To Supply or Not Supply Goods: Credit Risks and Remedies in Uncertain Times

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In ordinary times, a supplier of goods looks to customer-specific underwriting considerations to weigh the benefit of extending credit to a new or existing customer against the risk that the customer will fail to pay for the goods or services supplied. These are not ordinary times.

The COVID-19 pandemic that has yet to release its grip on nations around the globe has shifted the underwriting analysis from customer-specific financial review to global health and macroeconomic analyses that are outside of the comfort zone of most company credit managers. Those credit managers have seen their customers in long-thriving industries (e.g., travel, hospitality, entertainment) face a sharp and sudden loss of revenue. Major economic drivers (e.g., automotive and retail) that depend on what the pre-pandemic world referred to as the global economy are dealing with supply-chain disruptions. Suppliers must adapt in real time to ensure that credit decisions made today do not result in worthless receivables potentially discharged in bankruptcy tomorrow.

That analysis at least starts with evaluating current business relationships and terms to determine an appropriate strategy to reduce the risk of loss and litigation, while also considering whether to support the customer through these challenging times.

The following are some important considerations when making any supply or credit decisions.

Am I Obligated to Ship?

A supplier selling goods on credit should first understand whether and under what circumstances it is required to deliver product to a customer before withholding that product out of concern for nonpayment. This inquiry largely depends on whether

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the supplier and customer are parties to a contract governing their relationship in the long term, the terms of that contract and a calculation of whether the likely assessment of damages for a breach exceed the financial risk of performance.

In certain industries, such as automotive, tier-one manufacturers insist on long-term contracts that require the supplier to sell a product in quantities ordered by the customer for the duration of a specific program. These requirements contracts, in the simplest sense, bind the supplier to the relationship for the defined term and are typically drafted to protect the buyer in the event of seller insolvency, but not vice versa. A requirements buyer will contract for the ability to recover consequential damages flowing from the failure of a supplier to meet the delineated requirements of the buyer, amounts that could include not only the cost of replacement product but also lost revenue. Withholding shipments under this type of arrangement, therefore, subjects the supplier to financial risk beyond the increased costs the buyer incurs in obtaining substitute performance.

Any writings that contain the terms governing the parties' relationship should be reviewed at the time the supplier is considering whether (or not) to make delivery of product on credit to assess the ramifications of a refusal to ship. Particular attention to the purchaser's obligations is warranted to determine whether any material breaches by the purchaser justifying contract termination are present. Outside of a requirements contract, the ability to refuse to ship or to exit the relationship out of concern for the customer's solvency without threat of litigation may be more defined in the agreement or subject to applicable state law concepts.

What Are My Uniform Commercial Code (UCC) Remedies—Prior to Default?

To the extent that the supplier is a seller of goods,[1] Article 2 of the UCC provides certain remedies to suppliers that are concerned with ability of a customer to pay for a sale on credit. For instance, Article 2-609 provides that if a seller has reasonable grounds for insecurity with respect to the performance of a buyer, the seller may issue a writing demanding adequate assurance of due performance. Until that assurance is received, which could include a certified financial statement demonstrating solvency or a letter of credit, the supplier may suspend performance. *This is a powerful right enabling a seller of goods to reevaluate the credit line to be extended to a buyer.*

If a seller discovers a buyer to be insolvent after shipment, the supplier has the right under Article 2-702 to stop goods in transit, or if the goods have been delivered, to seek to reclaim the goods within 10 days of delivery with the latter rights subject to the rights of a good-faith purchaser. The ability to reclaim goods that are in possession of the customer, though, is often precluded when the customer has granted a lien on its inventory to a pre-existing lender.

What Are My Remedies After Payment Default and Termination?

Once a sale under a supply or requirements contract has occurred and the buyer has failed to make payment within the required invoice or contract terms, the breach by the buyer provides the seller with a variety of contractual or state law remedies. In this instance, the supplier typically holds the right to terminate the parties' business relationship in its entirety to the extent the breach is material and is not cured within a reasonable time or within the cure period delineated by agreement. Termination, like refusal to ship, also comes with consequences. Again, suppliers should first determine that any termination notice complies with the contract and applicable state law.

A supplier may be required to resort to litigation to collect the debt and otherwise exercise its remedies as creditor, perhaps racing to the courthouse sooner rather than later to beat other suppliers in recovery from the customer's limited resources. To the extent that the supplier desires to be relieved of the obligation to sell to a particular customer teetering on the brink of insolvency, speed is also at a premium to ensure that contract termination is effective prior to the date the customer files a petition for Chapter 7 or Chapter 11 bankruptcy relief. At that point, the supplier's state law rights become subject to the U.S. Bankruptcy Code and contract termination and collection efforts come to a screeching halt.

What Are My Rights If a Customer Files a Bankruptcy Case?

Once a company referred to as the debtor or debtor-in-possession (DIP) files a bankruptcy case, several provisions of the Bankruptcy Code become effective that are of consequence to a creditor of, or supplier to, the debtor. First, the automatic stay arises, which prevents a supplier from taking any action—including issuing invoices for shipments made during the pre-bankruptcy period—to collect a debt that arose prior to the filing or petition date. Prepetition litigation is subject to the automatic stay and is essentially paused, with any claims for amounts due dealt with in the Bankruptcy Court.

The automatic stay protects the broadly defined "property of the estate" of the debtor from collection activity. Among the debtor's property are its prepetition contracts, rendering any effort (with certain limited exceptions) by a supplier to terminate a contract without court permission a violation of the automatic stay that can expose the supplier to sanctions. A difficult corollary to these statutory concepts is that a supplier to a prepetition contract must generally continue to perform its obligations during the bankruptcy case while the debtor is relieved from its own obligations. While the supplier has remedies in the event it believes that it will be subject to substantial risk of loss should it comply with its own obligations, those remedies can only be exercised through procedures invoked in the Bankruptcy Court.

A supplier that is not under contract with a debtor is not obligated to continue accepting purchase orders after a bankruptcy case is filed.

Contracts that were properly terminated before the debtor filed its bankruptcy case, and those contracts that expire by their terms after the petition date, are not property of the estate within the jurisdiction of the Bankruptcy Court, demonstrating the benefits of terminating at the first available pre-bankruptcy opportunity following a customer's breach. A supplier that is not under contract with a debtor is not obligated to continue accepting purchase orders after a bankruptcy case is filed. The supplier's effort to collect a receivable owed under that terminated contract, though, is stayed.

As a general proposition, a supplier that sold to a debtor on credit without security is a general unsecured creditor, paid to the extent that secured claims and unsecured claims with a higher statutorily established priority are satisfied in full. In a Chapter 11, general unsecured claims are not paid until confirmation of a plan of reorganization. Under a plan, the distribution to general unsecured claimants must not be less than what the claimants would receive if the debtor's assets were liquidated in Chapter 7. Particularly when the debtor's primary asset is goodwill or unfinished goods, this is not a high benchmark.

A supplier may be required to resort to litigation to collect the debt.

All is not lost, however. The highest priority of payment in a business bankruptcy is slated for administrative claims allowed under Section 503(b) of the Bankruptcy Code. Under Section 503(b), administrative claims expressly include "the actual, necessary costs and expenses of preserving the estate," such as the cost of shipments delivered to the debtor that provided a benefit to the bankruptcy estate. In a successful Chapter 11 case, the holder of an administrative claim is almost certain to obtain full payment, since it is a requisite to plan confirmation that the debtor pay administrative claims in full. This right to payment provides the supplier to a debtor with a degree of reassurance that the risk of nonpayment during the pendency of a Chapter 11 case is low, particularly if the debtor has demonstrated that it has a committed funding source during that case.

In addition, sellers of goods receive an administrative claim under Section 503(b)(9) of the Bankruptcy Code for the "value of any goods [sold to a debtor in the ordinary course of business and] received by the debtor within 20 days before commencement of the case." As a result, a subset of pre-bankruptcy claims that would otherwise have been classified as general unsecured claims at the bottom of the distribution waterfall are treated as first priority administrative claims which must be paid upon confirmation of a plan. A Section 503(b)(9) claim, though, must be properly and timely asserted in order to be effective, or the underlying claim will be relegated to the pool for general unsecured claims.

In the event that the debtor defaults on its payment obligations during the post-petition period, the supplier is not without remedies. A supplier (or service provider) may request that the Bankruptcy Court provide it adequate protection of its accruing post-petition claim in some form, or even for leave to terminate the contract on account of the debtor's unwillingness or inability to pay for the goods (or services) it expects the supplier to deliver. To the extent that the debtor desires to continue its relationship with a supplier under a contract still executory at the time of the bankruptcy filing, it must formally assume that contract under Section 365 of the Bankruptcy Code prior to the conclusion of its Chapter 11 case, an act that is conditioned on curing both prepetition and post-petition arrears. A supplier selling without a contract may also be among the select group that the debtor, with court approval, identifies as critical vendors, to be paid for prepetition deliveries in exchange for an undertaking to continue shipping during the course of the Chapter 11 case.

The outcome of any of these efforts will depend, in large part, on the nature of the business relationship, the terms of any contracts in place and the financial condition of the respective debtor. Given that many of these variables are under the control of the supplier *in the present*, the stronger the protections built in and the leverage held by the supplier before the bankruptcy case is commenced, the better the ultimate outcome.

1 Defined in U.C.C. § 2-105 as "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. 'Goods' also includes the unborn young of animals and growing crops and other identified things attached to realty as described in the section on goods to be severed from realty."