

Insolvent Customers, Supplier Pacts and the Antitrust Laws: Tips for the Credit Team to Maximize Transparency and Leverage Payments

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Industry groups are a unique forum for credit team members to share customer account information, including delinquent accounts. Customers that encounter financial difficulties, including cash flow constraints, often direct the payables team to slow or hold payments to their suppliers to improve their cash position.

Credit team members may call on industry group members with open balances to act together to try to collect past due invoices, even where the sales team and management still view the customer as trustworthy. The unifying interest of suppliers acting as a team, a supplier pact (SP), is to create leverage through a single voice, and also achieve the cost savings of one counsel representing the SP's interests, and possibly have the debtor pay these costs.

The insolvent customer has a number of out-of-court (OCW), in-court (IC) and liquidation choices, none of which provides for the automatic recognition of a creditor or supplier committee. And the customer's lender also has a meaningful voice in these choices, as well as having independent litigation alternatives.

What are the legal restrictions, including antitrust issues, for a credit team participating in an SP? Are there distinctions for the SP in dealing with past due invoices vs POs that suppliers of the SP are holding? Let's explore these questions.

Reading the Risk Flags: Surprise Insolvency or Anticipated?

The credit team's mission is to identify and evaluate credit risk. To that end, team members evaluate a number of information sources, including trade data from industry group members. Some customers, especially the closely held who refuse to share their financials with suppliers, may be better able to conceal their credit risk flags. There are instances where customers declare their insolvency, whether through an OCW, IC or liquidation, while suppliers are still current.

More commonly, the customer's payables team has been instructed to hold payment of supplier's invoices to improve their cash flow. This often prompts the supplier's credit team to rescure the customer to capture the higher credit risk and to evaluate a collection strategy, whether acting individually or through an SP.

The Dynamic of Insiders, Lenders and Personal Guaranties

With the small- and mid-sized customer, a lender conditions financing on the principals personally guarantying the financing. The importance of the guaranty shows itself where

the customer breaches the loan covenants as a result of the insolvency, and the lender calls on the guaranty. In this setting, a principal's focus is on maximizing the company's assets to ensure that the lender is paid in full and the guaranty is released. This strategy may include the principals ordering more inventory on terms from key suppliers if they perceive the lender is undersecured, and the inventory can be liquidated to pay down the lender.

Supplier Strategy with Insolvent Customer: Alone or a Team Approach

The supplier's decision on whether to join an SP or act independently is based on a number of factors. Perhaps the two key factors are whether the supplier's claim is unique, such as holding a PMSI or letter of credit, or if not unique, possesses the collection resources to act alone. Often, industry group members and suppliers share the same priority, face a similar contingent liability in the form of a preference risk and their collection costs are comparable. Likewise, an SP likely has greater leverage in forcing the debtor (or receiver or assignee) to turn over key financial and creditor information to create transparency for the causes of the insolvency. The SP can share legal and accounting costs, and may have the leverage to force the debtor (or assignee or receiver) to pay these costs. All of these factors support joining an SP.

Working against a supplier acting alone is the risk that, should the supplier get a litigation advantage or judgement over other suppliers, those suppliers may have a financial interest in filing an involuntary bankruptcy petition to unseat the single supplier's judgment and recovery.

Supplier Pacts: A Tool to Get Information and Strategy for Payment

The unifying theme of an SP is that suppliers are of the same priority, that the threat of litigation by an SP may create leverage in a negotiation with the customer, and that members of an SP seek to limit their collection costs by sharing those costs with similarly situated suppliers. The SP seeks to collect the open invoices of those in the SP, and may try to negotiate a junior lien on the customer's assets in their favor, depending on the customer's workout or liquidation choice. The success of an SP depends, in part, on the customer's OCW, IC or liquidation choice, discussed below.

The SP, as a unified voice of key suppliers, may be able to leverage the trade debt as a tool to get financial and payment information from the debtor, depending on its OCW, IC or liquidation choice. Such information requests may include:

- Current financials, including balance sheet listing secured claims;
- Recent valuations and appraisals;
- Where the business is being sold, the identity of the buyer (insider), valuation of assets, marketing efforts, and the extent of urgency to sell;
- Whether the insiders guaranteed the lender's debts;
- Whether insiders hold claims against the company;
- Payments to creditors within the past 90 days;
- Transfers to insiders within one year and possibly up to four years;
- Documents to support secured creditor's priority status;
- The requirement that the customer should pay for the cost for the SP to have an accountant review the information.

Industry Group Bylaws

Industry group members should confirm that their group bylaws do not restrict industry group members from acting through their membership to form an SP, whether the industry group member is initiating an SP or merely responding to request an SP. The general principle is that industry group bylaws do not prevent group members from joining together to attempt to collect a customer's debt.

Supplier Pact Bylaws

The members of an SP should adopt bylaws that expressly state the duties and restrictions on members. The agreement should expressly restrict members from discussing orders pending by the insolvent customer, and whether they will fulfill the order on terms.

Customer Out-of-Court Workout and Liquidation Choices

The strategy of the supplier or SP depends on the insolvent customer's OCW or liquidation choice. A key point with OCW and liquidations is that meaningful information sharing by the debtor (or the assignee or receiver) with suppliers is generally not required. Rather, a key strategy for an SP is creating transparency through meaningful information submissions. Those OCW and liquidation choices include:

(1) Close Shop

When the customer closes its doors, key suppliers may get notice of the closing. With web based customers, the customer may post a banner of its closing.

SP strategy: recover from assets that remain. SP may have difficulty getting information from the debtor, and may conduct their own asset search. Third party assets and claims that may be investigated:

- Claims against insiders, such as piercing the corporate veil, or breach of duty to creditor with insolvent customer;
- Any preferences or fraudulent conveyance claims;
- Lender liability claims: did the lender exercise under control?
- Are insiders creditors and may those claims be subordinated?

(2) Negotiated Settlement with Suppliers

The customer is unable to meet supplier debts when due, but seeks to continue to operate by shedding liabilities by agreement with its suppliers and creditors. The percentage discount a supplier is asked to discount is unique to each customer. The negotiated settlement may be on a supplier-by-supplier basis.

A variation of the negotiated settlement is where a customer proposes a discount with an entire class of creditors, commonly at 75%+ of the dollar amount of the class.

SP strategy: comparable to close the doors. Here, however, the customer continues to operate. The SP access to key financial and creditor information is necessary to make their own evaluation as to the merits of suppliers discounting their invoices. This is the foundation of SP support. The evaluation of the information may lead the SP to propose an alternative payout.

(3) Bulk Sale

The customer sells assets to a third party, often to the owners of the business. The sale is subject to existing liens. Bulk-sale laws require that the seller's suppliers be notified of the sale, commonly within 10 days, and provide them an opportunity to assert their claims and obtain payment before the sale occurs, but the sale is not supervised. Because of this shortfall to protect suppliers and other creditors, most states have repealed the bulk sale statute.

SP strategy: comparable to close the doors. Here, however, the customer has sold its assets, and the buyer of the customer's assets may have protections from successor liability claims if the bulk sale statute was complied with. The SP may investigate whether the buyer of the assets complied with the Bulk Sale statute.

(4) Assignment for the Benefit of Creditors

The customer elects a formal out-of-court liquidation where a third party, selected by the customer, takes title to the assets and liquidates them for the benefit of the creditors, and distributes them similar to the priorities under the Bankruptcy Code.

SP strategy: comparable to a bulk sale. Here, however, the customer has assigned its interest in the assets to a third party, an assignee, who is attempting to sell or has sold the customer's assets. Is the assignee recognized as trustworthy in the industry, appreciating that the customer's insiders hand pick this party? If the assignee does not cooperate with the SP's request for information, the members of the SP may be forced to file an involuntary bankruptcy petition to ensure full financial disclosure is met.

(5) In-Court Insolvency Proceedings - Chapter 11

The customer elects a formal court insolvency proceeding. The customer's exit strategy may be set when filing Chapter 11 with a planned sale of assets. Unlike the OCW

alternatives, the Bankruptcy Code mandates the debtor make a number of financial disclosures, such as budget, bankruptcy schedules and statement of financial affairs and monthly operating budget. These disclosures give protections to suppliers. Likewise, with a sale of assets strategy, the bankruptcy court commonly mandates a bidding requirement to try and attract the highest bid for the debtor's assets.

SP strategy: the Bankruptcy Code provides for a statutory creditors' committee in a Chapter 11. To the extent that a committee is not appointed, or the committee appointed does not fairly represent the interests of suppliers, then an SP may create value for the supplier class.

The Customer's Lender's Choices

The two most common out-of-court choices by the customer's lender are:

(1) Secured Creditor Sale

The secured creditor forecloses on its security interest encumbering the customer's assets. The secured creditor forces a sale of the assets, which can be private or by public auction. Like with a bulk sale, the insiders of the customer are often the buyer in a private sale. The secured creditor has the burden to show the sale was done in a commercially reasonable manner.

SP strategy: Comparable to a bulk sale. Here, however, the secured creditor has the burden to show the sale was done in a commercially reasonable manner. Further, the SP may question whether the secured creditor conspired to sell the assets to insiders that limits the sale price and therefore defrauds suppliers.

If the customer and secured creditor do not cooperate with the SP's request for information, the members of the SP may be forced to file an involuntary bankruptcy petition to ensure full financial disclosure is met. The SP should negotiate with the secured creditor to pay the expenses of the SP's counsel.

(2) Receivership

The secured creditor files a lawsuit to have a third party take control of the debtor's assets. The receiver's sole purpose is to pay the secured creditor. The receiver does not have a duty to maximize the customer's assets for the supplier class. The receiver may sell the customer as a going concern, or through a piece-meal auction. The receivership suit is dismissed when the secured creditor is paid.

SP strategy: comparable to an assignment for benefit of creditors. If the receiver and secured creditor do not cooperate with the SP's request for information, the members of the SP may be forced to file an involuntary bankruptcy petition to ensure full financial disclosure is met. The SP should negotiate with the secured creditor to pay the expenses of the SP's counsel.

Supplier Pact and Antitrust Overlay

The Sherman Act prohibits competitors, including industry group members, from agreeing to restrain trade. This fundamental principle of the Sherman Act applies whether the customer is meeting its debts when due or is insolvent. A key component for members to an SP is an agreement between competitors or credit group members to refuse to extend credit or fix credit terms that may be deemed as a violation of the Sherman Act.

Supplier Pact and Holding POs

The Sherman Act does not prohibit an SP for the purpose of collecting on a mutual delinquent account. In *United Airlines v. U.S. Bank, N.A.*, 406 F.3d 918 (7th Cir. 2005), the court held that "cooperation in an effort to collect as much as possible of the amounts due under competitively determined contracts is not the sort of activity with which the antitrust laws are concerned." 406 F.3d at 921. However, an SP cannot have its members agree to refuse credit requested by the customer, even where the customer is delinquent and may be liquidating its assets. The decision to extend credit is with each SP member, and they must act independently.

The Takeaway with Supplier Pacts

For the credit team, an SP creates value on a number of fronts, including creating leverage to force sharing of information from an insolvent customer, a coordinated collection strategy with suppliers having the same priority and interest, and the opportunity to share collection costs. It is important to note that the Sherman Act limits the SP's collection strategy to the members' past due invoices. The members of the SP cannot collectively agree to hold orders or restrict terms as a strategy to obtain information or force payment. But beyond these antitrust prohibitions, an SP may provide a greater degree of protection and collection strategies to suppliers than they can achieve on an individual basis.

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