

MEMORANDUM

TO: **CASMI MEMBERS**

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RE: Managing Distressed Credit in the Bankruptcy Context

This Memorandum supplements my remarks at the January 2009 CASMI Membership Dinner. The following is designed to assist your sales and credit personnel with credit extended to customers (with an emphasis on those in the automotive industry) facing ongoing distress and potential bankruptcy. The checklist is separated into four major categories: (i) General Account Maintenance, (ii) Pre-Bankruptcy Planning, (iii) Early Bankruptcy Response, and (iv) Long-Term Bankruptcy Management. Also included are our general recommendations for making the best use of the information that the checklist contains and related assistance that our firm is willing to provide.

I. GENERAL ACCOUNT MAINTENANCE

You may be able to reduce credit risks by employing one or more of the following account monitoring and collateralization options. Some of these items may seem obvious, but others likely will not.

- **Regularly review accounts receivable aging reports.**

It is our experience that constantly monitoring aging reports is the most reliable way of identifying those customers not paying their debts on the agreed-upon terms. Additional credit should be curtailed or not extended at all until the arrearage is cured or satisfactory payments are made.

- **Obtain a purchase money security interest ("PMSI"), or sell on consignment.**

Depending on the nature of your business, it may be possible to obtain a lien on or consignment interests in the goods you sell by (i) requiring the purchase documentation to acknowledge such interests, (ii) timely filing appropriate UCC financing statements and (iii) timely serving notice on any creditors with recorded liens on the buyer's inventory. This procedure could aid you in recovering unused inventory after a default. This procedure would also give you priority over any pre-existing lien holders with respect to your inventory, as well as identifiable proceeds of your inventory. Inventory sold on a just-in-time basis may not support these types of arrangements, but they could be valuable in situations where your product is stored or otherwise held for some amount of time before being placed into your customers' production.

- **Require guaranties from affiliates or principals of account debtors.**

Guaranties will be increasingly difficult to obtain as an account debtor's creditworthiness worsens. However, to the extent a guaranty may be available, even if only for a limited amount, it should be taken. In addition, even if the request for a guaranty is initially rejected, future opportunities to obtain the guaranty may arise and should be considered periodically. Particularly when a customer is privately or family owned, a guaranty may be viable.

- **Periodically review analyst and financial news reports, or similar credit publications, relating to the account debtor and its industry.**

Monitoring trade publications can be useful in gauging credit risk over extended periods of time, but such information is generally not updated on a real-time basis and can have limited value when making discrete credit decisions. However, these sources provide an added layer of data to your credit decisions.

- **Require financial statements from the account debtor regularly.**

Most companies do not incur the expense of having their financial statements audited on a greater than annual basis. However, requesting financial statements

or balance sheets certified by one of the account debtor's officers may suffice. Requesting such information on a regular basis (*e.g.*, monthly or quarterly) should improve your credit decisions. Note, however, that your customer (particularly if distressed) may be reluctant to share such detailed information, and you may need to execute a confidentiality agreement or similar assurance.

- **Periodically request "no default" letters and/or copies of your customers' current loan commitments.**

For many customers, their continuing ability to pay you will largely depend on the status of their lending arrangements. Therefore, it may be appropriate or necessary to request written confirmation from your customers' banks or other major funding sources that, to their knowledge, no defaults exist. If your customer is in default with its bank or other working capital source, then it is advisable to seek copies of any amendments or forbearance agreements that address such defaults. As with non-public financial statements or disclosures from your customers, your access to these items may become subject to confidentiality agreements.

- **Purchase credit insurance.**

For significant ongoing accounts, you should consider purchasing credit insurance to protect against an account debtor's potential insolvency or other inability or refusal to pay. With respect to automotive customers, the credit insurance market is particularly expensive at this time, but you may have customers that are sufficiently diversified in other industries such that insuring their accounts is feasible.

II. PRE-BANKRUPTCY PLANNING

You should consider the following options and strategies when dealing with account debtors on the verge of bankruptcy. As a general matter, an approach to credit management that gradually increases the level of your response to an account's deterioration is appropriate (assuming you have been properly monitoring the account). With all of the actions described below, however, it is important that you consider any limitations imposed on you by your contracts or applicable law. You should not wait to act when action is warranted, but a relatively small amount of legal diligence can protect against creating further issues while enforcing your rights.

- **Send a formal notice of default, demand for payment and reservation of rights.**

If material defaults under your contracts exist and are not be adequately addressed by your customer despite informal reminders, you should consider sending formal notice regarding the situation. By identifying specific defaults and demanding in writing that they be promptly cured, you clearly put your customer on notice that the problem is serious and cannot be ignored. Further, the notice should reserve your rights to take action in the future if matters do not improve, and your customer will not have a basis to claim that your silence in the past indicated that you were willing to waive or forbear against the default.

- **Improve payment terms for account debtors that have past due accounts.**

As concerns about a defaulting account debtor move beyond initial stages, you should consider requiring (i) payment on more expedited terms (*e.g.*, net 10 days instead of net 30), (ii) payment in advance of delivery (or C.O.D.) for all shipments going forward, or (iii) payment in advance of delivery (or C.O.D.) plus some amount for payment of the past due obligations in exchange for current delivery. Factual circumstances will likely dictate your ability to tighten credit terms. If a supply contract exists, you may be required to formally declare defaults under the contract before shortening such terms.

- **Refuse to deliver goods to an insolvent account debtor.**

If you discover that an account debtor is insolvent (based on reliable information), you may stop delivery on an open order (except if the customer pays C.O.D.). You have the right to stop delivery until the account debtor has received the goods, a bailee (*e.g.*, a drop ship location) has made an acknowledgment to the account debtor that the bailee holds the goods for the account debtor, or title has passed to the account debtor. To stop delivery, you must provide appropriate notice.

- **Reclaim goods delivered to the insolvent account debtor within a reasonable period of time.**

You have the ability to reclaim goods delivered on credit to an insolvent account debtor, within a reasonable time following their delivery. Your right of reclamation, however, is likely subject to any pre-existing lien on the goods – *e.g.*, a customer's bank's lien on inventory. Thus, this remedy should be used, but it may have limited effectiveness. Note, however, that successful reclamation of goods may exclude all other related remedies, including a deficiency claim. If you retrieve goods, the claims related to them are generally deemed satisfied. After a bankruptcy case has commenced, your reclamation right still exists, but it is governed by the Bankruptcy Code and available on an even more limited basis, as more fully discussed below.

- **Terminate contracts in default that you do not want to fulfill in bankruptcy.**

If you suspect or learn that a bankruptcy is imminent, and you do not want to continue doing business under the terms of an existing agreement in bankruptcy, you should consider exercising your rights to terminate a contract in default before the bankruptcy commences. This will greatly reduce the effect the bankruptcy case could have on the contract – such as forcing you to continue supplying on credit notwithstanding pre-bankruptcy defaults. Following a termination, you can still continue doing business with the account debtor on better or more flexible terms.

- **Demand adequate assurance of performance (payment).**

You have the ability to demand "adequate assurance of performance" from a customer if you have a reasonable basis to be insecure about a customer's willingness or ability to perform under a contract. If such grounds exist (such as repeated or growing amounts of past due accounts), you can send a letter to the customer demanding that the customer provide adequate assurance that it will perform. Such letter should detail the facts that provide the basis for insecurity, and can indicate what type of adequate assurance would satisfy your insecurity (*e.g.*, immediate payment of outstanding accounts and C.O.D. sales going-forward). Please note, however, that an attempt to change contract terms in an adequate assurance demand letter could be challenged by the customer as an impermissible attempt to unilaterally change the terms of a contract.

Once you have sent an adequate assurance demand to a customer, you also have the right to suspend performance (*e.g.*, stop shipping) even prior to receiving the customer's response. Obviously, stopping shipment in situations where it is less than clear that you are insecure can risk causing your own defaults under the contract. However, if you send an appropriate demand and the customer fails to respond within a reasonable time (not to exceed 30 days), that failure is considered a repudiation of the contract, automatically allowing you to terminate.

- **Generally, take all legal means to secure payment on past due accounts.**

The fact that a customer may enter bankruptcy soon should not deter you from trying to obtain payment prior to that occurring. The worst thing that can happen is that certain payments received in the 90 days prior to the filing of a bankruptcy case are recoverable by a debtor's estate as preferences, but most of such recovery actions are settled for an amount less than you have received. Receiving the money and having to return a portion is almost always better than not being paid at all. Moreover, a customer may go into bankruptcy later than you expect, thereby allowing 90 days to pass and protect a payment. Also among your potential recovery strategies is commencement of an involuntary bankruptcy against the account debtor. Being part of an involuntary petition (normally with two or more other creditors) is subject to certain legal requirements and thresholds that should be discussed with counsel, but the process of an involuntary case is fairly straightforward.

III. EARLY BANKRUPTCY RESPONSE

Reorganizations and orderly liquidations proceed under chapter 11 of the Bankruptcy Code. Typically, the debtor continues to operate its business in a status known as a debtor-in-possession. You should consider the following promptly after such a bankruptcy case is commenced by or against an account debtor.

- **Exercise rights to reclaim goods shipped within the 45 days prior to the bankruptcy filing.**

After a bankruptcy is filed, you can exercise your reclamation right for shipments received by a debtor while insolvent, within the 45 days before the date of the bankruptcy filing. To exercise such reclamation right, you must make written demand for reclamation of the goods before the later of 45 days after the date the debtor received the goods or 20 days after the bankruptcy filing date, if the 45-day period expires after the commencement of the case. Please note, however, that if you do not provide notice as required, or if this reclamation right is otherwise not enforceable, you may still assert your right to an administrative expense claim with respect to goods that were received by the debtor within 20 days before the bankruptcy filing, as more fully described below.

- **Stop shipment on goods to which title has not yet passed to the debtor.**

You have the right to stop delivery of goods you have shipped to a buyer before bankruptcy, provided that title to the goods in question has not passed to the debtor and they have not been received by the debtor or a bailee of the debtor. If there is any question as to whether or not the debtor has obtained ownership rights to or possession of the goods in question, you should contact legal counsel before stopping any such shipment. If you mistakenly stop a shipment, you may be liable for violating the automatic stay in the buyer's bankruptcy case and be liable for damages.

- **Move to expedite the date by which the debtor must assume or reject its contract with you.**

If a long-term supply contract does not exist, you may insist upon different payment terms for postpetition shipments than those made prepetition. If a long-term supply contract does exist, you are generally required to perform under the contract until it is "rejected" or terminated with court approval. However, you have the right to request that the court shorten the date by which the debtor must "assume" or "reject" its contract. To "assume" means to agree to be bound by its terms going-forward and to cure existing defaults. To "reject" means to relieve both parties from continuing under its terms; provided that if a debtor rejects one of your contracts, you are still entitled to a prepetition claim for damages. If you identify an alternative customer for your supply or can present other compelling circumstances, you may be able to convince a court to force the debtor to assume or reject your contract quickly. While most courts will allow debtors some

breathing room to decide which contracts to keep, courts are also sensitive to third parties who are prejudiced by the bankruptcy.

- **File a timely request for payment of an administrative expense.**

If the debtor received goods from you in the 20 days before the commencement of the bankruptcy case and you have not been paid for them, you should consider filing a request for payment of an administrative expense for the value of such goods. This is called a 503(b)(9) claim, referencing the applicable Bankruptcy Code section. If allowed, this administrative expense claim will have priority over all general unsecured claims in the bankruptcy case – meaning, this portion of your claim must be paid 100 cents on the dollar before any general unsecured claimants are paid. Likewise, if you continue shipping to a customer after bankruptcy, and the customer commits new defaults under the contract, you should not hesitate to demand payment and file a motion with the court to compel payment and/or terminate any contract. While debtors tend to be given flexibility relative to prepetition defaults under their contracts, the same is generally not true with respect to postpetition defaults.

- **File a timely proof of claim.**

When bankruptcy ensues, you must file a proof of claim on account of all unpaid prepetition claims to reserve your rights to a dividend in the case. In chapter 11 cases, claims bar dates are customarily set by order of court, and it is important not to miss such a deadline.

- **Seek protection as a "critical vendor" of the debtor.**

In situations where your refusal to do further business with the debtor while in bankruptcy could have a dramatic adverse impact on the debtor's ongoing operations (making you "critical"), you may be in position to demand that all or a portion of your prepetition claim be paid ahead of unsecured creditors generally. As with other remedies, this type of demand may be limited by your obligations under executory contracts still in force upon commencement of bankruptcy. Please note, further, that the ability to seek "critical vendor" status has been significantly limited in Illinois, Indiana and Wisconsin, and courts in other areas of the country are also reluctant to allow debtors to enter into these types of agreements absent compelling reasons. Becoming a critical vendor is not typically an easy process, but it can be highly rewarding.

IV. LONG-TERM BANKRUPTCY MANAGEMENT

You should consider the following additional, longer-term issues during an account debtor's bankruptcy case.

- **Confirm the nature and extent of postpetition financing available to the debtor.**

One of the keys to the survival of a bankrupt company and to the payment of its suppliers, is the continued support of a lender or other financing source. Requiring copies of the bankruptcy court orders governing the debtor's cash flow can provide tremendous insights into the debtor's fortunes. The level of a lender's commitment will be a strong indicator of the prospects of the debtor's reorganization and its ability to pay its expenses on a timely basis. Moreover, such orders often contain expense budgets where you may be able to identify line items designated to satisfy your invoices.

- **Contact the Office of the United States Trustee and the Creditors' Committee.**

An attorney from the Office of the United States Trustee is assigned in each bankruptcy case and should be able to provide general information regarding the status of the case and whether any committees or meetings of creditors are going to be formed or held. If you are a large creditor, you should advise the U.S. Trustee if you is willing to serve on any Creditors' Committee appointed in the case. Further, even if you are not on a Creditors' Committee, you should communicate with it regarding the administration of the case (such as asset sales) and whether other vendors are still extending credit to the debtor.

- **Enforce defaults in postpetition transactions.**

As mentioned above, creditors may be limited in their ability to compel payment of pre-bankruptcy claims, but this is not necessarily the case with respect to claims arising during bankruptcy. Accounts arising after a bankruptcy filing are given priority over most pre-bankruptcy claims. Moreover, courts look unfavorably upon debtors who fail to pay such postpetition claims on a timely basis. Therefore, in the event one of your customers breaches an order or contract that arose after the bankruptcy case began, you should seek legal advice as soon as possible to discuss enforcement options, if the debtor does not respond to other demands.

- **Consider retaining bankruptcy counsel to advise and represent you.**

When warranted by the size of your claim or liability, it is advisable to consult legal counsel. The scope of the engagement should be determined by the extent of your involvement in the case. Seeking aid from counsel in larger matters can protect against significant prejudice to your rights, such as when a buyer proposes to assume your supply contract from the debtor but fails to provide you appropriate notice and/or offer full payment of your outstanding accounts.

V. GENERAL RECOMMENDATIONS

As an initial matter, we strongly suggest that you re-review your most significant contracts and customer orders to determine whether any changes should be made or actions taken that will provide you with reasonable protections against the adverse effects of bankruptcy. Taking the checklist above into account may indicate that there ways to significantly help yourself.

We also encourage you to review the foregoing points on a regular basis with respect to each account. While we may have placed each issue in a certain category, several of these options and limitations may be applicable throughout the credit cycle. Relatedly, please recognize that the matters discussed above are merely intended to focus you on major aspects of and options pertaining to distressed or otherwise risky accounts. They are not meant to be a comprehensive manual for dealing with every case – because every account is unique. Further, each contract and, often, each state's law are different. The foregoing should be used as a guide, and not considered advice regarding your specific accounts or business.

Finally, we recommend you discuss highly distressed accounts and bankruptcy matters with outside counsel (a) where you do not have established internal procedures for dealing with them, (b) when a bankruptcy claim exceeds \$20,000 or (c) when you are sued by a bankrupt company. **Goldberg Kohn has agreed to be available to each CASMI member for not less than fifteen (15) minutes (free of charge) to address further questions and issues raised by matters discussed in this Memorandum or by Mr. Downs during his CASMI Membership Dinner speech.** The contact information for and a brief biography of each of the members of our Bankruptcy Group can be found at our firm's website, listed below.

Please visit us at <http://www.goldbergkohn.com> for more information about our firm and members of our Bankruptcy Group.