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PERSPECTIVE

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Seven practical tips for healthy companies that do business with not-so-healthy companies

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Interest rates are rising, inflation is here, and it may only be a matter of time before our economy becomes severely distressed. As the leader of a healthy business, you undoubtedly are consulting your advisors as your company navigates these choppy waters. But did you consult a financial restructuring lawyer? Likely, the answer is no, because you have a healthy business, right? But that is only half of the equation. As a financial restructuring lawyer, I counsel healthy businesses on how to avoid the adverse impacts caused by their financially distressed strategic partners.

Each situation is unique, but below are seven basic steps that can help your healthy business anticipate, mitigate, and maybe even avoid someone else's problems becoming your own.

1. Be informed. It is vital to stay abreast of the operations of important customers and suppliers. Communication is key! Any signs of current or likely financial issues should be identified and quickly addressed, not ignored. For example, take note and be proactive when payments become delayed, accounts receivable expand, inventory is low, calls are not quickly returned or you learn the CFO has resigned (the latter is almost a sure sign of financial issues at a company). One of the best ways to stay informed is to have provisions in your contracts that require updated information be provided upon certain events: for example, if inventory falls below x%, notice to you is to be provided within y days thereof; or if it arises that current debt cannot be satisfied in full, notice is to be provided within x days thereof. Alternatively, for those significant accounts that could singularly or in the aggregate adversely impact your business if not timely or fully paid, calendar quarterly or more frequent calls with a company executive to check in and see how things are going. The better the communication is, the fewer surprises there will be.

2. Review and Update Contracts To Help Avoid Being Just Another Creditor in Bankruptcy Court. Critical to protecting a healthy company is the strength of its contracts. While you can't necessarily "bankruptcy proof" a business transaction, there are benchmarks and provisions that should be included in the contract so that you have a way out before things spiral out of control, or at least have some leverage should a bankruptcy be commenced by your counterparties. Examples might include deadlines for payment and performance obligations, cure periods and, most importantly, the ability to quickly terminate the contract

if deadlines are not met so that you can potentially avoid being involved in the bankruptcy case. Also, consider including a provision that does not allow the contract to be assigned without your written approval so you have control over any such assignment to a third party. While such a provision may not be enforceable in a bankruptcy generally and assignments of contracts regularly occur despite anti-assignment contract provisions, there are situations and certain types of contracts, like those pertaining to certain intellectual property, where a non-assignment provision may be enforceable in bankruptcy.

3. Monitor and Enforce the Terms of Your Contract. This sounds easy but in reality often gets overlooked. Calendar and monitor all deadlines and compliance dates in your contracts. It does no good to have provisions for your protection, as suggested above, if they are not monitored and enforced, and even worse, someone may argue that those provisions have been waived.

4. Think Outside the Box. Consult with your team and develop creative solutions for protecting your interests in a given business relationship. This requires understanding the other side's business and how the fragility of that business could possibly impact your company. Depending upon the circumstances of the transaction, there may be novel ways to accomplish the purpose of your contract that helps ensure timely and full payment. For example, a security interest provides priority payment in a bankruptcy upon the sale of the secured assets. You may be able to help protect your company through a limited security interest on the items you sell to the other party and the sale proceeds, even if a broader security interest would not be customary in your industry. Or perhaps you can obtain a letter of credit, have payments made in advance, require a deposit, or have certain payments that are otherwise owed to your counterparty assigned and paid to you or to an anonymous "lockbox" account which you can sweep. Thinking about creative ways to address the issues confronting your particular transaction also includes being flexible where it is strategically beneficial to you.

5. Have Leverage: Get Collateral for the Counterparty's Obligations to You. As mentioned above, obtaining a lien on a party's assets, or obtaining a guaranty, surety bond or a letter of credit may be very useful in providing additional protection to you for payments owed to your company, whether or not a bankruptcy takes place. A security interest in or lien on assets of a party that finds itself in bankruptcy will give you leverage to protect your company's interests in those assets and put your company ahead of other creditors who do not have such protection. It will also provide your company with payment priority upon sale of those assets. Guaranties, letters of credit and surety bonds may be beneficial because, generally, they are not considered property of a company's bankruptcy estate, meaning that they can be drawn on without being in violation of bankruptcy laws that otherwise prevent creditors from taking possession of assets of an entity in bankruptcy.

6. Beware of Payments Received That May be Clawed Back In a Bankruptcy. Perhaps one of the most exasperating aspects of bankruptcy for a creditor is the ability to be sued for the return of funds that were rightly due and received prior to the bankruptcy of the payor. While "cash is king" and it is beneficial to be paid by someone who owes you money, you must recognize that under certain circumstances that payment comes at a price and may be clawed back if a bankruptcy occurs. This is what is referred to as an "avoidance action" in bankruptcy, and there are generally two kinds, a "preference" and a "fraudulent transfer:"

a. A preference may occur, generally, when someone is paid on a past due debt while the payor is insolvent. If the payment is deemed a preference, payments that your company receives within 90 days prior to the date of the payor's bankruptcy filing are subject to clawback. AND, if you are an "insider," such as a relative, owner or officer of the payor, that clawback can extend to payments that you received as far back as one year from the payor's bankruptcy filing date. Preferences can stem from payments arising under many different types of transactions, including settlement agreements. The analysis of what constitutes a preference is detailed and often complex, but for purposes of this article it is important just to recognize the issue so you can discuss it further with a restructuring professional.

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b. The second kind of avoidance action is a "fraudulent transfer." This is really a misnomer because it has nothing to do with fraud. A fraudulent transfer can generally occur where, pre-bankruptcy, another party, while insolvent, enters into a transaction with your company and such party receives less than equal value in exchange for what was transferred to your company. For instance, pre-bankruptcy a customer gives your company inventory to satisfy its outstanding and past due debt. If that inventory has a value of more than the debt, that transaction potentially could be avoided or you may need to pay the full value for what was received. As another example, perhaps you purchased real estate from a third party with whom you had no prior relationship. If that seller goes into bankruptcy and the real estate value was more than what you paid for it, that transaction could be deemed to be a fraudulent transfer and sought to be unwound. Avoidance of transactions deemed to be fraudulent transfers can go back many years depending on the applicable state law, so consulting a financial restructuring lawyer when receiving payment from a financially distressed entity is important.

7. Don't Miss Opportunities Both Before and During the Bankruptcy of Another Company. Financial distress breeds opportunities. Given the expense and delays of bankruptcy for all stakeholders, don't miss the opportunity to potentially restructure a debt to your company without the public notice, costs and delays inherent in a bankruptcy, especially if the unresolved debt to your company may be the driving force for a bankruptcy filing. On the other hand, don't miss a favorable opportunity to acquire a business or assets of a company in bankruptcy for your own expansion or new business. Acquisitions through bankruptcy are often at bargain prices where such assets can be obtained free and clear of any debt of the selling company, and there may be some tax benefits obtained as well. In order to take advantage of such opportunities, you need to regularly communicate with your business partners and key vendors, know what is happening regarding the status of their businesses, and recognize the signs of a potentially distressed company as discussed above. Further, check in with a financial restructuring lawyer. I frequently communicate with my clients regarding foreseeable bankruptcy filings and alert them regarding bankruptcy filings that are relevant to their operations or strategic plan.

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