Fighting back against bankruptcy

Pulp & Paper International (online - http://www.risiinfo.com/)

By Michael L. Newsom and Louis F. Solimine

BRUSSELS, Oct. 29, 2012 (RISI) - It never is welcome news when a customer, especially an important one with a large open account balance, files bankruptcy. While the US Bankruptcy Code provides some relief in certain limited circumstances - such as where the supplier has a legitimate reclamation claim or where a portion of its claim is entitled to administrative priority - most suppliers often face the unhappy prospect of receiving little or nothing on account of their claims.

As difficult as those circumstances can be, the bad news often gets only worse when many months later the supplier receives a demand letter, or even a summons and complaint, from the bankrupt company, or a bankruptcy trustee, which seeks the return of all so-called "preference" payments; that is, all payments which the supplier received from the customer within the 90-day period before the customer filed bankruptcy. The demand letter typically includes a "generous" settlement proposal which affords the supplier the opportunity to settle the preference claim for 80% or 90% of the amount allegedly due. A surprising number of suppliers which receive such demands, unfamiliar with the details of the Bankruptcy Code or wary of incurring legal fees, or both, agree to settle preference claims on that basis.

Twofold objective

The purpose of this article is to two-fold. First, to suggest ways in which the supplier can minimize and even eliminate entirely the amount necessary to settle a preference claim. Second, to recommend ways in which the supplier can manage its customer accounts more effectively so if a customer files bankruptcy one day, the bankrupt company or the trustee will have no basis upon which even to assert a preference claim in the first place.

As to the first point, it is important to recognize that many bankrupt companies or bankruptcy trustees do not carefully analyze the merits of the preference claim when the initial demand for repayment is made. Rather, they simply assume - as the Bankruptcy Code does - that all payments made to creditors during the 90-day preference period are preferential and they purposely ignore the important defenses available to the supplier under the Bankruptcy Code.

Those defenses include circumstances where the payments by the customer: (1) are in the "ordinary course of business", (2) are intended as part of a "contemporaneous exchange" of value between the supplier and the customer, and (3) are followed by "new value" provided by the supplier to the customer. These defenses, alone or in combination, often are available to suppliers and can reduce significantly the preference claim or, in the ideal circumstances, eliminate it entirely.

Ordinary course of business: The ordinary course of business defense under the Bankruptcy Code, in sum, provides that if the payments made by the customer during the 90-day preference period are consistent with the customer's payment history prior to that 90-day period, then the otherwise preferential payments are deemed to be in the ordinary course of business and, therefore, immune from recoupment by the bankrupt company or the trustee. There often is room for debate as to whether certain payment patterns are consistent with each other and bankruptcy judges have identified the following as examples of what is not in the ordinary course of business:

- Payments received quicker than normal.
- Payment received on unusually old invoices.
- Payments made with a large payment paying multiple invoices when normally invoices are paid with one check paying one invoice.
- Payments made in an unusual way, i.e.,wires instead of checks.

Contemporaneous exchange: The Bankruptcy Code also protects payments which are made by the customer as part of a so-called contemporaneous exchange of value. The most common example of a contemporaneous exchange is a COD payment. In order words, where the customer is required to pay for a shipment immediately upon its arrival, that payments is not considered to be a preferential payment. For related reasons, payments by the customer in advance of delivery also are protected from recoupment by the bankrupt company or the trustee. In cases, the underlying theory and justification is that the bankruptcy estate has not been depleted to the benefit of a particular supplier because the supplier's delivery has added value to the estate which presumably is equal to the customer's payment. If at all possible, a supplier should insist on a cashier's check, or other form of immediate payment, since if the customer stops payment on its check, or if the check bounces, then the payment will be lost.

New value: Another defense available to a supplier is the so-called "new value" defense. That defense, in sum, provides that if the supplier, after receiving an otherwise preferential payment, subsequently makes a shipment to the bankrupt company on credit, then the value of that shipment automatically reduces whatever preference exposure the supplier may have had prior to that shipment. Although there are legal technicalities has to exactly how and when the new value shipments should be credited, that defense can be, depending on the circumstances, very useful to a supplier.

While all these defenses can be extremely helpful, the supplier nonetheless has the burden of proof since, as noted previously, the Bankruptcy Code assumes all payments made during the preference period must be returned to the bankruptcy estate unless the supplier can prove otherwise[1]. For that reason, it typically is very helpful for the supplier to consult experienced bankruptcy counsel and, in cases where they may be hundreds or even thousands of payments which must be analyzed, experienced financial advisors who can use sophisticated accounting and statistical techniques to present the supplier's defenses in the best possible light. Although that will entail some cost to the supplier, that legal and financial analyses and advice frequently saves the supplier more - and often far more - than the cost involved.

Critical vendor status

Apart from the defenses available to a supplier under the Bankruptcy Code, suppliers which are designated as Critical Vendors typical need not worry about future preference claims. Although the Bankruptcy Code never once mentions "critical vendors," over the years bankruptcy judges have exercised their considerable equitable powers to permit a bankrupt company to pay certain key suppliers all or a substantial portion of their outstanding pre-petition debts in exchange for the suppliers' agreement to continue to supply goods or services, on credit, to the bankrupt company. Those special payment arrangements typically also include a commitment by the bankrupt company that it will not assert a preference claim against the supplier. While Critical Vendor status obviously provides a significant benefit to the supplier, the terms of the critical vendor agreement should be examined carefully by a bankruptcy attorney since, among other things, protection from preference claims still must be specified in the Critical Vendor agreement, or else payments still can be recouped form the supplier. It also is important to keep in mind that while a supplier can lobby the bankrupt company to be designated a Critical Vendor, the final decision - subject to the approval of the bankruptcy court - rests with the bankrupt company. A disappointed supplier cannot independently petition the bankruptcy court for Critical Vendor status.

While effective damage control after a preference claim has been asserted can save a supplier a substantial amount of money, these best defense against a preference claim is for the supplier to manage its account with its customer - especially a customer which is or may be in financial distress - in such a way that even an aggressive bankrupt company or trustee will find nothing about which to complain. And, while a supplier usually cannot control how or when it receives payment, there are several things that can be done to limit exposure. These actions fall into four categories. The first is providing key personnel and the sales team with an understanding of the basics of bankruptcy preferences. The second involves keeping the appropriate records that can be used to mount an accurate defense. The third includes setting up payment expectations and general surveillance of customer status, and the final category includes making preference mitigation a formal procedure in customer relations. The following is a discussion of the elements of these action categories.

Training in the basics of bankruptcy preferences

Providing a copy of this article is a good start for the basics, and there are numerous articles on the internet. A company might also find it beneficial to seek the help of professionals in the field to assist with training and the other efforts. The goals of the training are to provide key individuals with:

- Information describing technical elements of the bankruptcy preferences code.
- Awareness of the potential for loss from preference actions even if a company is being paid.
- A direction to alert management regarding customers having financial difficulties.
- A preference mitigation program.

Keeping appropriate records

A supplier, as a potential defendant, does not want to rely on the debtor, or plaintiff, in a preference action to provide the relevant financial data. The key information to record is as follows:

- The date that the customer received the good or service. If the date of the invoice does not coincide with the date of the transfer it is imperative that both dates be recorded. If a company is a service provider, the dates of the actual services should be recorded.
- The date of the receipt, or log in, of the payment. This date is critical in the development of the defense.
- The payment numbers and the invoice numbers that are the subject of the payment as stated in the remittance advice of the payment. Mounting a defense could be difficult when payment numbers are not linked to the invoice numbers.
- The method of payment.
- The entity that made the payment.

Preference exposure mitigation general application

A supplier of goods or services should take advantage of the influence it has regarding how it gets paid during the good times. This is the time to set up reasonable payment expectations and reduce or eliminate any practice of letting payments linger. Also, prompt payments are very good with respect to steady cash flow, but extremely tight payment terms can also be troublesome to maintain when customer falls on troubled times. Other than being a time to set standards, this is also the time to identify customers that might be on the road to bankruptcy. While the process of making such a determination might be a just matter of professional judgment, the actual assignment of trouble status should be formalized. A few of the ways to recognize a troubled customer are as follows:

- Noticing a change in the ordinary course of payments, as described above.
- Obtaining feedback from the customer employees that payments might be delayed.
- Reviewing industry information regarding troubled companies.
- Precipitating direct communication with the customer regarding their financial status.
- Noticing a cut back in business or an announcement of a manpower cut.

Preference exposure mitigation addressing troubled companies

Once a customer is identified as being financially troubled, discussion of the customer status should be made a part of management meetings. The following includes some items to consider:

- Management should make a specific assignment of responsibility for the target customer.
- The responsible person, the "Leader," should prepare an analysis to characterize the customer's payment practice over the past two years. This will give an indication as to if the customer is paying in or out of the ordinary course of business.
- The Leader should calculate the running three month total of business for the customer to demonstrate the maximum preference exposure.

- A Leader should initiate a discussion with a high level customer official to stress the importance of maintaining a consistent payment trend.
- This is not the time to issue an ultimatum or change the payment terms. Records of such threats can be used by the plaintiff in a preference action to demonstrate that all such payments are out of the ordinary course of business.
- Certainly, a company should never turn down a payment, but it should recognize that payments are rationed during troubled financial circumstances. Only after current business is paid should a company insist that old business payments be caught up.
- It is important to communicate to the customer that it must identify invoices when payments are made. The receipt of a payment for round figures with no remittance advice will certainly stand out as a possible preference.
- The one sure method for a supplier to avoid having to return a payment is to get receive payment in advance of the delivery of its goods. If a company has the leverage to do this, it should pursue this strategy.
- The one sure way to have to give money back is to receive a payment from an unaffiliated third party if that party happens to go into bankruptcy.
- The defense of new value should be strategically pursued so that a supplier plans the optimum sequence the supply of new goods.

Conclusions

Preference claims frequently provoke outrage on the part of suppliers. After all, the supplier patiently worked with a customer in financial distress, often tolerating late payments, in the hope of helping the customer survive. When the customer files bankruptcy, not only is the supplier's open account often unlikely to be paid, the bankrupt company or the trustee then adds insult to injury by demanding the supplier repay the amounts which the customer paid during the 90-day period leading up to the bankruptcy filing. Given how unpleasant preference claims can be, suppliers should make every effort to manage their customer accounts to minimize or, if possible, eliminate the supplier's preference exposure. To the extent those efforts are not entirely successful, then the supplier should make good use of the defenses available under the Bankruptcy Code, and experienced professionals, to reduce
any amount which may be necessary to settle a preference claim.

Michael L. Newsom *is the president of Qorval Creditor Recover Services, a financial advisory firm specializing in bankruptcy matters and creditors' rights. www.Qorval.com;* ***Louis F. Solimine*** *is a partner with the Law Firm of Thompson Hine, practicing in the areas of business restructuring, creditors' rights & bankruptcy. www.ThompsonHine.com*

1. The Bankruptcy Code also generally protects payments by a customer to a secured creditor; that is, to a supplier which retains a security interest in the goods until payment is received. Furthermore, payments made to a supplier under a letter of credit also are protected since the payments are from the letter of credit bank, not the customer. Those sorts of credit support, however, usually are not available to a typical trade vendor, particularly from a customer in financial straits.