

Working with Customers in Financial Distress

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The COVID-19 pandemic is causing financial distress across industries worldwide, impacting businesses large and small. According to the American Bankruptcy Institute, in May of 2020, total commercial Chapter 11 bankruptcy filings increased 48% from May 2019. Chapter 11 filings also increased in April and March. As of mid-June, there have been more Chapter 11 bankruptcy filings for the first six months of a year than any year since 2009. Experts expect the trend to continue and increase, with some worried that the bankruptcy system will become overwhelmed.

Based on this current environment of financial distress and uncertainty, it is prudent for a business to consider what may happen in the event one of its customers experiences financial failure and whether there are any steps that can be taken to prepare for such an event. This article outlines certain steps that can be taken when dealing with financially distressed customers prior to a Chapter 11 bankruptcy and, in the event of a Chapter 11 bankruptcy, what steps can be taken to provide maximum protection.

Identifying a Customer's Financial Distress

The initial step is to identify when a customer is experiencing financial distress. The earlier financial distress is detected, the more proactive a business can be in protecting itself. There are certain "telltale" signs: for instance, if a customer is stretching out its payments by not paying by the due date (or when it otherwise typically does) or when a customer asks for different payment terms or discounts.

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Being proactive may lead to a business learning crucial information about a customer. For instance, if a business learns that a customer has resorted to alternative forms of financing, such as merchant cash advance loans, that is a sign the customer cannot secure necessary cash from a traditional lender and is very likely in financial distress. The more information a business can learn, the better equipped it is to deal with the distressed customer.

Tools for Dealing with Distressed Customers

1. Negotiate Revised Payment Terms

Negotiating revised payment terms can be valuable, particularly if a customer later files Chapter 11. A primary example is negotiating prepayment or payment on delivery, which has two benefits: first, it gets a business cash-in-hand today, even if means it giving the customer a discount. Second, prepayment or payment on delivery mitigates a business's risk of a preference claim against it in the event of the customer's bankruptcy filing. In the event of a bankruptcy filing, a trustee will seek to claw back any payments made by the debtor within 90 days prior to the bankruptcy. These preference claims can be a very unwelcome surprise, typically coming years after payment was received and from a customer that still owes the business money. If the payments made during the 90-day period were pre-payments or payments on delivery, the preference risk is substantially mitigated.

Another example of negotiating revised payment terms is to limit or reduce a customer's credit limit to avoid being "too far" into a single customer in the event of a bankruptcy filing, at which time, any chance of payment is significantly decreased.

2. Guarantees

Another possible tool is obtaining guarantees from the customer's individual owner(s), parent company, or related entities. These potential guarantors may have more financial wherewithal than the actual customer, and guarantees increase the potential sources of payment and remedies in the event of a default. In the event the customer files bankruptcy, the guarantee still provides a business with a tool for payment outside the bankruptcy, provided the guarantor has not also filed bankruptcy.

3. Security Interest

Obtaining a security interest in a customer's personal property to secure its payment obligations is another tool worth considering when dealing with a customer experiencing financial problems. This provides the business with collateral to back-up the payment obligation. In the event of a bankruptcy, a business with a properly-perfected security interest has additional protections beyond simply being an unsecured creditor.

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Keep in mind, any security interest will have to comply with the customer's agreements with its lender, which may restrict whether the customer can grant a security interest and what type of security interest it can grant. To the extent that a customer agrees to grant a business a security interest, the business should consult with legal counsel to ensure the security interest is properly documented and perfected to obtain its maximum benefits.

4. Setoff

If the business owes its financially distressed customer money, the business may be able to exercise a right of setoff to at least partially satisfy the customer's obligation to it. Prior to exercising a right of setoff, it is worthwhile to consult with legal counsel to understand what setoff rights may exist and, if the customer later files for bankruptcy, how the bankruptcy filing may impact the setoff. Once a bankruptcy is filed, exercising a right of setoff is barred by the automatic stay. Bankruptcy counsel can assist with obtaining relief from the automatic stay to exercise a right of set-off post-petition.

5. Enforce Payment Terms

When a customer is in financial distress, regardless of what the payment terms are, a business should make a concerted effort to enforce those payment terms. In the event the customer files bankruptcy and a business is faced with a preference claim that seeks to claw back any payments received from the customer within the 90-day preference period, the business will want to utilize the ordinary course of business defense. In order to support that defense, the business will need to demonstrate that whatever payments it received during the 90-day preference period were consistent with the parties' historical transactions and ordinary course of business. If a business just began to enforce its payment terms in the 90-days prior to the bankruptcy filing, that will make proving the ordinary course of business defense more difficult.

If a Customer Files Bankruptcy . . .

If a financially-distressed customer does file for bankruptcy, a business is not without options. Bankruptcy counsel can assist a creditor with:

- Determining whether a business can be classified as a critical trade vendor, which allows a business to be paid for all or a portion of its pre-petition claim early in the bankruptcy;
- Filing an administrative expense claim for goods delivered within 20 days of the bankruptcy petition date under Section 503(b)(9) of the Bankruptcy Code. These administrative expense claims are given priority status under Chapter 11's payment scheme. In many large Chapter 11 cases, administrative expense claims are paid in full;
- Monitoring the assumption and rejection of executory contracts, including leases. If a contract is assumed, the business may avoid a preference claim and be paid the "cure" amount – that

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is, the amount owed to it under the contract. If a contract is rejected, bankruptcy counsel can assist with preparing a claim for rejection damages;

- Timely and properly filing a proof of claim; and
- Defending a preference claim that seeks to claw back any payments made by the customer to the business within the 90-days prior to bankruptcy.

Being proactive with customers who are facing financial distress can help save you money and overcome some hurdles that will arise if the customer does file for bankruptcy. Our team has helped clients navigate these issues successfully through several economic downturns, and we are happy to help with proactive planning or navigating bankruptcy issues.