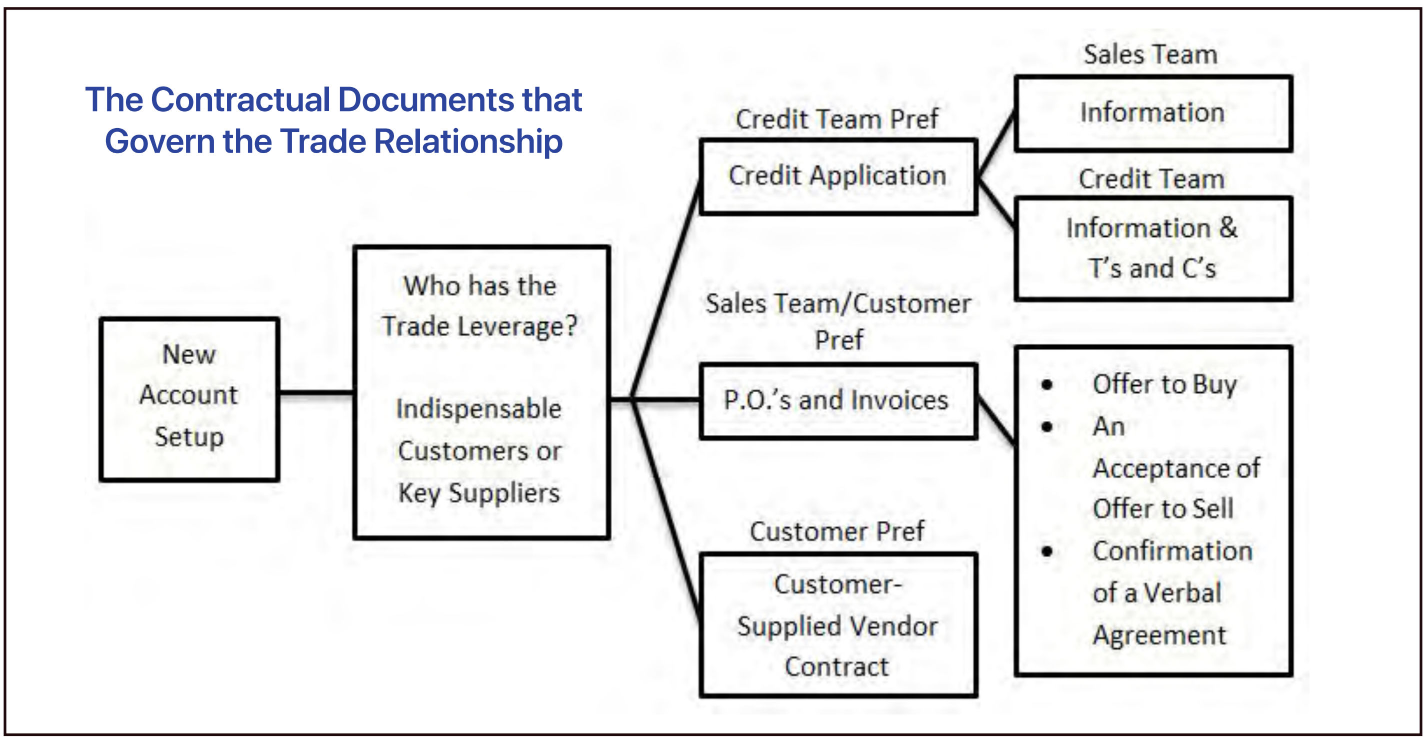
Avoiding a Customer Challenge – Your Team Has Identified and Verified the Heightened Credit Risk, Even Insolvency Risk, with a Key Customer: Steps to Move the Customer from Credit Terms to Cash

By Scott Blakeley
Blakeley LLP

Suppliers generally provide goods to consumers via a purchase order ("PO") or supply contract. A PO based supply arrangement is only contractually binding until the order is fulfilled usually, there is no commitment or duty to continue selling after fulfillment of the PO. This type of relationship is beneficial to a supplier because there are few negotiations, and the supplier can generally get the terms it wants. On the other hand, a supply contract based supply arrangement involves a contractual obligation to abide by and fulfill the terms of the supply contract for a specific amount of time. In contrast to the PO approach, the supply contract approach is more involved and contains substantive negotiations as both parties would be binding themselves for a period of time.

Sears Roebuck and Company ("Sears"), a big box retailer with over 1,000 locations, relies heavily on supply contracts to ensure consistent inventory for its consumers. With rising speculation of Sears' financial peril, reflected by a 50% decline in its stock price since last summer and a planned closure of over 200 stores since January, suppliers have started becoming nervous about getting paid. Although suppliers were nervous, many felt powerless because they were bound by their supply contracts; however, when Sears issued a "going concern" disclosure an official warning that the company may run out of money within the year in its annual report, filed March 21, 2017, some suppliers believed they had enough leverage to repudiate the contract.



One supplier, One World Technologies Incorporated ("One World"), used this "going concern" disclosure to threaten to cancel its supply contract unless Sears agreed to more stringent financing terms. Another supplier, Ideal Industries ("Ideal"), decided to not renew its supply contract with Sears. Moreover, because

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of the “going concern” disclosure, Ideal reneged on a contractual provision which required it to provide Transition Assistance to Sears for 6 months after expiration of the contract.

Credit Risk

When entering either arrangement on credit terms, a supplier must be cognizant of the inherent credit risk and remain informed of any additional credit risk that could jeopardize its position. To monitor additional credit risk, a supplier can turn to customer financials, data analytics, and social media. In addition, suppliers should also take note of any changes to communication patters or changes in management as potential indicators of an unstable company. In order to manage and minimize the impact of credit risk, a supplier must (1) identify the credit risk flags; (2) validate the risk flags; and (3) act on the information to preserve the credit value and mitigate loss.

The complexity of identifying credit risk varies greatly when dealing with a public company as opposed to a private company. Identifying credit risk in a public company customer is much easier as they are required to make financial disclosures on an annual and quarterly basis—these financials can be found on the Securities and Exchange Commission (“SEC”) website and can help suppliers analyze trends in the customers’ financial condition, which paints a picture of their customers’ financial future.

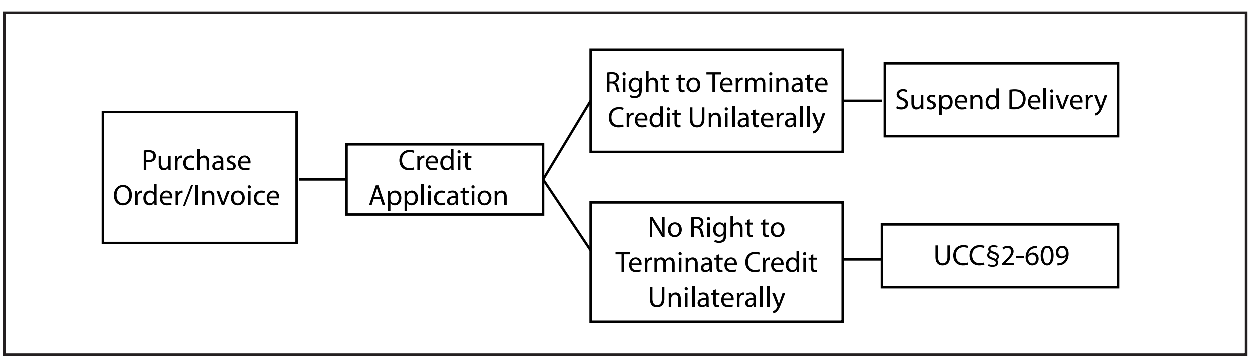
On the other hand, identifying credit risk when it comes to private companies is much harder as most private companies are not required to make their financial statements public. A supplier can request, or negotiate as part of the supply arrangement, for the customer to provide periodic financial statements; however, a potential customer is unlikely to oblige. In such instances, suppliers should implement creative solutions. Suppliers should be concerned with, amongst other things: (1) low traffic; (2) poor presentation; (3) departure of management; and (4) changes in communication or payment patterns.

Purchase Orders

Supplying customers on a PO basis generally carries less risk because the supplier does not have an obligation to continue supplying past the fulfilment of the PO Although there is no duty to continue and the risk factor is lower, suppliers should still be informed of the customer’s credit risk. Suppliers who supply goods are somewhat secured against concerns of non-payment through the Uniform Commercial Code (“UCC”) §2-609. UCC §2-609 outlines the right to adequate assurance of performance and allows an imposition of an obligation on each party to adequately assure the other party of its ability to perform. This requirement for assurance could be invoked if a party has reasonable concern about the other party’s ability to perform.

If the supplier develops a reasonable concern of nonpayment, then the supplier can require the customer to adequately assure the supplier of its ability to pay for the goods. Further, the supplier can hold off on performance until it receives such adequate assurance. If the customer is unable to adequately assure the supplier (within thirty days) of its ability to pay for the goods, the supplier would have the legal right to repudiate the contract. If the concern of nonpayment is in the future, the supplier can choose to not issue additional POs to that customer.

If the supplier has already shipped the goods prior to determining that there is credit risk, a supplier can still request adequate assurance under UCC §2-609. This request for assurance should be accompanied by contacting the shipping agent and stopping the delivery until such adequate assurances have been met. It is imperative that delivery be stopped when requesting adequate assurances because, in the event of nonpayment, once the goods are delivered, a supplier would have no recovery except suing for breach upon nonpayment at the expiration of the credit period. The legal theory supporting the demand for adequate assurance and stoppage of shipment would be the customer’s anticipatory breach.



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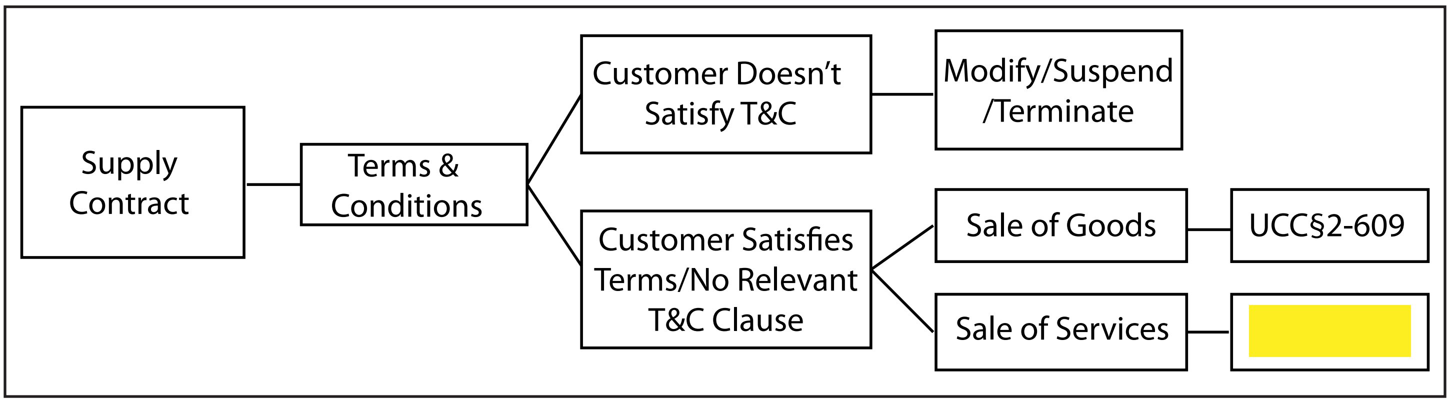
Alternatively, a supplier could also include clauses allowing it to unilaterally change credit terms to prepayment or payment on delivery (or its equivalent) if the supplier reasonably believes there is a high risk of nonpayment or insolvency. Although this contractual provision may dissuade some potential customers, it is the most ideal avenue for a PO based supply arrangement because a contractual provision is easier to enforce and defend in the court of law.

Supply Contracts

Although supply contracts generally carry more financial security for suppliers, they also carry additional risk because a supplier, upon getting wind of a customer's potential inability to pay, allows a supplier to terminate the contract if the customer fails to pay within the allocated credit terms. Moreover, a supplier can also negotiate for the unilateral right to terminate the credit terms. This clause would provide the supplier with the ability, upon adequate notice (preferably 60 days), to amend or terminate credit terms and require the customer to provide prepayment or payment at delivery. In addition, suppliers accepting payment via Letters of Credit should negotiate a credit rating trigger. This trigger would allow a supplier to terminate/amend the contract if the issuer's credit rating falls below a certain threshold. To take it a step further, suppliers can and should also try to negotiate for the right to terminate due to threatened insolvency.



would not be able to unilaterally terminate the contract—generally, because termination requires breach. Furthermore, unlike a PO based sale, where upon getting the slightest hint of potential financial struggles of a customer a supplier can refuse to further supply the customer, in a supply contract a supplier must continue supplying. A supplier could, with reasonable grounds for insecurity, ask for adequate assurances; however, the supplier would not be able to stop supplying if such adequate assurances are met.

This may not seem serious or very different from the PO method; however, when a supplier sells goods on 60-day credit terms and ships goods every two weeks, a supply contract, with a company approaching insolvency, could mean losing revenue for 4 shipments. Although a request for adequate assurances can potentially mitigate this situation, a company approaching insolvency can satisfy the adequate assurances one day and become insolvent in the subsequent 60 days.

To shield itself from potential losses in such situations, a supplier should negotiate for a variety of default and termination clauses. The payment default clause is the most common and

Sears v One World Technologies

The impact of the "going concern" disclosure and the threat of nonpayment was so large that one supplier, One World, went so far as to demand changes to the supply agreement and even threatened to unilaterally cancel its contract with Sears. One World cited the lowered credit rating of Sears' financing arm which provided Letters of Credit for international shipments; however, the lack of a credit rating trigger likely rendered this concern unactionable.

Additionally, One World also cited to Sears' "going concern" disclosure stating that Sears believed it would not survive; therefore, in anticipation of the breach, One World should be able to modify or terminate the contract. Since One World did not negotiate for clauses authorizing modification/termination in light of threatened insolvency, One World likely does not have the contractual right to change the contract in light of Sears' "going concern" disclosure.

One World's threat to cancel its supply contract with Sears led to Sears filing a lawsuit in the Chancery Division of the Circuit Court of Cook County. The lawsuit asked for declaratory relief, stating that Sears has not breached its side of the

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supply contract. Since filing of the lawsuit, the two parties have reached an amicable solution; however, terms of the resolution have not been made public.

Sears v Ideal Industries

Amidst speculation of Sear's demise, another supplier, Ideal Industries, a key supplier of Craftsman tools for Sears, decided that it would not renew its supply contract with Sears. Sears and Ideal were in deep discussions to renew the supply contract which expired on April 28, 2016; however, after months of negotiations, and alleged assurances from Ideal that it would renew the contract, Ideal decided it was in its best interest to not renew the contract.

Even though Ideal allegedly led Sears to believe it wanted to renew the contract, Ideal retained the right to withdraw from negotiations and refuse to renew the contract. Sears is not disputing Ideal's right to not renew the contract; rather, Sears is bringing a lawsuit because their supply agreement required, upon termination or expiration, and at the request of Sears, for Ideal to provide Transition Assistance. Transition Assistance required Ideal to provide goods at the same terms for up to 6 months after expiration or termination of the contract. Ideal stopped providing Transition Assistance after one month and demanded Sears sign an agreement altering the terms if Sears wanted to keep getting supplies. Sears brought a lawsuit against Ideal to compel Ideal to provide Transition Assistance until it is contractually obligated to do so.

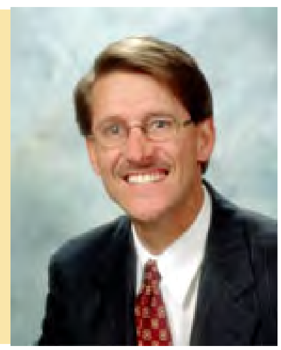
What Should Suppliers Do?

- Identify and verify initial credit risk prior to entering contract
  - If too high, do not provide credit, or negotiate for additional credit protections
- Identify additional credit risk throughout the contractual period
- Verify additional credit risk
- Act upon verified credit risk by evaluating exit strategies through contract or statute
  - Provide notification to customer ASAP to trigger any time requirements
- Include a unilateral right to modify or terminate credit terms upon 60 days notice
  - If unable to get such terms, request adequate assurances under UCC §2-609 if there is doubt about customers' financial future and ability to perform
- If receiving Letter of Credit, negotiate for a credit rating trigger which would authorize modification or termination of the credit terms if the credit rating dropped below a threshold

About the Author:

Scott Blakeley *is a principal with Blakeley LLP, where he practices creditors' rights and bankruptcy.*

Email at: seb@blakeleyllp.com



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