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Reasonable **Insecurity**

Strategies for doing business with financially troubled counterparties.

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IN THESE TURBULENT economic times, frantic calls from clients doing business with counterparties facing financial distress or bankruptcy is an increasingly common occurrence. As businesses continue to endure decreased sales, a tight-fisted credit market and an uncertain outlook, their suppliers, shippers and service providers may have reasonable cause for insecurity. Clients may face exposure to increased credit risk and even missed payments from their counterparties, and the future of their business and their business relationships may be in doubt.

Against this backdrop, clients seek guidance to position themselves to respond to the warning signs of a counterparty's financial distress in order to minimize exposure to harm before a breach or bankruptcy. This article discusses various strategies for consideration when doing business with financially distressed counterparties to maximize recovery and mitigate losses. While it is not the "end all, be all," this article provides helpful guidance to protect against risk ever present in the marketplace.

See and Heed Early Warning Signs

It is critically important to identify potential economic distress as early as possible and to take proactive steps to reduce exposure to losses. Early preparation and action can mitigate the potential impact of a counterparty's economic failure.

One of the most recognizable warning signs is a slowdown or other industry-wide shock that may be affecting the counterparty's business. For example, retailers, manufacturers, automotive suppliers and media-related companies have been hit particularly hard by the current economic downturn.

Specific signs of problems pointing to a counterparty's weakened financial health may include changes to its course of dealing, such as sudden or unexplained increases or decreases in orders that could indicate alternatively that a counterparty is seeking to stockpile inventory or supplies, or conserve and stockpile cash, prior to filing for bankruptcy, or is about to downsize or even possibly go out of business.

Similar distress signals include delays in payment and requests to postpone payment or alter related contract terms.

Protective Strategies Pre-Bankruptcy

Several strategies may be employed by clients who suspect that a counterparty is a potential candidate for bankruptcy. Certain pre-bankruptcy tools are provided under the Uniform Commercial Code (UCC),[1] while others are a matter of contract law or common sense.

Warning: The implementation of these strategies involves rules and procedures that may not be uniform in every case and may vary from state to state or jurisdiction to jurisdiction. Care and experience must be brought to bear to formulate the specific strategies that are appropriate under the unique circumstances of each particular case and before these measures are implemented.

A. Request for Assurances. Faced with signs of business disruption or financial distress, it may be appropriate to seek adequate assurances from a counterparty. Under UCC §2-609(1), when "reasonable grounds for insecurity" arise regarding a counterparty's performance, a seller or vendor may demand "adequate assurance" of performance.

Whether a particular request for assurances is reasonable is determined with reference to commercial standards under the circumstances. Examples of indicators that assurances may be reasonably requested include the counterparty's missing scheduled payments or inappropriately seeking contract modifications affecting financial terms, or making unilateral changes in performance that have the effect of increasing the client's credit exposure.

Demands for "adequate assurances" must be in writing and should describe the grounds for insecurity and the specific assurances requested. Examples of adequate assurances that may be sought include new collateral, performance bonds,

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third-party guarantys, letters of credit, cash on delivery (COD), prepayments or deposits. Until adequate assurances are received, the client may, if commercially reasonable under the circumstances (which is highly fact-specific), suspend performance for which it has not yet been compensated, and is excused from causing any resulting delay.

Further, under UCC §2-609(4), the client may treat the contract as repudiated if the counterparty fails to provide adequate assurances within a reasonable time, not to exceed 30 days. This is, however, an extreme remedy, considering the client runs the risk of breaching a contract if its demand for assurance is not reasonable. As a practical matter, most clients will strive to continue business relationships with their counterparties whenever possible, consistent with prudence and the risk tolerance of the particular client under the presented circumstances.

B. Reclamation of Goods. A client that ships goods and later discovers that the buyer is insolvent may be able to reclaim the goods from the buyer, but fast action is required. Subject to certain defenses relating to third parties, UCC §2-702(2) provides that a seller generally may reclaim goods that were sold on credit to a customer if the seller makes a demand within a reasonable time after the customer received the goods.[2]

Successful reclamation of goods requires that the buyer still have the goods when the notice is received, and excludes other remedies. Under UCC §2-702(1), sellers may also refuse delivery to insolvent buyers, except when payment is in cash.

C. Modification or Termination of the Agreement. A client typically wants to continue its business relationships, but if confronted with signs of a counterparty's financial distress, the client should consider examining its operative agreements to determine its rights and remedies and to explore its contractual options. Contracts may allow for termination with or without cause, for example. While termination is typically not the preferred option, the termination right may provide leverage to obtain adequate assurances or contract modifications to reduce credit exposure, including to delay shipment, increase frequency of payment or reduce lines of credit.

If a client intends to terminate an agreement, it should act quickly, as the landscape changes dramatically as counterparties approach and enter bankruptcy.

Once the counterparty files for bankruptcy, the automatic stay imposed by §362 of the Bankruptcy Code generally prohibits contract termination for which the trigger is a counterparty's bankruptcy, insolvency or financial condition.[3] While a debtor is required to perform under its agreements during the bankruptcy, the ultimate status of a client's agreements and pre-bankruptcy claims arising thereunder may not be determined until the end of the bankruptcy case because debtors in bankruptcy have the right to reject, or assume and assign executory contracts and unexpired leases, until confirmation of a Chapter 11 plan.[4]

D. Goods on Consignment. In an effort to increase sales, to hedge against counterparty instability, or as may be common in a particular industry, a client may deliver goods on a consignment basis. Properly done, including execution of prophylactic security interest documentation and filings, consignment arrangements can provide consignors with excellent protection against a counterparty's financial distress. However, a consignor is well advised in most cases to proceed as if it were transferring title and taking a security interest in the goods as if it were a purchase-money secured creditor.

While UCC §9-103(d) generally grants consignors an automatic purchase-money security interest, if a consignor fails to perfect that interest prior to delivery, by filing appropriate financing statements, or if other creditors have received a blanket security interest, there is a risk in bankruptcy that third-party liens may have priority over the consignor's interest in the goods. Absent prior notice to other creditors and perfection, the consignor may be deemed to be an unsecured creditor or junior in priority relative to pre-existing secured creditors.[5]

In contrast, a properly perfected and noticed security interest gives the consignor a first priority purchase-money security interest in the consigned property, which is superior to the claims of third-party creditors. This can be critical in bankruptcy, as a consignor's recovery may be largely dependent on whether and when it perfected its interest in the consigned goods.[6]

E. Mitigate Preference Exposure. As a general rule, a client should always accept payments for amounts owed regardless of when they are received. However, payments received prior to a counterparty's bankruptcy may be subject to avoidance and the amount recovered pursuant to the "preference" doctrine under §547 of the Bankruptcy Code.

A "preference" is a transfer of the debtor's property made while the debtor was insolvent and in satisfaction of an "antecedent" debt and that allows a creditor to receive more than it would have received if the debtor were liquidated under Chapter 7 of the Bankruptcy Code. The reach-back period for preferences is 90 days prior to the filing of the bankruptcy petition, or one year if the creditor was an "insider."[7]

Due to the bankruptcy estate's ability to recover preferences, clients may find themselves in the most unenviable position of not only having pre-bankruptcy claims against a debtor counterparty, but also being required to return "preference" payments received from the counterparty prior to bankruptcy. Nevertheless, it is better to receive a potentially avoidable payment than to have not received the payment at all since actions seeking to avoid preferences are subject to contest and compromise.

There are several defenses and strategies that may mitigate, or even eliminate a client's preference exposure. A common defense to a preference action is the "ordinary course" defense where the client demonstrates that payments received from the debtor were made according to the ordinary business terms of the parties or the relevant industry.[8] Because the defendant bears the burden to establish this fact-intensive defense, clients should encourage compliance with payment terms and preserve documentation establishing such terms.

Preference exposure may be avoided entirely with COD terms or prepayment, which eliminate the requirement for a preference of an "antecedent" (i.e., pre-existing) debt, when possible to do so.[9] Lastly, new goods supplied on an unsecured basis to the debtor after receipt of a preferential payment reduces the preference claim by an amount corresponding to the "new value" of the subsequently supplied goods or services.[10] These defenses may be asserted simultaneously.

Despite potential preference exposure, clients are well advised to always accept payments from a counterparty that may appear to be heading towards bankruptcy. It is unlikely that a client will know for sure if or when a counterparty may file for bankruptcy, and it is perfectly permissible and highly advisable to accept all payments for goods and services provided, even if any such payments are eventually alleged or determined to be preferential.

Maximizing Recovery After a Filing

Just because a counterparty enters bankruptcy does not mean all is lost, and a client should be vigilant and assertive in protecting its interests to maximize its recovery in the event of a counterparty's bankruptcy. There are several fundamental steps for protecting rights and avoiding a complete forfeiture of claims, some of which are addressed below.[11]

A. Proofs of Claim. Filing a proof of claim is perhaps the most critical act a creditor can take once a counterparty files for bankruptcy.[12] A proof of claim is a written statement of the amount and bases of a creditor's claim, and it must be filed by the "bar date," which is the last day for filing proofs of claim against the bankruptcy estate.[13] A proof of claim should conform with the requirements of Rules 3001 and 3002 of the Federal Rules of Bankruptcy Procedure (Bankruptcy Rules).[14]

There is no need to wait for the bankruptcy court to set a bar date before filing a proof of claim; early filing is permissible. If a client's claim is not listed on the schedules filed by the debtor, or is scheduled as "disputed," "contingent" or "unliquidated," and the client does not file a proof of claim, it forfeits the right to recover from the debtor's bankruptcy estate.[15]

B. Seek Administrative Claim Status. For clients who shipped goods to a counterparty in the ordinary course of business during the 20 days prior to the counterparty's bankruptcy filing, §503(b)(9) of the Bankruptcy Code grants an administrative expense priority claim for the value of the goods received during that time period. Unlike general unsecured claims, which are typically not payable during the pendency of a bankruptcy case (other than in the case of "critical vendors," discussed below), holders of administrative claims may seek their payment during the case by applying to the bankruptcy court for an order requiring the debtor to pay such claims.

In any event, administrative claims, which share priority with the debtors' professionals' fees during the case, are among the first to be paid in a bankruptcy case and must be paid in full in cash on the effective date of a Chapter 11 plan unless the holder of the claim agrees to accept less favorable treatment.[16] For certain vendors, such as lessors of real property or equipment, it is highly advisable to file an application for payment of an administrative claim early in the bankruptcy case, as debtors may otherwise delay the payment of such claims notwithstanding any requirement that payments be made on a current basis.

Unlike provisions controlling reclamation demands, there is no requirement in asserting an administrative claim to demonstrate that the debtor was in possession of the particular goods or was insolvent when the goods were received.

C. Demand Reclamation. Reclamation, discussed above, also may be available after a counterparty enters bankruptcy. Under §546(c)(1) of the Code, a vendor has the right to reclaim goods received by the counterparty in the ordinary course of business within 45 days of the bankruptcy filing date while the debtor was insolvent.

In order to preserve this right, a vendor must make a written reclamation demand within 45 days after the receipt of the goods by the debtor, or not later than 20 days after the filing of the debtor's bankruptcy petition if the 45 day period ends after the bankruptcy is filed.[17] Because these claims may be subject to prior perfected liens on the debtor's assets (such as by a vendor with a security interest in inventory), there is a possibility that the client may not recover on account of its reclamation demand, thus highlighting the importance of applying for administrative expense status under §503(b)(9) of the Code.

D. Seek "Critical Vendor" Status. Early in a Chapter 11 case, a debtor may move for permission to pay "critical vendors" in an effort to minimize operational disruption from the bankruptcy and enhance the likelihood of a successful reorganization. All efforts should be made to have a client included on the list of critical vendors, as the client will then be paid during the pendency of the bankruptcy case and before general unsecured creditors. Inclusion in the list of critical vendors is not automatic, and courts generally require "critical vendors" to be virtually irreplaceable and a showing that the payments are required in order to maximize the debtor's estate.[18]

E. Move to Setoff Claims. After a bankruptcy filing, creditors certainly want to setoff their claims against amounts they may owe to the debtor where it is permissible for them to do so. While the Bankruptcy Code preserves the right to setoff claims against a debtor's mutual debts or deposits, consistent with applicable non-bankruptcy law, the setoff right is subject to the automatic stay under Code §362.[19] Accordingly, clients may not setoff their claims against the debtor or against assets of the bankruptcy estate absent permission from the bankruptcy court to do so, in the form of an order granting relief from stay.

As such, it may be advisable for a client to exercise the right of setoff pre-bankruptcy mindful, however, of the potential risk that certain pre-bankruptcy setoffs made during the 90 days before the bankruptcy is filed may be subject to avoidance.[20]

Conclusion

Clients dealing with financially distressed counterparties may have reasonable cause for insecurity, but careful preparation and implementation of the strategies described above may provide substantial protection in some cases and loss mitigation in others.

Given the many pitfalls that might arise due to the highly fact-specific nature of clients' business relationships and the intricacies of applicable law, it is prudent to consult experienced bankruptcy counsel in conjunction with providing substantive guidance to a client on these matters.

1. UCC §§1-101-9-709 (2010). References to the UCC in this article refer to the UCC as promulgated by the American Law Institute and the National Conference of Commissioners on Uniform State Laws, not as adopted by any particular state.
2. For example, UCC §2-702(2) applicable in New York provides that reclamation demands must be made within 10 days after receipt of goods.
3. See 11 U.S.C. §§365(e)(1), 541(c). These sections provide that upon bankruptcy, the interests of a debtor generally become "property of the estate," including all of the counterparties' contractual rights, which rights may not be terminated, regardless of the existence of "ipso facto" or bankruptcy termination clauses. The automatic stay provisions are found at 11 U.S.C. §362(a).
4. See 11 U.S.C. 365(d)(2). A more thorough treatment of executory contracts and unexpired leases is beyond the scope of article.
5. Notice must be provided to all creditors of record within the past five years. See UCC §9-324(b).
6. See, e.g., *In re The Holladay House Inc.*, 387 B.R. 689, aff'd, 2008 WL 4682770 (E.D.Va. 2008)(description in financing statement narrower than that in security agreement limited consignor's perfected interest to that described in financing statement); *In re Whitehall Jewelers Inc.*, No. 08-11261 (KG), 2008 WL 2951974 (Bankr. D. Del. July 28, 2008) (refusing to approve a sale of goods without first establishing whether the consigned goods were property of Whitehall's bankruptcy estate).
7. See 11 U.S.C. §101(31) for the definition of the term "insider."
8. See 11 U.S.C. §547(c)(2).
9. 11 U.S.C. §547(c)(1). This is the "contemporaneous exchange" defense.
10. 11 U.S.C. §547(c)(4).
11. This article does not discuss various strategies creditors may use to enhance recoveries in bankruptcy cases, including participation on official committees, "ad hoc" unofficial committees, litigation with respect to Chapter 11 plans and corresponding disclosure statements, and other rights and remedies that may be available to creditors.
12. Caution: By filing a proof of claim in a bankruptcy case, a creditor submits to the bankruptcy court's jurisdiction. See *Langenkamp v. Culp*, 498 U.S. 42, 111 S. Ct. 330 (1990). This may be inadvisable for strategic reasons, which are beyond the scope of this article.
13. The "bar date" is established by the bankruptcy court presiding over the case. See Bankruptcy Rule 3003 (c) (3).
14. See Official Form 10 available at http://www.uscourts.gov/rules/BK_Forms_Pending_2008/B_010_1208v4.pdf.
15. See Bankruptcy Rules 3002 and 3003(c).
16. See 11 U.S.C. §1129(a)(9)(A).
17. See 11 U.S.C. §546(c)(1).
18. See generally, *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004) (calling into question the continued viability of the "critical vendor" doctrine and examining its requirements).
19. 11 U.S.C. §553.
20. A pre-bankruptcy setoff that improves the creditor's position may be recoverable under §553(b) of the Bankruptcy Code. Thus, the benefit of a pre-bankruptcy setoff, and the attendant risk of avoidance, should be weighed against the strategy of seeking relief from stay to effect the setoff after the bankruptcy is filed.