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Client Alert: Sales Incentives and Rebates: When Customers Extend Terms, Default or File Chapter 11 in the Perfect Storm

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The world economy is experiencing the perfect storm of inflation, interest rate increases, supply chain disruption, and a potential global recession. These conditions exert pressure on trading partners who may have nowhere to turn but each other to relieve pressure. Contract parties are experiencing requests for price increases, extended payment terms, and cancellation of some or all orders. How a contract party addresses these issues depends on the business leverage between the parties and the importance of the business relationship.

If companies accommodate their counterparties on these requests, it is advisable to document any contract changes in a temporary concessions addendum to a contract with a fixed termination date, rather than a contract modification that is ongoing.

It is common in commercial sales for sellers to provide purchase incentives for customers. Sales incentives are intended to enhance sales with customers that are good business partners. These incentives are often rebates of a percentage of the purchase price for annual purchases that meet or exceed a volume threshold. Usually rebates are accrued and paid quarterly or annually.

We have also encountered companies within certain industries that barter or buy and sell among each other. This may be as a temporary supplement to capacity or customer needs in a certain geographic location. As a result, the companies will have mutual obligations to each other, creating an opportunity to utilize setoff to be paid.

Suppliers of goods who provide rebates to their customers may consider utilizing rebates as a negotiating point. Perhaps eliminating, reducing or postponing rebates for the duration of the temporary concessions addendum. Not only does the supplier derive some economic “quid pro quo” for concessions, but it also provides incentive to the parties to revert to normal terms as soon as possible.

Customer Default

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What happens if a customer defaults in payment of the seller's invoices, or worse, files for Chapter 11?

When a customer fails to pay invoices or pays beyond stated credit terms, should that customer nevertheless be entitled to rebates?

A seller can utilize the common law remedies of setoff or recoupment to offset all or some of the accounts receivable owed to the seller by a deduction of any rebates owed by the seller to the customer. In effect, the seller is paid by cancelling the rebates.

It is recommended that agreements to pay rebates be set forth in a written contract. The following should be considered for such agreements:

1. Rebates are due only for invoices that are paid, and paid within credit terms. At a minimum, rebates are materially reduced for late paid invoices. Rebates should be "earned".
2. If a threshold amount of invoices is paid late, say 25%, the customer forfeits all rebates owed.
3. If either the seller or the customer are part of a larger company group with affiliate companies, it may be that each of the seller and customer are doing business with affiliates of each other. Seller A may sell to Customer B and also to Customer B's affiliate. In such cases, Sellers should consider a "triangular setoff agreement" allowing any rebates owed by the seller or any of its affiliates to be offset against any debts owed by the customer or any of its affiliates. Such triangular setoff agreements are generally enforceable outside of Chapter 11.

<u>Customer Chapter 11</u>

If a customer files Chapter 11, the rules are different.

The Bankruptcy Code recognizes the common law remedy of setoff in Chapter 11 proceedings. However, the Bankruptcy Code adds requirements to be able to exercise setoff.

1. The debts to be setoff must be mutual, meaning setoff can only occur between the precise legal entities that owe each money. Bankruptcy Courts routinely refuse to enforce triangular setoff agreements in Chapter 11.
2. The obligations to be setoff must both be pre-petition obligations or both be post-petition obligations. Parties cannot setoff a pre-petition obligation against a post-petition obligation.
3. The debts to be setoff do not have to arise out of the same contract or transaction between the parties. Normally sales agreements and rebates owed with respect to such sales do in fact arise out of the same transaction.
4. The Bankruptcy Code also provides that a setoff exercised within 90 days prior to the Chapter 11 filing may be recovered if the seller exercising setoff improved its position based on a calculation prescribed in the Bankruptcy Code. Given the lack of clarity of the rules in this regard, it is often best for sellers to not exercise this setoff right during the 90-day period. Rather, it may be prudent for sellers to wait until Chapter 11 is filed and then file a motion seeking court approval of the setoff (specifically, relief from the automatic stay), which should be granted. However, cash-strapped debtors may attempt to oppose a setoff motion to improve their cash position.
5. Recoupment is setoff's first cousin but requires that the mutual obligations must arise out of the same transaction. Unlike setoffs, to exercise the recoupment remedy, a creditor is not required to file a motion for court approval.

<u>Setoff in a Section 363 Sale</u>

Often in Chapter 11 cases, the “main event” is a sale of all of the debtor’s assets to a third party pursuant to Bankruptcy Code Section 363. Section 363 sales are considered highly efficient sales since assets can be sold free and clear of all liens and encumbrances; instead, they attach to the proceeds of sale. This creates an incentive for potential buyers to submit purchase offers as they receive “clean title” in a Section 363 sale, often at a heavily discounted price. Debtors’ lenders seeking to liquidate their collateral embrace Section 363 sales as an efficient liquidation tool.

We have seen many Section 363 sales (which are almost always asset purchases, not stock purchases) where the buyer purchases “all assets” including all monies owed by third parties, including rebate obligations from vendors. Yet, the accounts receivable obligations owed to vendors are not assumed by the buyer and remain with the debtor/customer which has virtually no assets post-sale. This maneuver is intended to bifurcate the obligations that are subject to setoff, effectively eliminating the setoff remedies. In such cases, vendors must object to the Section 363 sale to the extent it eliminates setoff rights.

Setoff is a Secured Claim

The Bankruptcy Code provides that a vendor holds a secured claim to the extent of the value of the setoff. If the debtor owes the vendor $100,000, and the vendor owes the debtor $50,000, the vendor is a secured creditor in the amount of $50,000.

The Bankruptcy Rules require that any determination of the validity, extent and priority of a secured claim must be effected in a formal adversary proceeding commenced by a complaint and formal service of process to provide the secured creditor adequate due process.

However, it is common for Chapter 11 debtors to seek elimination of setoff rights by motions, including Section 363 motions, with easily missed omnibus service of process to all creditors. Creditors with setoff claims should be diligent and object to such motions to preserve material setoff claims.

Summary

Setoff and recoupment are strong remedies for sellers of goods, who are owed money by customers but also owe money to their customers such as rebates. Such remedies should not be left to the vagaries of courts interpreting common law remedies. Rather, the parties should memorialize the setoff remedy in a clear, well-written contract.

In Chapter 11, setoff is a remedy that effectively provides sellers 100% recovery to the extent of the value of the setoff. Compared to the usual de minimis recovery on pre-petition unsecured claims, a setoff claim is valuable low-hanging fruit. Creditors need to be proactive to preserve and effect setoff and recoupment rights.