

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

*Collective supplier vigilance is emerging as a trend. The supplier team approach, called a Supplier Pact (SP), is changing the way suppliers engage with their delinquent accounts and negotiate with insolvent customers.*

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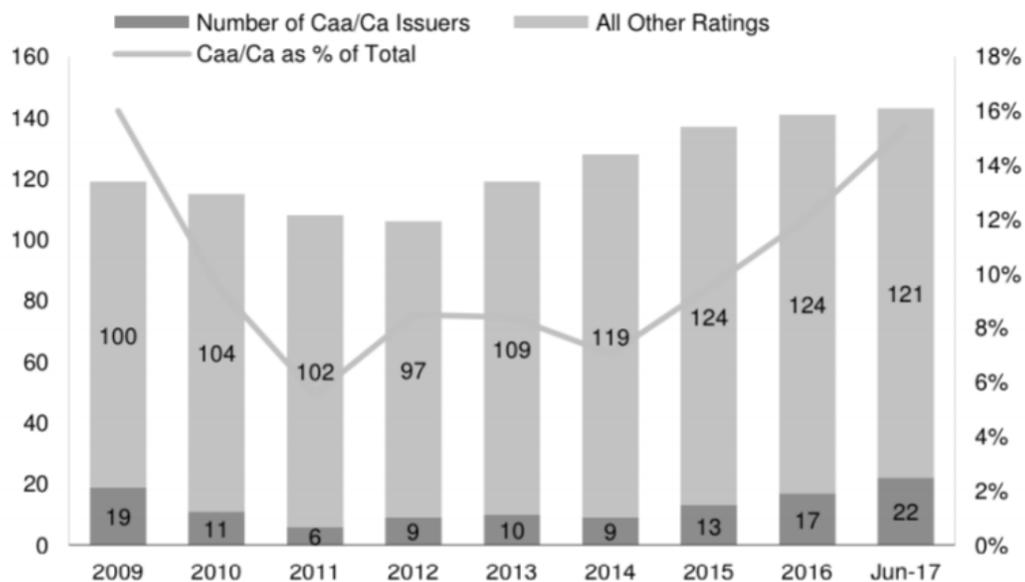
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## Overview

With the transformation of retail, where consumers are changing the way in which they purchase goods, retailers are becoming distressed as the chart below shows—the so-called Amazon affect.<sup>1</sup> In response, credit teams are responding (with the support of management and sales) with their retail customer base by shortening and shrinking credit lines. In response to this shakeout, credit teams are more vigilant to identify credit risk flags, especially given that suppliers generally do not receive distributions on account of their prepetition invoices, even those claims entitled to priority (503(b)(9)) are at risk because of administrative insolvency.



Source: Moody's Financial Metrics, SEC Filings 12 July 2017

But credit teams are also experiencing not just retailer insolvencies, but wholesalers and distributors. And its not just customers in financial distress electing to file Chapter 11, but many are now electing for out-of-court alternatives to address their insolvency, many of which do not provide for supplier participation or even meaningful financial disclosure to the supplier class.<sup>2</sup>

The out-of-court liquidation thus poses unique challenges for suppliers seeking to get basic information regarding the customer's liquidation, including prospects for payment on open invoices. A supplier's go-it-alone collection strategy likely will be met by silence to the demands for payment and even basic information regarding the liquidation. Thus, a key starting point is to create transparency of the liquidation where there is not a statutory mandate to do so.

<sup>1</sup> Chris Isidore, *Retail Bloodbath: Bankruptcy Filings Pile Up*, CNN Money (June 13, 2017), <http://money.cnn.com/2017/06/13/news/companies/retail-bankruptcies/index.html>

<sup>2</sup> George B South III and Daniel G. Egan, *How to Decide Between Out-Of-Court Workout and Bankruptcy*, Law360 (Feb. 19, 2014), <https://www.law360.com/articles/510976/how-to-decide-between-out-of-court-workout-and-bankruptcy>

Given the number of customers attempting to bury their liquidation strategy from suppliers, a trend is emerging of collective supplier vigilance, where suppliers are organizing to deal with their customer's insolvency or backslide into insolvency. The supplier team approach, a Supplier Pact (SP), is changing the way suppliers approach their delinquent accounts and their approach to negotiate with insolvent customers. An SP reinforces the value of suppliers participating in industry groups, as SPs are often formed by industry group members with their credit peers.

With the emergence of the SP, the credit team must still evaluate the threshold of whether they are better served by a collection strategy of going-it-alone, as opposed to a team approach to collect the past due debt.

### **Supplier Pact Defined**

An SP is a group of suppliers who come together, commonly after a debtor has failed to pay invoices, with a singular voice to negotiate with the debtor for internal financial information and payment on the invoices. Although not disclosed, the debtor is often insolvent and is liquidating its assets. An SP can attain cost savings through synergy of goals with a single counsel representing the SP, with the group's demand that the debtor pay the SP's expenses.

### **The Debtor's Backslide into Insolvency**

Customers can encounter a calamitous financial event that may require an emergency Chapter 11 filing for the protections of the automatic stay, such as when a key customer terminates the trade relationship or litigation results in an unexpected judgment. The profile of most customer insolvencies is a deterioration of cash flow and a buildup of short term liabilities, often as a result of lost sales, commonly over months. This means that this type of customer has a greater opportunity for insolvency planning, and more time to adopt a liquidation strategy with no involvement by the supplier class. A debtor's common afterthought for excluding the supplier class is that the lender is undersecured and, therefore, the unsecured creditors are out of the money.

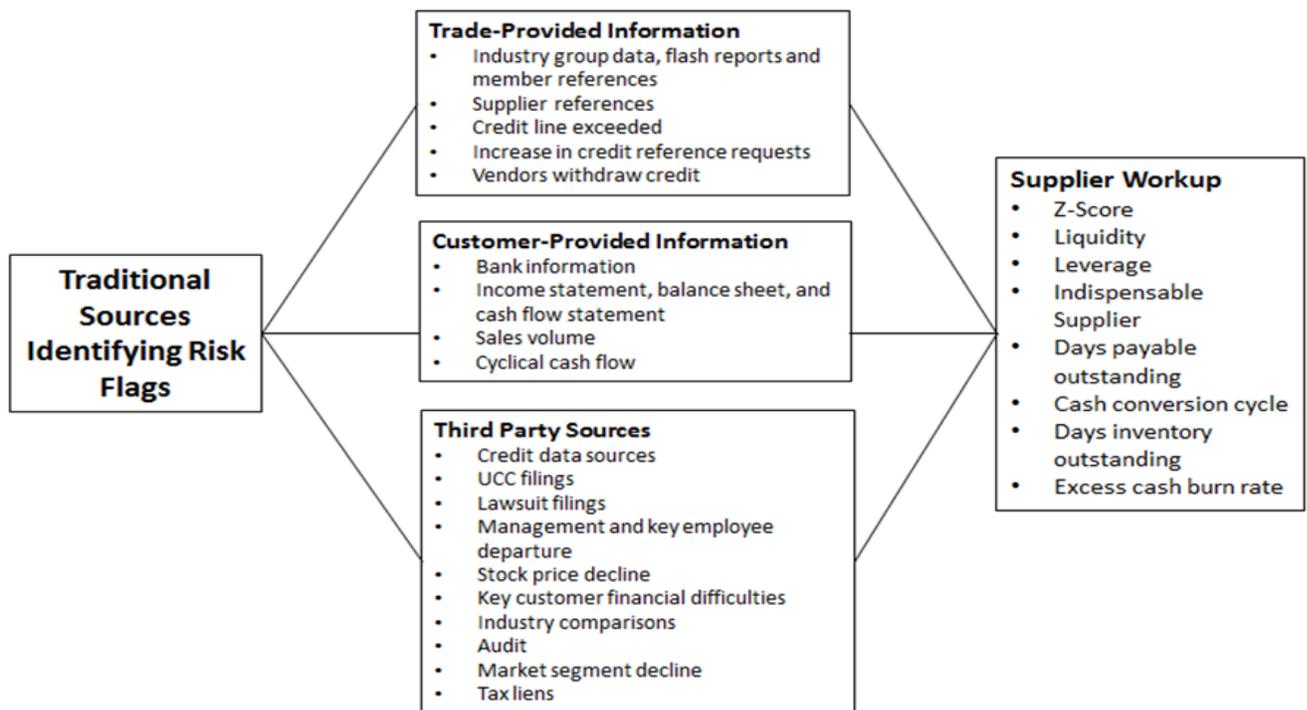
There is also a debtor's owner's self-interest dynamic; with small and mid-sized customers, lenders financing the business commonly require the owners or officers enter into a personal guaranty loan. As a personal guaranty carries significant individual liability, most principals want to maximize the company's assets in insolvency and repay the lender to release the guaranty.

Although a principal's individual liability to a lender does not directly concern suppliers, credit teams appreciate the self-interest of loading up on inventory on terms and liquidating the inventory as a method of repaying an undersecured lender.

## Attempting to Read the Risk Flags of a Freshly Minted Liquidating Debtor: Surprise Insolvency or Anticipated?

In this environment, credit teams continuously identify, monitor and evaluate credit risk. The challenge is that most customers in the zone of insolvency do not share internally generated financials with suppliers or otherwise disclose their financial condition, as they are trying to convince suppliers to continue to ship on terms or otherwise buy time from suppliers.

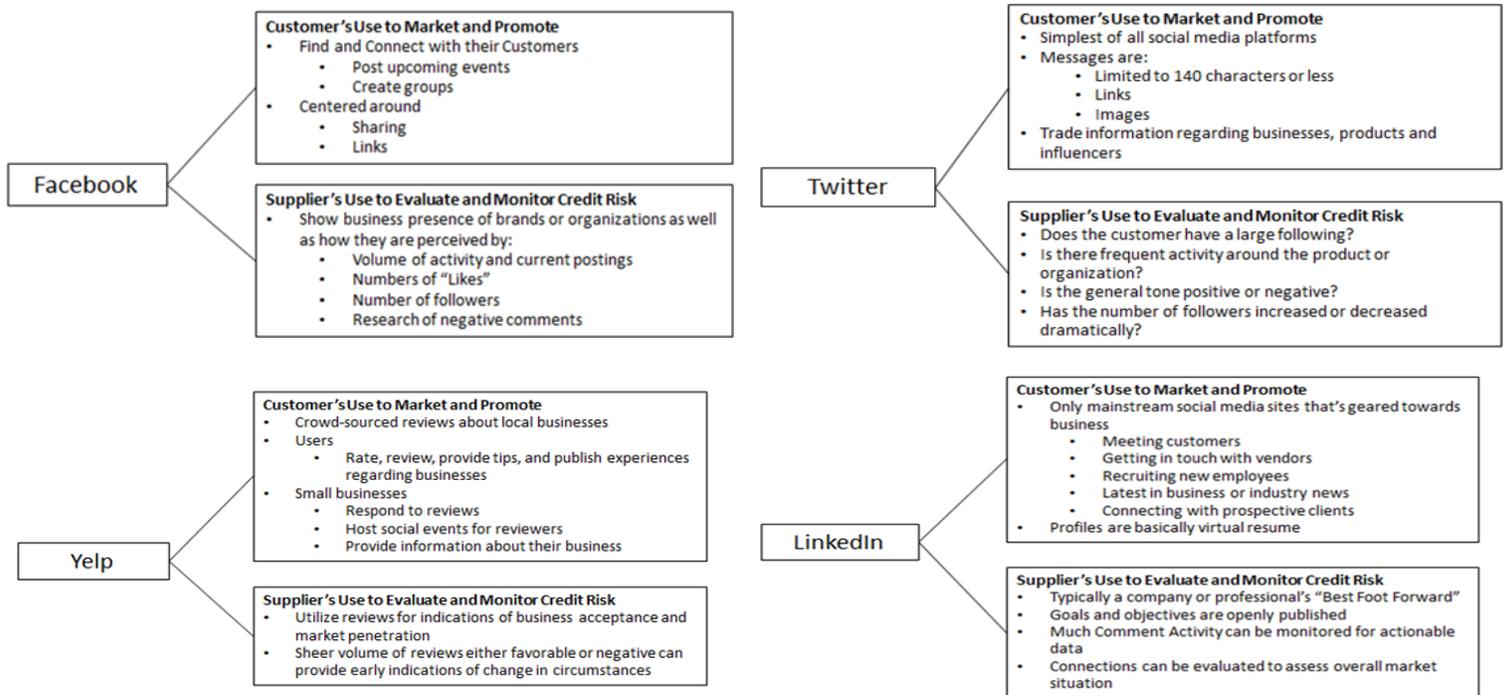
### Traditional Information Sources to Detect Insolvency Risk: Are They Effective?



A problem with traditional information sources is they are historical and backward looking. With a debtor on the verge of insolvency that is rolling out a liquidation strategy that imperils supplier payments, the reliance on historical information, where the customer is silent as to their financial condition, does not provide a path for payment.

### Social Media Sites: Added Sources to Gauge Insolvency for the Small and Mid-Sized Customer?

In addition to the traditional methods of evaluating credit risk, credit teams may look at social media and other news sources, for their small and mid-sized customers, for red flags such as customer satisfaction and complaints.



## Industry Group Information Sharing: A Key to Early Detection of Customer Insolvency

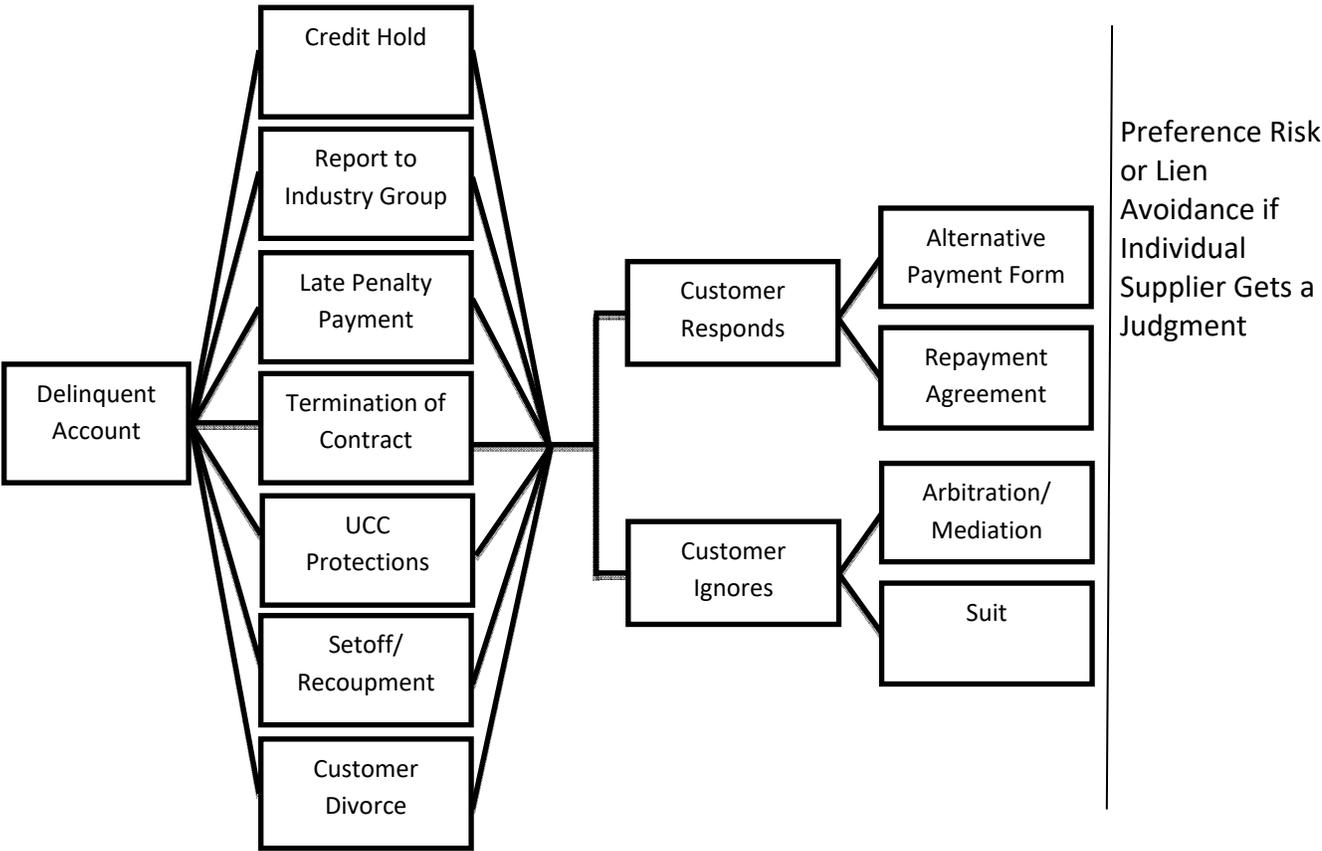
Perhaps industry group trade data and account discussion by members may be the most effective way for raising and validating a customer's backslide into insolvency, especially given a customer's liquidation strategy is not to share financial information with suppliers. Industry group trade data can show the early signs of a customer's decline, even in the face of customer denial, including payments beyond terms, suppliers withdrawing credit and flash reports.

## Insolvency Confirmed: Supplier Collection Strategy - Alone or Team Approach

Ideally, a credit team manages credit risk and avoids supplying to insolvent customers or those in the zone of insolvency. However, the decision to extend terms to a high credit risk customer is often a collaborative approach with the sales team and management, with sales and management possibly winning out. With an insolvent customer, is the supplier with a delinquent account more likely to collect if the supplier goes-it-alone or instead forms or joins an SP? The matrix considers the benefits and risks of these alternative collection strategies:

ALONE	SUPPLIER PACT
<b>Benefits</b> <ul style="list-style-type: none"> <li>• Unique claim</li> <li>• Negotiate repayment plan</li> <li>• Race to courthouse: first to the assets</li> </ul>	<b>Benefits</b> <ul style="list-style-type: none"> <li>• Same priorities</li> <li>• Threat of an involuntary petition</li> <li>• Share costs (legal + administrative)</li> </ul>
<b>Risks</b> <ul style="list-style-type: none"> <li>• Expense and resources to act alone</li> <li>• Too late to the liquidation. Debtor's assets sold off</li> <li>• Customer silence</li> <li>• Preference risk</li> <li>• Complaining about customer's silence: defamation and libel</li> </ul>	<b>Risks</b> <ul style="list-style-type: none"> <li>• Antitrust Risk</li> <li>• Share distribution with others</li> <li>• Freerider Risk</li> <li>• Credit team's support by sale's and management</li> </ul>

**A Go-It-Along Collection Strategy Decision Tree**



If the credit team is not confident with a successful outcome of a go-it-alone collection strategy, they can join forces with other similarly situated suppliers and form an SP. An SP gives members a unified voice and creates the leverage to negotiate with the debtor. Furthermore, an SP gives smaller creditors the ability to have a voice - an option a smaller creditor might not have pursued otherwise due to the lack of resources or the amount owed. The SP carries with it the implication to the debtor that the SP has standing to file an involuntary petition, something an individual creditor does not have.

## **The Supplier Pact and the Insolvent Customer**

### **Industry Groups: The Common Starting Point for Forming an SP**

Credit teams value their membership to industry groups, as they provide key information regarding payment trends and conditions, as well as historical information regarding status of accounts. The groups create a repository of credit information, through member self-reporting, which enables each member, acting independently, to better assess credit risk.

In this environment where more suppliers are considering the option of acting together in dealing with an insolvent customer, the industry group provides the unique forum for members to collectively identify customer delinquency and the credit risk flags that the customer is insolvent or may be backsliding to insolvency. While the industry group provides members with both access to member account payment history and the forum to discuss customer accounts, the federal antitrust law, the Sherman Act, restricts how members may use the information in a group setting, which is discussed below.

### **Formation of the SP**

The impetus for industry group members or suppliers to consider forming an SP following a delinquent account can be a number of factors, such as: customer silence; industry rumors as to customer financial difficulties; change in customer's commitment to provide financials; departure of key management; and delinquent accounts of industry members. These considerations are a starting point for a supplier to consider when determining whether to form an SP.

Unlike a customer's Chapter 11 filing, where the Office of the United States Trustee may appoint a statutory creditors' committee, an SP is formed where the customer may liquidate its assets outside of a Chapter 11 or formal liquidation proceeding, as discussed below, or as a prelude to an insolvent customer commencing a court-supervised liquidation proceeding.

Formation of the SP usually starts with an industry group member contacting another, and quickly moves by emails several group members selling the customer. The impetus to form the SP usually is shown in the need to promptly act in calling a meeting with the debtor.

## **SP Bylaws**

At the formation stage, the SP needs to promptly adopt bylaws so as to create structure for the SP and set-out the duties and responsibilities of SP members. The bylaws set out the conditions for participation and adherence to the antitrust laws.

## **Qualifications to Serve on an SP**

The bylaws should establish restrictions to serve, such as potential conflicts of interest. Does the supplier hold a personal guaranty or a security interest? Does membership include creditors that are not suppliers, such as landlords, unions or bondholders? Will it include other creditors such as landlords, unions or bondholders?

## **Scope of SP**

Is the SP negotiating payment for the entire class of unsecured creditors or only for the SP members? For example, if the SP negotiates a settlement and payment with the debtor and its lender of payment of 50% of claims, does that 50% include the entire unsecured class or only SP members? SP members do not have a duty to non-SP members for a distribution. However, the SP should define the scope.

## **Mission of the SP**

The first order of business is access to customer financials and their strategy to work through their financial issues. With that information, the SP can strategize payment.

## **Closing the SP**

Tied to the scope of the SP is closing the SP. The SP invites suppliers to participate in the SP, but if a supplier does not respond by a specific date, then the SP may consider closing the membership.

## **Duties of SP Members**

All members of the SP should assist the SP with investigation of facts to expedite and maximize recovery. In addition to determining the operational structure of the debtor's business, members should research assets, liabilities and financial conditions of the debtor. Members should also investigate and determine the likelihood and desirability of the debtor continuing the business. These determinations can help an SP determine its strategy and whether it wants to push for an involuntary bankruptcy petition.

The SP should also consult with the debtor for administrative purposes and implementing a point of contact for the SP. Moreover, all members should adhere to strict confidentiality with regards to communications. SP members must also be wary of any potential conflicts of interest—the members must put the benefit of the pact before their individual benefit, even if this results in a lower individual payout. The SP also has a fiduciary duty to non-members.

### **Counsel Advising the SP**

Counsel for the SP has a number of responsibilities in advancing the SP's interests and agenda, such as:

- Compliance with antitrust laws;
- Demand information and payment from debtor;
- Evaluate lender liens for avoidability risk;
- Evaluate insider actions and claims against insiders;
- Prepare SP term sheet;
- Negotiate preference releases;
- Negotiate payment through carve out from lender's collateral; and
- Negotiate a carve-out to pay SP's professionals.

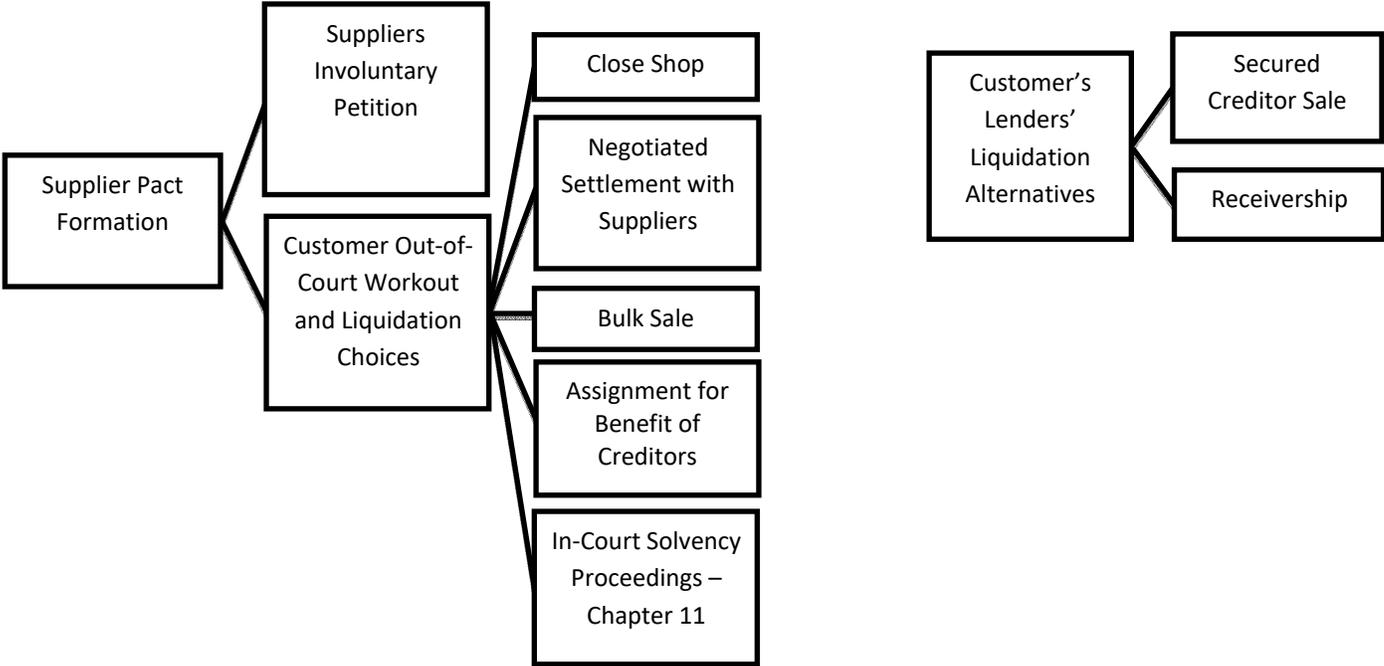
As noted, one of the benefits to SP members is having one counsel represent the group's interests and that counsel looks to the debtor first for payment of SP's expenses.

### **SP Deal Term Sheet**

After all issues have been worked out and the SP has negotiated an agreement to satisfy the debts, the SP should enter into a Term Sheet to memorialize the agreement into writing. This agreement should be between the SP, the debtor and the debtor's lender, and should encourage transparency amongst the parties. Additionally, the Term Sheet should address the following:

- Reconciliation of claim amounts;
- Who will be paid: supplier or supplier class;
- Payment amount and method;
- Preference risk: source of payment;
- Releases; and
- Confidentiality agreement.

### Insolvent Customer's Liquidation Alternatives

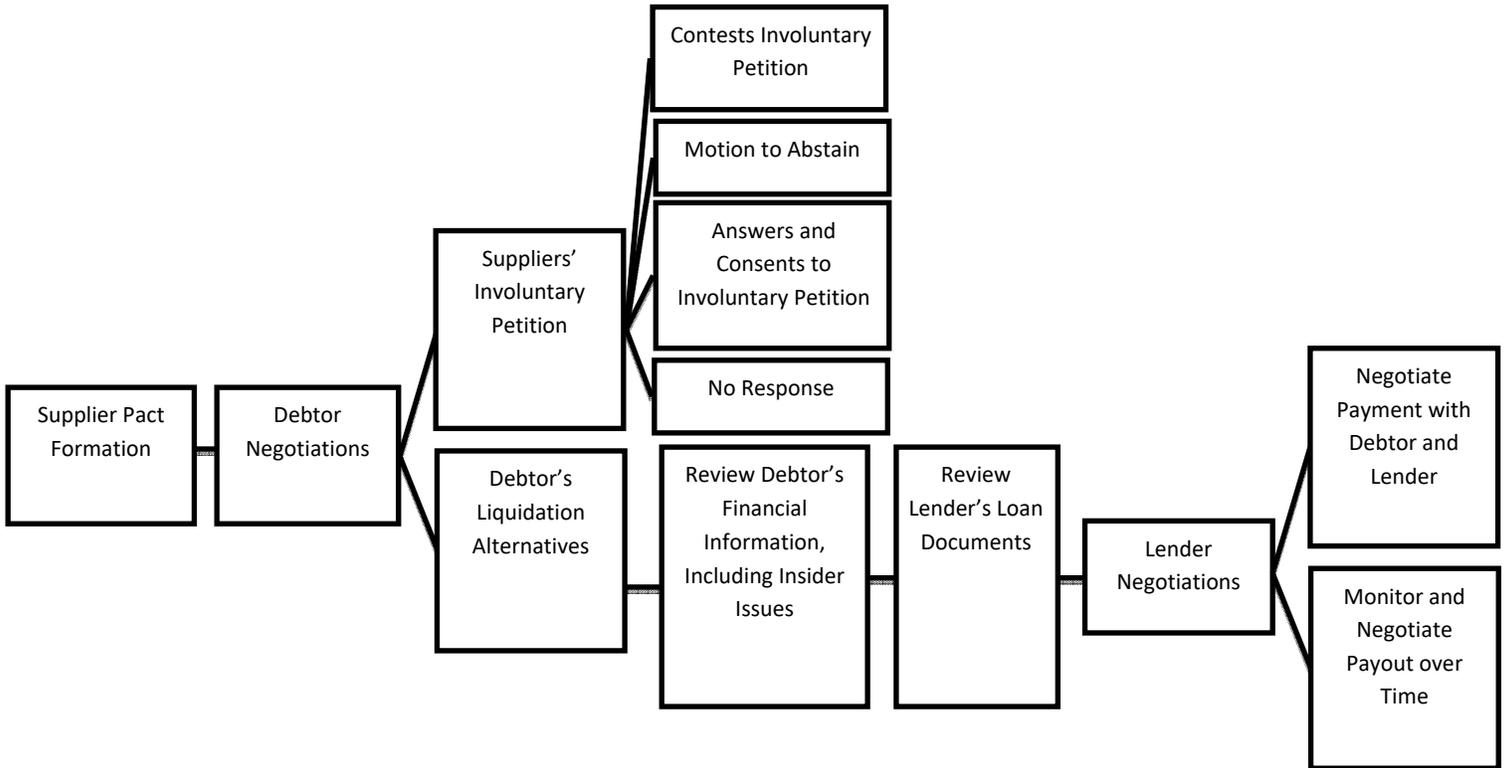


**Supplier Pact Flow Chart**

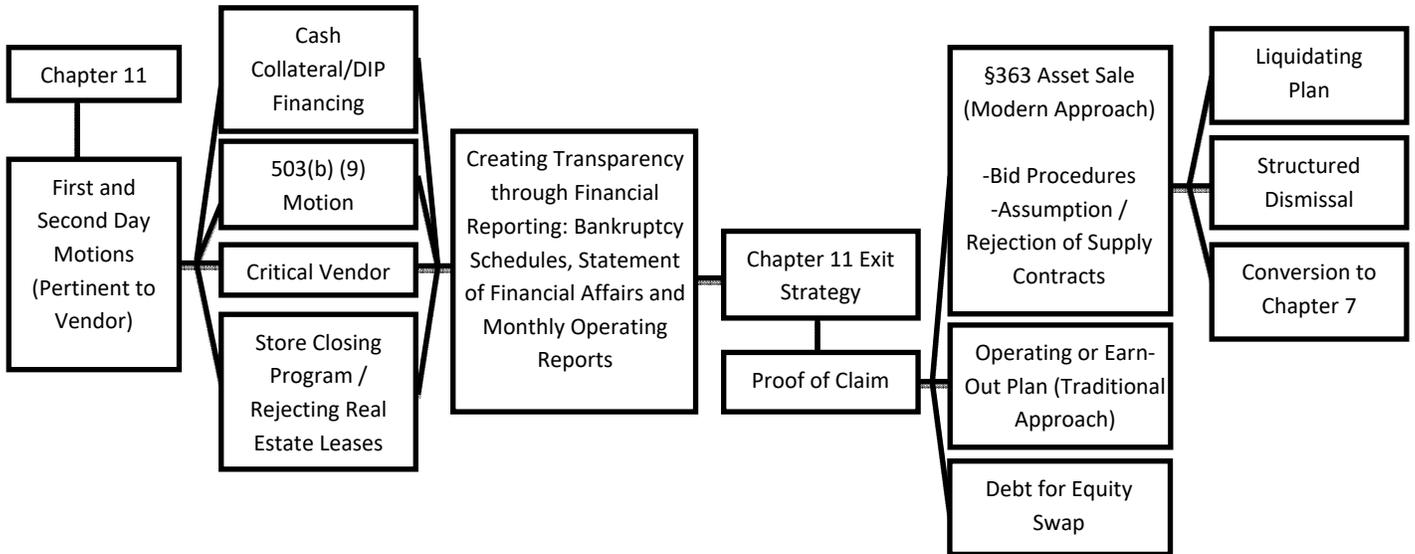
A debtor's out of court liquidation alternatives and the suppliers forming an SP in response can be shown in the below flow chart. The key decision tree split in the flow chart is SP's negotiations with the debtor. If the debtor refuses to negotiate, or the SP views the negotiations as non-productive, the SP may elect to file an involuntary petition to force court supervision over the debtor's liquidation.

The SP flowchart also highlights that an out of court liquidation lacks structure, which requires the SP to create such by demanding financial reporting and meeting with the key constituents.

### Supplier Pact Flowchart



### Chapter 11 Flowchart



The fundamental difference between the flow charts is that with the Chapter 11, the supplier class, as unsecured creditors, have statutory powers and the debtor has defined financial reporting responsibilities. Generally, with out-of-court liquidations this is not the case. The SP must negotiate a voice and seat at the liquidation table with the debtor and lender.

**Antitrust Overlay for the Supplier Pact: *In its broadest definition as it relates to the supplier trade relationship, the Sherman Act prohibits any person, including a supplier, from conspiring to restrain trade. The following may constitute illegal activity under the Sherman Act as they relate to the credit team:***

- Agreement between competitors or credit group members to fix credit terms;
- Agreement between competitors or credit group members to “black list” or refuse to extend credit;
- Agreement between competitors to secure a particular outcome with new POs; and
- Agreement between competitors to allocate specific customer demographics or geographic territories.

### **The Grounds for Creditors to Act Collectively to Deal with Delinquent Accounts**

Although suppliers cannot agree with competitors to fix price or credit terms, the U.S. Supreme Court recognizes that suppliers may meet and share factual, historical customer account information.<sup>3</sup> And with this customer information, the Sherman Act does not prohibit cooperation among creditors to collect under competitively negotiated POs or supply contracts.<sup>4</sup>

When bringing a claim under antitrust laws, the plaintiff needs to show actual collaboration because parallel acts, not counter to economic self-interest, are insufficient to rise to the level of price/term fixing under the Sherman Act.<sup>5</sup>

### **The SP and Distinguishing Between Group Members Negotiating POs (Terms or Otherwise) vs. Collecting on a Delinquent Account**

SP members should treat collectively negotiating POs differently than collecting on a delinquent account. With respect to collections, courts hold that the Sherman Act does not prohibit cooperation among creditors to collect under competitively negotiated contracts. By contrast, where suppliers collectively negotiate terms of a new order, an alternative evaluation may apply.

For example, in 2012, a federal court found that book publishers colluded to collectively set prices for the sale of e-books in violation of the Sherman Act. The suit was in response to a major

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<sup>3</sup> *Cement Mfrs.’ Protective Ass’n v. U.S.*, 268 U.S. 588 (1925)

<sup>4</sup> See *CompuCredit Holdings Corporation v. Akanthos Capital Management LLC*, 916 F. Supp.2d 1326 (N.D. GA, 2011)

<sup>5</sup> *Anderson News, LLC v. American Media, Inc.*, 123 F. Supp.3d 478 (S.D.N.Y. 2015)

customer in the industry, Amazon, selling the books at a discount. The publishers collectively agreed to sell their e-books only through Apple at a substantially higher price.

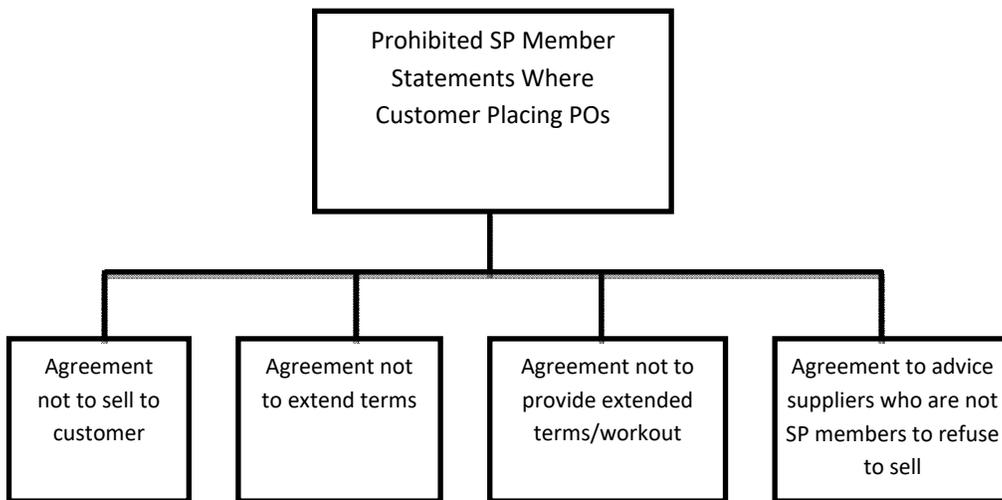
To avoid a comparable Sherman Act challenge of competitors collectively setting price with customers, the News Media Alliance, a newspaper industry group, is requesting Congress to grant it a temporary exemption from the Sherman Act and allow news outlets to collectively negotiate contracts with Google and Facebook.<sup>6</sup>

What is the distinction between the antitrust limits on suppliers collectively negotiating with a customer for a sale as opposed to allowing group action to collect a delinquent account? Competitive negotiation during the contract that creates the accounts receivable is the distinction.

In *United Airlines*, the leases were competitively negotiated for by each supplier, and the Court allowed creditor collaboration when the debtor failed to pay. Similarly, in *CompuCredit*, the initial terms of the promissory note were competitively negotiated for by each supplier, and collective negotiations were permitted for payment of the notes.

### Antitrust and Defamation Restrictions on SP Members' Communications

As mentioned earlier, SPs should be aware of its communications about its customers with other suppliers, especially e-mail, with relation to the Sherman Act. As the chart below highlights, SP members should never act with other members, or non-members, when deciding to extend credit terms or sell to customers. SP members must make an independent determination when a customer places a PO. Where a customer is going through a straight liquidation and no longer placing orders with suppliers, these restrictions on SP members' communications do not apply.



<sup>6</sup> CNN Wires, Newspapers Face Steep Uphill Climb in Effort to Negotiate with Google, Facebook, July 12, 2017

SPs should also be mindful with their demands for payment being construed as defaming or libelous. This is most commonly seen in the form of complaining and false statements about a customer's silence as lever to get financial information and negotiate payment.

### **Involuntary Bankruptcy Petition Alternative**

When an insolvent debtor refuses to negotiate with an SP regarding its liquidation, including sharing information, suppliers (or an SP) can file an involuntary bankruptcy petition. Bankruptcy Code §503(b)(9) grants an administrative priority to suppliers of goods for any goods received by the debtor within 20 days of filing. Suppliers often prefer this remedy because 503(b)(9) claims must be paid before a bankruptcy plan can be confirmed—this ensures at least some recovery for suppliers.

Well counseled debtors are aware of the 503(b)(9) timeframe and may attempt to load up on inventory, on credit terms, and delay planned bankruptcy filing until the 20-day clock expires. Suppliers should be cautious if a customer places an abnormally large order—especially if there are other red flags that indicate towards potential financial struggles. This should trigger the credit team to conduct a thorough investigation on the customer and validate the credit risk. If the credit team is able to validate the red flags, a supplier should be proactive and consider filing an involuntary bankruptcy petition to trigger the 20-day clock and give itself an opportunity to recover its 503(b)(9) claim.

In order to file an involuntary bankruptcy petition, where the debtor has twelve or more creditors, at least three creditors must have claims totaling \$15,775. These claims must not be contingent as to liability or must be the subject of a bona fide dispute as to liability or amount.

### **Conclusion**

Like shareholder activism, where institutional shareholders take an aggressive agenda with their corporate investments to maximize their value. Suppliers too are acting in unison to try and protect their accounts receivable and maximizing a distribution from their insolvent customers, even where the supplier class may be out of the money and where a secured creditor may have insufficient collateral to pay their debt in full.

Suppliers have learned that sitting back in an out-of-court liquidation means that the debtors, insiders and lenders will take all of the value. If the debtor, insider and lender refuse to negotiate, the SP has the leverage to revert to bankruptcy court through an involuntary bankruptcy petition to create access to information and oversight.

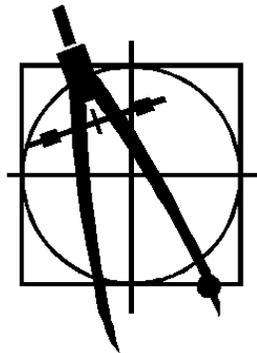
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## RESOURCES

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