Reducing a customer's Accounts Receivable in the zone of Insolvency

David Conaway explains how suppliers can help themselves by being proactive

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Reuters, Bloomberg and Debtwire are all reporting negative financial information about your customer:

Bond ratings are downgraded, bond prices are falling, a likely "restructuring" to address the bond debt is on the way, bondholders form an "ad hoc" committee to negotiate with the customer, the bondholders retain financial advisors and counsel… as does the customer.

You know what's coming, a Chapter 11 filing, but the customer will not confirm that. In fact, the customer denies the "rumors", fearful of triggering defaults and losing credit terms provided by suppliers.

Your accounts receivable balance is $500,000, which will become a pre-petition general unsecured claim in Chapter 11. You know all too well that such claims are rarely paid in a Chapter 11 proceeding, so the $500,000 accounts receivable is looking like a write-off.

You're in the twilight zone – the zone of insolvency, which often lasts weeks if not months depending on the negotiations among the customer and its lenders and bondholders on DIP financing and on a bond restructuring (often a debt-equity swap). It will likely be a "prepackaged" or "pre-arranged" Chapter 11 filing.

The good news is that you don't have to sit back and watch the painful slide into bankruptcy. You can be proactive and reduce your accounts receivable balance, even absent a material payment default.

Vendors have two powerful tools in Article 2 of the Uniform Commercial Code governing the sale of goods:

Section 2-609 Anticipatory Breach

When reasonable grounds for insecurity arise with respect to the performance of either party, the other may demand in writing adequate assurances of due performance and if commercially reasonable, suspend any performance.

Section 2-702(1) Cash Before Delivery Upon Buyer's Insolvency

Where the seller discovers the buyer to be insolvent, the seller may refuse delivery except for cash.

Section 2-609 and 2-702(1) work well together. The seller's performance obligations, which may be suspended under 2-609, concern shipping goods and providing any credit terms agreed on between the parties. If reasonable grounds for insecurity exist, the seller may suspend its obligation to ship or to provide credit terms, or both. Section 2-702(1) likewise allows the seller to sell goods on a cash basis.

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Frequently Asked Questions

1. What are "reasonable grounds" for insecurity?

Although not defined by Article 2, courts have found that "reasonable grounds" for insecurity exist when a party fails to make required payments pursuant to a contract, such as when a buyer fails to pay outstanding invoices under a supply contract or when the accumulated debt of a buyer making purchases on credit substantially exceeds the buyer's credit limit.

Additionally, courts have held that a report from an apparently trustworthy source that a party is in financial distress can be enough to give the other party reasonable grounds for insecurity, even if those reports ultimately turn out to be untrue.

2. When does a buyer become insolvent?

Insolvency is normally defined on a balance sheet basis: liabilities exceed assets. Also, a company may be insolvent if generally it is unable to pay debts as they come due.

In many instances, the customer may be solvent with respect to its working capital facility, and mostly solvent on its trade payables. However, if the customer has insufficient resources to pay its bond debt in accordance with its terms, he is unable to meet its financial obligations as they come due. Also, the amount of bond debt, working capital and term debt, along with all other debt obligations, may cause the customer to be balance-sheet insolvent.

3. What if the customer is not in material default?

Neither Section 2-609 nor 2-702(1) hinge on the buyer's default. In fact, Article 2 provides a seller clear remedies when a buyer fails to pay. Section 2-609 addresses the situation where there is no current default, but the seller can reasonably anticipate a default.

Likewise, Section 2-702(1) hinges on the buyer's insolvency, not the buyer's default.

Nevertheless, sellers exercising these remedies can anticipate push-back from buyers because they are current.

Also, well-written "terms of sale" provide that the failure to pay any invoice when due accelerates payment of all open invoices in which case a non-material breach may trigger a breach of the entire open accounts receivable balance.

4. What if there is a supply contract with the customer?

In this context, there is little difference between doing business on a purchase order and invoice basis and under a supply contract. In both cases, a seller has an obligation to deliver goods and extend terms and the buyer has the obligation to pay for the goods within terms. However, buyers tend to assert that a supply contract heightens the seller's obligation to perform, regardless of reasonable grounds for insecurity or insolvency.

5. Can the supplier refuse to ship goods altogether?

Arguably, yes, but if the seller delivers goods on a cash before delivery basis, the seller fulfills its business mission with no risk of not being paid.

Section 2-609 allows a seller to suspend all performance "*if commercially reasonable*". Moreover, the Uniform Commercial Code imposes a standard good faith, which weighs in favor of continuing to ship, particularly if the buyer's business operations would be damaged without a consistent flow of goods.

6. How do Sections 2-609 and 2-702(1) benefit the seller?

If the accounts receivable balance is $500,000 and the credit terms are net 30 days, the $500,000 accounts receivable balance should be zero in 30 days, or $250,000 in 2 weeks. Depending on how long the zone of insolvency lasts, the seller will likely reduce, if not eliminate, its accounts receivable balance before the customer files. These are 100% dollars compared to pennies on the dollar if the accounts receivable balance exists at the time of Chapter 11 filing.

Given this extreme range of outcomes, sellers should always pursue its remedies under Section 2-609 and 2-702(1).

Buyers often use the threat of future business to avert being put on a "cash before delivery" basis. Experience suggests that buyers need quality suppliers, and suppliers need quality customers. They will likely do business again despite the pre-Chapter 11 rhetoric. Perhaps a supplier increases the price discount a point or two for "cash before delivery" payments, for good customer relations.

7. What about preference risk?

Accelerated pay-downs of accounts receivable balances during the zone of insolvency normally imply an increased preference risk. This is because accelerated pay-downs are not considered in the "*ordinary course of business*".

However, if the existing accounts receivable balance is paid in accordance with terms during the zone of insolvency, those payments should be protected by the ordinary course of business defense. Future shipments will be on a cash before delivery basis, so the payments by the customer are not "*on account of an antecedent (existing) debt*" since a debt does not arise until after delivery has occurred.

Given the normal Chapter 11 outcome for unsecured claims, minimizing such claims before filing is highly recommended.

Stay tuned … in a future article, we will address how to respond when your customer, now in Chapter 11, insists on normalized credit terms because the DIP facility approved by the Court provides adequate cash to pay. ■

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