



**BEST PRACTICES FOR MINIMIZING RISK AND
MAXIMIZING RECOVERY WHEN DEALING WITH
A FINANCIALLY DISTRESSED PROJECT**

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Presented by:
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Jason M. Torf is a bankruptcy and creditors' rights partner in the law firm Ice Miller LLP. Jason regularly represents clients in helping them solve their problems with troubled customers, both in bankruptcy proceedings and otherwise. Jason is a frequent speaker to credit groups to help them understand practical steps their companies can utilize to minimize risk and maximize their recovery when dealing with a financially troubled customer.

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FORMS SHOULD BE STRONG

CREDIT APPLICATION, PURCHASE ORDERS AND TERMS & CONDITIONS

- Starting point – have good forms
 - Credit application
 - Purchase order
 - Terms & Conditions
- These documents should all be strong and seller-friendly
- Strong set of seller forms = good rights and remedies in the event of customer issues or default

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CREDIT INSURANCE

- Credit insurance offers protection in the event of a covered customer payment default
- Requires a premium
 - Like any insurance, could end up paying for nothing
 - But if a covered event occurs, the premium might be worth it
- The sooner in a relationship you can get credit insurance to cover a customer, the better because
 - Premium will be lower while customer is healthy
 - More likely that credit insurer will offer coverage for the customer

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GUARANTEES

A GOOD CREDIT ENHANCEMENT

- Use of a guaranty gives unpaid seller recourse against a third party in the event of a customer default
- Best options as guarantor
 - For closely-held companies: Principal of company
 - For public companies: Parent company
- Ensure creditworthiness and collectability of guarantor

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PREFERENCES: TO COLLECT OR NOT TO COLLECT

WHAT HAPPENS TO MY ORDINARY COURSE OF BUSINESS DEFENSE

- Collect now
- Let debtor try to recover from you later
- Even if ordinary course of business defense is affected by collecting sooner during preference period, debtor bears burden and expense of seeking to recover preference, and you might have other defenses
 - Like your mother said, possession is 9/10ths of the battle

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PURCHASE MONEY SECURITY INTEREST

- A purchase money security interest (“PMSI”) has priority over a secured lender’s lien if the PMSI is properly and timely perfected
- Gives seller of goods a security interest in the goods being sold and the proceeds of sale of those goods
- If done properly, seller’s security interest in the goods being sold and the proceeds of those goods comes ahead of the secured lender’s lien
 - This is so even through secured lender perfected its lien first
 - PMSI gives seller of goods a superpriority lien

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PURCHASE MONEY SECURITY INTEREST

HOW TO ASSERT A PMSI PROPERLY

- First, must have language where customer grants seller a purchase money security interest
 - Can be included in:
 - Purchase order
 - Supply contract
 - Terms and conditions

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PURCHASE MONEY SECURITY INTEREST

HOW TO ASSERT A PMSI PROPERLY

- Must take steps to perfect PMSI in inventory
 - File a UCC-1 financing statement
 - Send notice to any secured party with a security interest in those goods
 - Conduct lien search to ascertain other secured parties
 - Notice must state that seller has or expects to acquire a purchase money security interest in inventory of the debtor and describes the inventory
- UCC-1 filing and notice to other secured parties must be done:
 - Before goods are delivered to customer for inventory
 - Within 20 days after delivery for goods other than inventory (i.e., equipment)

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PURCHASE MONEY SECURITY INTEREST

HOW TO ASSERT A PMSI PROPERLY

- Make sure that customer does not have prohibition on PMSI's in its loan documents
 - If there is a prohibition, make sure that customer obtains lender's consent first
- Effect of customer's failure to obtain lender's consent where required
 - No effect on your PMSI
 - But could be a default under loan documents that lender will call, causing a bigger problem for your customer

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PURCHASE MONEY SECURITY INTEREST

HOW TO ASSERT A PMSI PROPERLY

- How to “sell” PMSI to lender where lender’s consent is required
 - You will not sell goods without PMSI, so lender will not have those goods as part of its collateral either way
 - Should consent to PMSI because your goods on the shelf drives foot traffic and enhances borrower’s value

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PURCHASE MONEY SECURITY INTEREST

ENFORCEMENT

- Foreclosure option
 - In the event of non-payment, a PMSI gives you, as a secured party, the option to foreclose
 - Allows secured party to sell collateral and collect proceeds of sale to be applied to unpaid debt

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PURCHASE MONEY SECURITY INTEREST

EFFECT IN BANKRUPTCY

- If customer files bankruptcy:
 - PMSI gives you, as PMSI secured party, superior rights to any other creditor, secured or unsecured, with respect to your collateral
 - What does this mean?
 - Whether customer reorganizes or liquidates in bankruptcy, you get paid the value of your collateral ahead of other creditors
 - If you did not have a PMSI, you would be paid as a general unsecured creditor and recovery, in most cases, is much lower
 - ***Proactive Pointer:*** You must document your PMSI property, including the UCC-1 filing, in order to have this superpriority!

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UNIFORM COMMERCIAL CODE REMEDIES

ADEQUATE ASSURANCE OF FUTURE PERFORMANCE

- UCC §2-609 governs for sales of goods
- Upon reasonable grounds for insecurity, a seller can demand adequate assurance of performance from financially distressed buyer

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UNIFORM COMMERCIAL CODE REMEDIES

ADEQUATE ASSURANCE OF FUTURE PERFORMANCE (CONT'D.)

- Reasonable grounds for insecurity
 - Determined by “commercial standards” as between merchants
 - Customer past due
 - With the seller
 - With other vendors
 - Warning signs of future customer bankruptcy
 - Missed interest payments on long-term debt
 - Hiring of restructuring advisers
- What constitutes adequate assurance of performance?
 - Revoke credit terms and switch to cash in advance / C.O.D.
 - Collateral security
 - Letter of credit
 - Cash deposit

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UNIFORM COMMERCIAL CODE REMEDIES

ADEQUATE ASSURANCE OF FUTURE PERFORMANCE (CONT'D.)

- Pending receipt of adequate assurance, creditor can
 - Suspend performance
 - Switch to cash in advance / C.O.D.
 - Impose more restrictive credit terms
- Debtor’s failure to provide adequate assurance within reasonable time not exceeding 30 days results in repudiation of contract

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UNIFORM COMMERCIAL CODE REMEDIES

STOPPAGE OF DELIVERY

- Seller's right to stop delivery of goods in transit to buyer due to buyer's insolvency
 - Buyer's insolvency
 - Balance sheet test: Liabilities exceed assets
 - Failure to pay debts as they mature
- Withholding delivery of goods in creditor's possession and switching to cash terms going forward
- Stopping delivery of goods in possession of carrier/warehouse/other third party (bailee)

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UNIFORM COMMERCIAL CODE REMEDIES

STOPPAGE OF DELIVERY (CONT'D.)

- Notice must be given to carrier/warehouse
 - Should also be given to debtor
- Following notice, carrier, warehouse/other third party must hold and deliver goods according to seller's direction
 - Seller responsible for charges of carrier/warehouse holding goods prior to release to buyer or return to seller

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UNIFORM COMMERCIAL CODE REMEDIES

STOPPAGE OF DELIVERY (CONT'D.)

- Right of stoppage of delivery cut off primarily by:
 - Buyer's receipt of goods
 - Requires physical possession
 - Title transfer is irrelevant
 - Acknowledgment by warehouse or other bailee that it is holding goods for buyer

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UNIFORM COMMERCIAL CODE REMEDIES

STOPPAGE OF DELIVERY (CONT'D.)

- Stoppage of delivery rights superior to rights of secured lender with lien on inventory
 - ***Proactive Pointer:*** Take necessary steps (i.e., seek injunction if necessary) to prevent actual delivery of goods or rights might be lost to secured lender
- In contrast, reclamation rights are subordinate to secured lender with lien on inventory

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UNIFORM COMMERCIAL CODE REMEDIES

STOPPAGE OF DELIVERY – EFFECT OF BUYER’S BANKRUPTCY FILING

- Seller retains rights under UCC to stop delivery
- Generally not precluded by automatic stay
- However, seller must seek relief from the automatic stay to obtain return of goods after they have been stopped

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WATCH FOR RED FLAGS

CUSTOMER BULKING UP ON INVENTORY

- Beware a customer that orders unusually large volume of inventory
 - Could be sign of expansion or increased sales – good!
 - But could instead be a sign of a looming bankruptcy
 - Customer might be bulking up on inventory now with no plan to order additional inventory for a few weeks
 - This avoid 503(b)(9) exposure
 - Talk to other vendors to common customer to find out if larger volumes are isolated with your company or across many vendors
 - Do this BEFORE shipping

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DOING BUSINESS WITH A DEBTOR IN BANKRUPTCY

PROTECTING YOUR POST-BANKRUPTCY SHIPMENTS TO A CUSTOMER

- TRUE OR FALSE
 - DIP financing is a guarantee of payment

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DOING BUSINESS WITH A DEBTOR IN BANKRUPTCY

PROTECTING YOUR POST-BANKRUPTCY SHIPMENTS TO A CUSTOMER

- TRUE OR FALSE
 - DIP financing is a guarantee of payment

FALSE!!!!

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DOING BUSINESS WITH A DEBTOR IN BANKRUPTCY

PROTECTING YOUR POST-BANKRUPTCY SHIPMENTS TO A CUSTOMER

- DIP financing is not guarantee of payment
 - Debtor will try to get you to believe that DIP financing and administrative claim sufficiently cover you
 - NOT TRUE!!!
- DIP financing and administrative claim are good, but not guarantee of payment
 - Administrative insolvency problem

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DOING BUSINESS WITH A DEBTOR IN BANKRUPTCY

PROTECTING YOUR POST-BANKRUPTCY SHIPMENTS TO A CUSTOMER

- Cash in advance
- Reducing terms combined with credit limit as a technique to manage credit risk
- Letter of credit

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DOING BUSINESS WITH A DEBTOR IN BANKRUPTCY

PROTECTING YOUR POST-BANKRUPTCY SHIPMENTS TO A CUSTOMER

- Guaranty
- Purchase money security interest
- Obtain critical vendor treatment if applicable
- Stoppage of delivery of goods in transit
- Third-party hedging arrangements
 - Put agreement
 - Receivables assignment agreement

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SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY

CASH IN ADVANCE IS BEST ALTERNATIVE

- Questions often arise regarding the best way to protect post-bankruptcy shipments
- Cash in advance / COD is best
 - Give us the cash, we'll give you the goods
 - No risk
 - ***Proactive Pointer:*** If switching to cash in advance, make sure to get paid by wire, not by check. Payment by check still presents risk due to possibility of dishonored check after goods are shipped.

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SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY

WHAT IF CUSTOMER WILL NOT PAY CASH IN ADVANCE?

- What options are available if customer refuses to pay cash in advance
 - I still want to ship
 - We place a large volume of goods with this customer and do not want to lose the revenue
 - At the same time, we want to maximize the likelihood of collection

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SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY

HEDGING ALTERNATIVES

- Opportunities to hedge post-bankruptcy shipments exist
 - Receivables Put Agreement
 - Receivables Assignment Agreement
- There are financial counterparties, such as banks and hedge funds, that in some, but not all, circumstances will take the opportunity to enter into these arrangements

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SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY

RECEIVABLES PUT AGREEMENT

- Your company pays a negotiated fee (a “put premium”) for the right to “put” (i.e., sell) receivables owed by a bankruptcy counterparty
- Put right arises upon occurrence of certain predetermined events by specified deadlines
 - Examples (all of which are negotiated):
 - Conversion to chapter 7
 - Dismissal of bankruptcy case
 - Failure to file a plan by a certain date
 - Appointment of a trustee or receiver

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SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY

RECEIVABLES PUT AGREEMENT

- Can cover any number of shipments, present and future
 - Negotiated between you and put counterparty
 - Can be subject to restrictions, such as an aggregate dollar cap
- If any of the predetermined events occur by the deadline stated in the put agreement, your company has the absolute right to sell to the put counterparty all of the receivables covered by the put agreement for 100% payment of face value of invoices supporting those receivables

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SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY

RECEIVABLES PUT AGREEMENT

- Ensures payment in full if buyer runs into deeper trouble during bankruptcy case and cannot pay
 - But only so long as contingencies triggering put right occur by specified deadlines
 - Otherwise, you are still stuck with the potentially uncollectible receivables and you will have paid the put premium

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SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY

RECEIVABLES PUT AGREEMENT

- ***Proactive Pointer:*** Make sure that your contract with your buyer does not prohibit sale or assignment of receivables owed by your buyer
 - Could create a defense by your customer to collection efforts by your put counterparty
 - If you provided your put counterparty with a representation that the receivables are valid and collectible, you could be in breach of warranty and could be forced to return the cash and take back the receivables

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SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY

RECEIVABLES ASSIGNMENT AGREEMENT

- Financial counterparty agrees to buy, at a discount, receivables owed to you by bankrupt counterparty immediately upon shipment
- Percentage to be paid is negotiated between you and the financial counterparty
- Specific receivables are identified in assignment agreement
- Usually negotiated at the time of each shipment
 - In other words, covers only one shipment, not a series of shipments

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SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY

RECEIVABLES ASSIGNMENT AGREEMENT

- No collection risk
 - Because receivables are sold immediately upon shipment
- No loss for time value of money
 - Because payment is immediate

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SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY

RECEIVABLES ASSIGNMENT AGREEMENT

- Absolute assurance of payment
 - So long as you do your own due diligence on receivables purchaser to ensure its financial viability and ability to pay
 - You don't want to ship the goods, then find out that your receivables purchaser cannot pay
- Your cost to ensure collection in this manner is losing some of your profit margin on the shipment
 - Because receivables are sold at a discount
 - But enables you to ship (i.e., receive the revenue) while eliminating collection risk

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SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY

RECEIVABLES ASSIGNMENT AGREEMENT

- ***Proactive Pointer:*** Make sure that your contract with your buyer does not prohibit sale or assignment of receivables owed by your buyer
 - Could create a defense by your customer to collection efforts by your receivables purchaser
 - If you provided your receivables purchaser with a representation that the receivables are valid and collectible, you could be in breach of warranty and could be forced to return the cash and take back the receivables

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SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY

RECEIVABLES PUT AGREEMENT vs. RECEIVABLES ASSIGNMENT AGREEMENT

	<u>Put Agreement</u>	<u>Assignment</u>
Fee / Discount:	Put premium likely lower than discount for assignment	Discount generally greater than put premium
What Is Being Sold:	Usually all receivables from specific customer (but might be subject to limitations)	Receivables as to one specific shipment – must be separately negotiated for each shipment
Contingencies:	Put right does not arise until and unless specified contingencies occur by set deadlines	None
Likelihood of Collection:	Lower than assignment because subject to occurrence of specific events by set deadlines	Absolute – subject only to counterparty’s ability to pay
Subject to Due Diligence by Counterparty:	Yes	Yes

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SELLING TO A DEBTOR-IN-POSSESSION

OVERVIEW

- Rights and obligations of parties depends upon whether there is a contract
- No contract – answer is straightforward
 - Non-debtor party is under no obligation to continue doing business with a debtor where there is no contract
 - As a business matter, though, you might wish to continue selling to debtor (making sales is good!), but with appropriate safeguards to ensure payment:
 - Revoke credit terms and sell on COD or CIA basis
 - Ask for deposit
 - Ask for a letter of credit
- But what if there is a contract?

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EXECUTORY CONTRACTS

OVERVIEW

- Section 365 of the Bankruptcy Code allows the debtor, subject to court approval, to assume or reject executory contracts
- Compliance with certain requirements is a condition:
 - For example, debtor must:
 - cure certain defaults
 - provide adequate assurance of future performance where the contract is in default
- Also permits assumption and assignment of executory contracts notwithstanding an anti-assignment provision except in limited circumstances

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EXECUTORY CONTRACTS

OVERVIEW

- It is important that:
 - When a customer files bankruptcy, you consider whether you have an executory contract with that customer
 - You understand your rights and the debtor's rights with respect to those contracts

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UNDERSTANDING EXECUTORY CONTRACTS

WHAT DOES "EXECUTORY" MEAN?

- What is an executory contract:
A contract with material performance obligations still owed by both parties.

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UNDERSTANDING EXECUTORY CONTRACTS

DEBTOR'S OPTIONS WITH RESPECT TO EXECUTORY CONTRACTS

- Assume
- Assume and assign
- Reject
- Do nothing

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UNDERSTANDING EXECUTORY CONTRACTS

RIGHTS AND OBLIGATIONS UNDER EXECUTORY CONTRACT PRIOR TO ASSUMPTION OR REJECTION

- Non-debtor counterparty cannot compel performance – debtor has discretion whether to perform
 - Some exceptions apply
 - Intellectual property license agreements
- But if debtor performs, then non-debtor counterparty must also perform

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UNDERSTANDING EXECUTORY CONTRACTS

TIMING FOR ASSUMPTION OR REJECTION OF EXECUTORY CONTRACTS

- **Chapter 7**: Within 60 days after order for relief
 - Can be extended for cause on order of court
- **Chapter 11**: Before plan confirmation

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UNDERSTANDING EXECUTORY CONTRACTS

WHAT CAN YOU DO

- What if you have a contract under which you have to have certain inventory volumes on-hand for your customer?
 - File a motion asking the court to compel the debtor to assume or reject the contract sooner

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UNDERSTANDING EXECUTORY CONTRACTS

EFFECT OF ASSUMPTION

- Reinstates contract such that rights and obligations of both parties exist irrespective of bankruptcy
- As a condition to assumption, debtor must:
 - cure any defaults; and
 - provide adequate assurance of future performance

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UNDERSTANDING EXECUTORY CONTRACTS

EFFECT OF ASSUMPTION

- As an example, debtor might assume a contract if it entitles debtor to purchase goods at below-market rates
- Benefit to non-debtor counterparty is payment of cure – absent assumption and a cure, non-debtor counterparty would be left with a prepetition, general unsecured claim
 - Therefore, try to leverage your way into the debtor assuming your contract – a cure payment is good!
 - But maybe not if you are selling at below market prices

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UNDERSTANDING EXECUTORY CONTRACTS

ASSUMPTION AND ASSIGNMENT

- Debtor can assume and assign an executory contract to a third party
- Non-debtor counterparty to contract is entitled to adequate assurance of future performance from assignee, which can include:
 - Access to financial information of assignee
 - Deposit
 - Letter of credit
 - Personal guaranty

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UNDERSTANDING EXECUTORY CONTRACTS

ASSUMPTION AND ASSIGNMENT

- Non-debtor counterparty to contract might be entitled to block assignment under certain circumstances:
 - Adequate assurance not provided
 - Cure not provided
 - Applicable non-bankruptcy law prohibits assignment of:
 - Personal services contracts
 - Government contracts
 - Patent licenses

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UNDERSTANDING EXECUTORY CONTRACTS

ASSUMPTION IN THE CONTEXT OF 363 SALES

- When debtor sells assets, debtor often must decide whether to assume and assign contracts or reject them, in consultation with buyer
- Debtor usually serves an omnibus assumption notice
 - Short notice (*e.g.*, two days) before closing of sale
 - Often lists many pages of contracts to be assumed
 - ***Proactive Pointer:*** Look out for the zero dollar cure!
 - ***Proactive Pointer:*** Respond promptly to preserve rights

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UNDERSTANDING EXECUTORY CONTRACTS

RIGHTS OF NON-DEBTOR COUNTERPARTY TO EXECUTORY CONTRACTS

- As a general rule, the non-debtor counterparty to an executory contract may not unilaterally terminate the contract once a bankruptcy is filed by the other party to the contract
- Non-debtor counterparty may file a motion to modify or terminate the automatic stay to permit termination (*e.g.*, if contract cannot be assumed because cure is impossible)
 - Cure may be impossible if default consists of debtor's failure to act or abstain from acting in the past rather than a monetary default (*i.e.*, a requirements contract)
 - Theory: cannot turn back the clock

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OTHER PROACTIVE REMEDIES

CHANGING TERMS POSTPETITION

- Ascertain whether you have a contract with the debtor
- If not (*i.e.*, shipments on open purchase orders), then you have the freedom to impose any payment terms you deem fit
- Even if you do have a contract, you probably have the right under UCC Article 2 to shorten or revoke credit terms due to debtor's lack of creditworthiness
- If you are not comfortable with extending credit postpetition, you can impose COD or cash in advance terms or elect not to ship at all

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CRITICAL VENDOR TREATMENT

- Provides trade vendors priority payment of prepetition claim, usually in full and immediately rather than at end of bankruptcy case
- If you can leverage your way into becoming a critical vendor, the result can be a much better recovery in the bankruptcy
 - Swaps a prepetition, general unsecured claim for, at worst, a postpetition administrative claim

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CRITICAL VENDOR TREATMENT

PROS

- May get some or all of your prepetition invoices paid in full
- Preserves ongoing business relationship with debtor
- Likely indicator that your relationship will survive sale of assets and potentially have contract assumed by acquirer of assets

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CRITICAL VENDOR TREATMENT

CONS

- Typically requires execution of a critical vendor/essential supplier contract
- Typically have to extend credit terms
- May be subject to potential claw-back if debtor thinks you “misbehave”
- Rarely receive preference waiver so you end up litigating that at another time

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CRITICAL VENDOR TREATMENT

HOW TO OBTAIN

- You know or should know how debtor views you
- Remains debtor’s business decision
- Be careful not to violate automatic stay by blatantly asking to be a critical vendor
- ***Proactive Pointer:*** Obtain a personal guaranty when you sign-up new customer to use as leverage to obtain critical vendor status
 - The individual making the decision regarding who is a critical vendor might be the individual on the hook personally if you obtain a guaranty

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QUESTIONS



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