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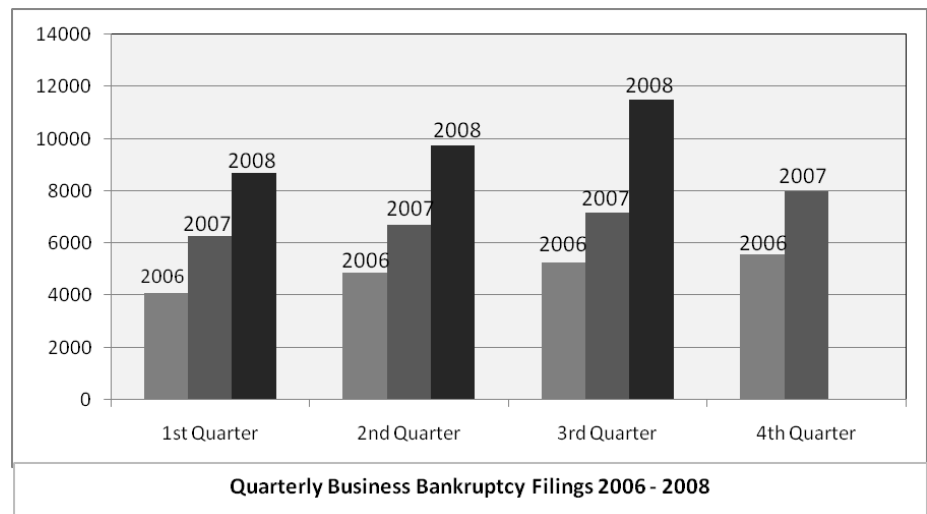
Protecting Yourself Against Loss If Your Customers File for Bankruptcy

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Chapter 11 bankruptcy filings have tripled since the first quarter of 2006, and the near future doesn't promise to get appreciably better.

Consequently, even companies with the resources to get through the current economic crisis should take steps to protect themselves against lost revenues when their customers do not fare as well. Such proactive measures to manage and even reduce credit risk assure that your company will emerge from the current recession as strong, if not stronger, than before.



Risks? What risks?

If a customer to whom you have extended credit files for Chapter 11 bankruptcy protection, you risk losing most of what you are owed -- even having to return payments received in the period prior to the bankruptcy filing.

Here are a few of the most common issues:

Large discount on unsecured claims

If a customer who owes you money files for bankruptcy protection, as a creditor you will typically receive only a small fraction of what you are owed -- often as little as 10%. This means that you stand to lose approximately 90% of your receivable. And, to make matters even worse, the fractional payment will not be paid until your customer's plan of reorganization has been approved, which means you may have to wait 12-24 months or possibly longer for your money.



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Potential preference lawsuit

In addition to losing most of your receivable, if your customer files a Chapter 11 bankruptcy petition, you may even have to return certain payments you received prior to the petition. The Bankruptcy Code allows such a customer to "recover" any payments made to a supplier within the 90-day period before the date of filing the bankruptcy petition. Such payments are commonly referred to as "preference payments." The Bankruptcy Code does provide for certain exceptions to your bankrupt customer's payment recovery right. Later in this newsletter, we will discuss those exceptions and ways you can manage your customer credit to assure you qualify.

Loss of ability to terminate contract with customer

If you have a long-term supply agreement with your bankrupt customer, you may not be able to terminate it. Even if your customer owes you money for supplies delivered and invoiced prior to the filing, as long as the customer remains current on the contract for post-bankruptcy petition invoices, you may still be required to honor the contract.

Steps that you can take to minimize your credit risk

Avoid long-term contracts with at-risk customers

Because of the potential inability to terminate a long-term contract with a customer who seeks bankruptcy protection, it may be advisable to enter into only month-to-month contracts with any customer who is potentially at-risk.

Structure contracts that qualify for administrative claims

Under the Bankruptcy Code, there is an allowance for "administrative" claims against a customer for the value of any goods received by the customer within 20 days before the filing of bankruptcy, as long as the goods have been sold in the ordinary course of business. Thus, if one of your customers files for bankruptcy, you will have a right to a 100% payment for the value of goods received by the customer for the 20 days before the bankruptcy petition was filed.

To qualify you need to require 20-day payment terms, or cut off supply if payment is not received within 20 days. By adhering to this protocol you will qualify for 100% repayment of all invoices due for any goods delivered within the 20-day period before the bankruptcy petition.

Require a deposit

For customers who do not agree to the 20-day payment terms, you can require a deposit equal to the value of approximately 40-60 days of goods supplied. Each month thereafter, you can invoice the customer for the amount needed to replenish the deposit account. This, coupled with 100% administrative claim rights on goods supplied within 20 days, should nearly eliminate all credit risk.

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Purchase money security interests

The Bankruptcy Code does not allow your customer to file a preference action for payments made prior to bankruptcy if you - the vendor - have a "security interest" in goods sold to the customer. To achieve this protection, the security interest must secure the value of future goods sold as of the signing of the security agreement. This does not include value of past goods sold.

To take advantage of this protection, you should ask your financially distressed customers to sign a "purchase money security interest" agreement. This agreement gives you a security interest in all products sold to the customer, as well as all proceeds from the sale of such products, if applicable. If the customer agrees to sign a security agreement, you must give appropriate notice to other secured creditors. Most secured creditors will not formally object to your agreement, which means you can avoid a preference lawsuit; retain the option to take back the products from the customer for failure to pay; and/or insist on payment in full if the customer wants to keep possession of the products.

After the bankruptcy filing

If the worst has happened and your customer has filed for bankruptcy before you have instituted any of these protections, here are a few situations you may experience and what, if anything, you can do to minimize your loss.

Critical vendor status

After a bankruptcy filing, the business owner has the option to designate certain suppliers as "critical vendors." If your bankrupt customer designates you as a "critical vendor," you will be required to agree to maintain customary supply terms and to continue to supply the customer. In exchange, the customer must agree to pay a negotiated higher portion (up to 100%) of the pre-petition debt. Unfortunately, you have little or no ability to ensure that your bankrupt customer will designate you as a critical vendor. Thus, your safest course of action to protect yourself against loss is to limit your customer's inventory of your products prior to a bankruptcy filing. BEWARE: A slow-pay customer who suddenly orders an unusually large volume may be a signal that the customer is stocking up in anticipation of a Chapter 11 filing.

If the customer is in dire need of your products, has a low inventory, and cannot readily obtain the items from another supplier, you have a better chance of being designated as a "critical vendor."

Post-petition defense: How to continue doing business with a customer who has filed for bankruptcy

The customer will not succeed on a preference action if the transfer was intended by the customer and you to be a contemporaneous exchange for new value given to the customer and the transfer was in fact a substantially contemporaneous exchange. Cash or a check are intended to be contemporaneous and if the cash or check is presented for payment in the normal course of business, then this generally qualifies as an exception.

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Although potentially unworkable for larger customers, this option could be useful for smaller customers, particularly in light of today's economic climate.

Additionally, the customer will not be able to institute a successful preference action if the payment of a debt was incurred by the customer in the ordinary course of business or made according to ordinary business terms. It would be your burden to offer evidence that the payment was within the ordinary course of business in the relevant industry. Most preference lawsuits are resolved by a settlement involving partial return of a payment.

Don't delay. Protect yourself now.

We have discussed only the most prevalent issues that arise when dealing with a financially distressed customer. In an economic downturn, it is important to assess your own credit risk so that you are not blindsided by a customer who files for bankruptcy protection. If you have any questions or would like to discuss assessing and managing your credit risk, contact one of the experienced lawyers at Metz Lewis for help. Our Corporate Law Division is dedicated to meeting the specific needs of businesses.

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