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Supplier Strategies for the Financially Distressed Buyer: Part II

In Part I of this article in the June issue of *Business Credit*, we described strategies to limit risk by selling goods on a secured basis or through a consignment arrangement. Part II of this article discusses shortening credit terms, strategies for an insolvent buyer and how different credit strategies may impact the seller's preference liability in a subsequent bankruptcy filing.

Shortened Credit Terms

Depending on their circumstances, buyers may be unable to buy goods on a secured basis or through a consignment arrangement as discussed in Part I. In that case, the seller should consider shortening its unsecured credit terms with a distressed buyer. Cash in advance (CIA) or cash on delivery (COD) is the safest option for the seller, both for credit risk and preference risk. However, many struggling customers will not have the cash flow to pay on such terms. In that case, the seller can continue to extend credit but shorten the period for payment and amount of credit. The process to put in place for tightened credit terms will depend on whether the supplier and customer have a contract and the terms of such contract. If the parties' contract governs credit terms for accepted orders, the seller should explore the ability to reject new orders until credit terms are renegotiated. In the absence of such contract, a seller of goods may be able to unilaterally impose new credit terms.[1]

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When shortening credit terms, a seller of goods should consider requiring payment within 20 days of the buyer's receipt of the goods. By doing so, the seller limits its risk in the event of a bankruptcy because the Bankruptcy Code provides that amounts owed for goods received by the debtor within 20 days of the filing are entitled to administrative expense priority.[2] These claims are entitled to payment before any other unsecured claims and must be paid in full to confirm a plan of reorganization.[3]

The Insolvent Buyer of Goods

A seller continuing to sell on unsecured credit terms may learn that it has pending orders to an insolvent buyer. If that occurs, Article 2 of the Uniform Commercial Code (UCC) provides a seller of goods with remedies to avoid making a bad situation worse. The seller can refuse to deliver goods to an insolvent buyer, except for cash payment for all the goods previously delivered under the parties' contract.[4] If the goods have been placed in the possession of a carrier or other bailee by the time the buyer's insolvency is discovered, the seller can direct that the goods be returned to it.[5] Finally, a seller who discovers that a buyer received goods on credit while insolvent, can reclaim the goods by making demand within 10 days of receipt.[6]

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The right to exercise such remedies is based on the buyer's insolvency, which is measured in any of three ways: (i) if the buyer has generally ceased paying its debts in the ordinary course of business (unless the subject of a *bona fide* dispute); (ii) the buyer is unable to pay its debts as they become due; or (iii) the buyer's liabilities exceed its assets.[7] Accordingly, a seller concerned about a buyer's solvency should closely review its credit reports and public filings, if any, or consider requesting certified financial statements before continuing to ship.

A Few Words about Preferential Transfers

The Bankruptcy Code provides a debtor or its trustee with the right to recover payments made by the debtor to a creditor in the 90 days before its bankruptcy filing. The code applies if those payments were made on account of a debt that it owed to the creditor at the time the transfer was made and allowed the creditor to receive more than it would in a Chapter 7 liquidation.[8] The concept is to allow the debtor to recover transfers that may have "preferred" certain creditors over others, and then redistribute those amounts to all creditors more equitably. Because pursuing some of the strategies discussed here and in Part I of this article may impact the seller's preference liability risk, we briefly highlight the interplay between some of those credit strategies and the seller's preference risk.

Shortened Credit Terms

There is a strong argument that COD and CIA payments are not subject to recovery as preferences. Generally, if there is no obligation to pay until the good is delivered, COD or CIA payments will not fall within the definition of a preference because the payment would be made before there was a debt owed by the buyer.[9]

On the other hand, shortening credit terms in the weeks and months before a bankruptcy filing may weaken the seller's ordinary course of business defense. The Bankruptcy Code provides that payments made in the ordinary course of business of the debtor and the transferee, which pay debts incurred in the ordinary course of parties' business, are exempt from recovery as preferences.[10] Courts evaluate many factors to determine whether payments were made in the ordinary course of business, including the timing of payments. If the allegedly preferential payments are made much quicker than the parties' prior course of dealing, this will often weigh against a finding that the payments were made in the ordinary course of business.

The tail should not wag the dog, though. A seller's credit strategies should not be overly governed by preference liability risk because such liability is contingent on a bankruptcy filing and prosecution of such claims. Even if a preference claim is asserted, they are often resolved at a discount. As Alfred, Lord Tennyson would have said, had he been a bankruptcy lawyer, it is better to have been paid and risk a preference claim than never to have been paid at all.[11]

PMSI[12]

Payments received to pay a fully secured obligation will not be recoverable as preferences. A preferential transfer must be one in which the creditor received more than it would have received had the debtor been liquidated in Chapter 7.[13] Thus, payments received on account of a properly perfected purchase money security interest in the goods sold should not be recoverable as preferences.[14]

Conclusion

As discussed above and in Part I of this article, it is possible to take concrete steps to reduce a seller's credit risk from a distressed customer. However, the right approach will be driven by many factors, such as the relationship with the customer, the customer's particular financial circumstances, the terms of the parties' agreement, if any, and the governing law. Once a credit strategy is decided upon, the seller should ensure that it is properly effectuated under the governing law, and remain alert to changes in the buyer's financial condition that may warrant additional protections.

1. *See* Uniform Commercial Code ("UCC") § 2-310 (providing default rule for sale of goods that payment is due upon delivery, unless altered by agreement of parties).

2. 11 U.S.C. § 503(b)(9). A recent case held that the 20-day period is measured from the date that the debtor takes actual, physical receipt of the goods. *In re World Imports, Ltd.,* 862 F.3d 338, 346 (3d Cir. 2017). Moreover, this relief is solely afforded to the sale of "goods." While the Bankruptcy Code does not define the term "goods," courts have used the UCC's definition. *See In re Great Atl. & Pac. Tea Co., Inc.,* 498 B.R. 19, 25 (S.D.N.Y. 2013). The UCC defines "goods" to include "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action…." UCC § 2-105(1).

3. 11 U.S.C. § 1129(a)(9)(A).

4. UCC § 2-702(1).

5. UCC § 2-705. If the buyer files bankruptcy after the order is accepted but before the buyer received the goods, case law suggests that the seller can stop delivery of the goods, without violating the automatic stay that arises upon a bankruptcy filing. *In re Nat'l Sugar Ref. Co.,* 27 B.R. 565, 573 (S.D.N.Y. 1983).

6. UCC § 2-702(2). The 10-day window to make demand is not applicable if the buyer has misrepresented its solvency to the seller in writing in the three months before delivery. *Id.*

7. UCC § 1-201(23); 11 U.S.C. § 101(32).

8. 11 U.S.C. § 547(b).

9. *See* 11 U.S.C. § 547(b)(2). Alternatively, these payments may come within the affirmative defense as a contemporaneous exchange for value. 11 U.S.C. § 547(c)(1); *see In re Chez Foley, Inc.,* 211 B.R. 25, 27 (Bankr. D. Minn. 1997) (trustee acknowledging that COD payments were subject to contemporaneous exchange defense).

10. 11 U.S.C. § 547(c)(2).

11. "Tis better to have loved and lost than never to have loved at all." A. L. Tennyson, *In Memoriam A.H.H.*, 27, st.4 (1850).

12. *See Business Credit* (June 2018) at p. 34, for a discussion of purchase money security interests.

13. *See generally 5 Collier on Bankruptcy* (16th Ed.) ¶ 547.03[7].

14. The Bankruptcy Code also shields the avoidance of the grant of a PMSI during the preference period under certain circumstances. *See* 11 U.S.C. § 547(c)(3). There should be a similar defense to preference recovery for payments on account of the sale of consigned goods if the consignor has a properly perfected PMSI in the underlying goods.

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