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Managing Distressed Customer Relationships

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In the wake of the COVID-19 pandemic, we are often asked what our clients should do if a business (such as a supplier, customer or any other contract counterparty) is suffering distress and may be contemplating filing for insolvency.

It is, of course, impossible to anticipate every potential scenario, but here are several general "do's and don'ts" to consider. Recognising that the facts and circumstances differ as to each situation, as always, it is best to consult your restructuring advisers as soon as possible if you believe a business counterparty is suffering financial distress and may be close to insolvency. They will be able to tailor the advice to fit the specifics of the circumstance.

Before Insolvency

Stay on top of payment terms.

Distressed companies often fall behind on receivables. If you believe a customer or other counterparty is suffering distress, then you should monitor collections carefully to avoid slippage in payment. We frequently hear concerns regarding accepting payments that might be subject to clawback as a preference if there is a subsequent insolvency. We generally recommend that should you not be overly concerned whether a payment may be a preferential transfer. While it is true that a payment from a distressed party can in some cases amount to a preference, that payment can be clawed back only if the company making the payment files for insolvency within a specified time period, if the statutory elements of a preference are met and if the insolvency practitioner seeks to avoid the transfer as a preference. There are a number of "if's" in that scenario. The bottom line is that, if you are owed money, then you should do your best to collect.

Collecting is easier said than done in practice. The fact is that you may have a longstanding relationship with your customer that precludes you from demanding payment on time every time. Moreover, the COVID-19 pandemic has most businesses looking for concessions now, so you may feel obliged to be flexible. Whatever the scenario, it is better to have the payment in hand prior to an insolvency. You should understand that the longer you put off receiving payment, the more likely it is that you may never receive payment, especially if your customer files for insolvency. It is a business risk that should be carefully managed.

Know and understand your rights.

You undoubtedly have written terms that govern most of your counterparty relationships. If you believe your business counterparty is in distress, it is a good time to dust off those agreements and review to understand exactly what rights you have. Your written terms will have remedies that you should consider whether and when to exercise. There may also be applicable notice and cure periods that need to be followed in order to exercise remedies, including termination. Importantly, properly terminating an agreement before insolvency commences may be a game changer, particularly in light of the proposed changes to UK Insolvency Laws that may prevent you from being able to terminate post-insolvency, regardless of what your rights are under the contract.

Understanding precisely what you can do when your counterparty is in breach is critical to effectively managing through the distress of your counterparty. This is not to say that every remedy should be exercised. Rather, you should consult your lawyers to understand your rights and understand the ramifications of exercising those rights (or not). Again, you likely will want to consider balancing collection pressure with maintaining the relationship you have with your customer. Recognise, however, that an intervening insolvency changes the dynamic regardless of your longstanding customer relationship.

Understand your shipping/delivery terms and when title to goods passes.

An intervening insolvency during the shipment of goods on credit can often create problems for the company supplying the goods. The intervening insolvency may raise questions about whether the goods are or are not property of the insolvent estate. Ensuring that your supply contract incorporates a robust retention of title clause will put you in a better position to secure the return of your goods if your customer files for insolvency, or at least in a better position to receive payment post-insolvency. Pre-payment may also be necessary under circumstances where your customer is suffering distress.

Consider whether a forbearance agreement or a modification of existing rights makes sense.

Distress often results in a breach or default in your agreement. This may provide an opportunity to negotiate a forbearance agreement or modification that improves your position. Oftentimes, good faith negotiations concerning a forbearance or modification may result in obtaining collateral for previously unsecured debt, although such security may be challenged by a subsequently appointed insolvency practitioner. Despite collateral obtained in these conditions possibly being open to challenge, it is better to have that security. Moreover, you may have an opportunity to cure defects included in loan documents (e.g. unperfected security interest, incorrect legal name for borrowers, incorrect guarantor information, signatures, etc.).

You also may be able to negotiate financial incentives or other favourable terms as part of the forbearance agreement or other modification. The party seeking a forbearance may also agree to more lucrative terms in consideration for the relief you are providing – perhaps you can obtain a personal guarantee from a parent company or more stable affiliates. You may also have your lawyers' fees paid as part of the negotiated deal.

In short, and in consultation with your lawyers, there may be a number of benefits to negotiating a forbearance agreement or other modification.

After Insolvency

The landscape changes once the insolvency commences. Once that occurs, you should consult your lawyers immediately because you:

- May be prevented from bringing or continuing litigation, enforcing your contractual rights and other actions against the company
- May be able to stop goods in transit
- May be able to recover your goods if you have a valid retention of title claim
- Should consider freezing payments owing to the debtor to determine whether you can offset those against monies owed to you
- Should assess your payment history to determine whether and to what extent you have a claim in the insolvency
- Should timely file a proof of claim for any and all amounts owed
- Should assess preference exposure to understand whether there is any clawback risk

Conclusion

Taking a proactive approach with distressed customers is always the best tactic. A few hours crafting a thoughtful strategy with lawyers early in the process can save you large sums as your customers' distress deepens and they perhaps file for insolvency. Know your rights, exercise those rights when appropriate and protect yourself.

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