of *"if's"* in that scenario. The bottom line is that if you are owed money, then you should do your best to collect.

Collecting is easier said than done in practice. The fact is that you may have a longstanding relationship with your customer that precludes you from demanding payment on time every time. Moreover, the COVID-19 pandemic has most businesses looking for concessions now, so you may feel obliged to be flexible. Whatever the scenario, it is better to have the payment in hand prior to a bankruptcy. You should understand that the longer you put off receiving payment, the more likely it is that you may never receive payment, especially if your customer files for bankruptcy. It is a business risk that should be carefully managed.

Know and understand your rights. You undoubtedly have written terms that govern most of your counterparty relationships. If you believe your business counterparty is in distress, it is a good time to dust off those agreements and review and understand exactly what rights you have. Your written terms will have remedies that you should consider whether and when to exercise. There may also be applicable notice and cure periods that need to be followed in order to exercise remedies, including termination. Importantly, properly terminating an agreement before a bankruptcy is filed may be a game changer. Also, state law, as well as purchase orders or contracts, may provide reclamation rights in your favor. Understanding precisely what you can do when your counterparty is in breach is critical to effectively managing through the distress of your counterparty.

This is not to say that every remedy should be exercised. Rather, you should consult your counsel to understand your rights and understand the ramifications of exercising those rights (or not). Again, you likely will want to consider balancing collection pressure with maintaining the relationship you have with your customer. Recognize, however, that an intervening bankruptcy changes the dynamic regardless of your long-standing customer relationship.

Understand your shipping/delivery terms and when title to goods pass. An intervening bankruptcy during the shipment of goods on credit can often create problems for the company supplying the goods. The intervening bankruptcy may raise questions about whether the goods are or are not property of the bankruptcy estate, including whether they are subject to a senior lender's liens and security interests. Collection on delivery (COD) or pre-payment may be necessary under circumstances where your customer is suffering distress. You may also be entitled to adequate assurance of performance under state law.

Consider whether a forbearance agreement or a modification of existing rights makes sense. Distress often results in a breach or default in your agreement. This may provide an opportunity to negotiate a forbearance agreement or modification that improves your position. Oftentimes, good faith negotiations concerning a forbearance or modification may result in obtaining collateral for previously-unsecured debt. Obtaining collateral in this fashion may be a preferential transfer, but it is always better to have that security (see above). Moreover, you may have an opportunity to cure defects including in loan documents (e.g., unauthorized purchase money security interest, unperfected security interest, incorrect legal name for borrower, incorrect guarantor information, signatures, spousal signature on a guaranty in a community property state, etc.).

You also may be able to negotiate financial incentives or other favorable terms as part of the forbearance agreement or other modification. For example, instead of net/30 payment terms, you may want to negotiate net/20 payment terms in order to be consistent with Bankruptcy Code Section 503(b)(9), which provides priority payment for unpaid goods delivered on credit within the 20-day period before the bankruptcy. The party seeking a forbearance may also agree to more lucrative terms in consideration for the relief you are providing – perhaps you can obtain a personal guaranty from principals or more stable affiliates. You may also have your attorneys' fees paid as part of the negotiated deal.

In short, and in consultation with your counsel, there may be a number of benefits to negotiating a forbearance agreement or other modification.

After Bankruptcy

The landscape changes once a bankruptcy is filed. Once that occurs, you should consult your counsel immediately because:

- Litigation, foreclosure, and other actions against the company or its property should cease immediately
- You cannot unilaterally terminate an executory contract
- You may be able to stop goods in transit
- You should consider freezing payments owing to the debtor to determine whether you have recoupment or offset rights
- You should consult the debtor to determine if you will be treated as a critical vendor
- You should assess your payment history to determine whether and to what extent you have a claim in the bankruptcy
- You should timely file a proof of claim for any and all amounts owed
- You should assess preference exposure to understand whether there is any clawback risk
- Before continuing to do business with the debtor, you should understand whether it has authority to use cash from its lender(s) to pay for your goods and services

Conclusion

Taking a proactive approach with distressed customers is always the best tactic. A few hours crafting a thoughtful strategy with counsel early in the process can save you large sums as your customers' distress deepens and they perhaps file for bankruptcy. Know your rights, exercise those rights when appropriate and protect yourself.

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