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Client Alert: COVID-19 Impact for Manufacturing Companies: Strategies to Flatten the Curve with Customers and the Supply Chain

INDUSTRY SECTOR

Manufacturing

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INTRODUCTION

COVID-19 has and for the foreseeable future will have unprecedented adverse impact on the global economy and all companies' business operations. Government and banking systems throughout the world have initiated massive aid programs to blunt the impact of COVID-19. Regardless, there will be substantial market disruptions including the supply and deliver of goods and services. Business relationships and contracts between sellers and buyers will be at the center of this disruption, from contract modifications or terminations, to breaches of contract, to the insolvency of contract counter-parties. All companies should be proactive in protecting business and contractual relationships, and in minimizing risks and loss, based on practical use of their legal rights and remedies in navigating contract issues and in insolvency proceedings.

WHAT COMPANIES SHOULD EXPECT

Companies' business goals are to sell products or services, and to maintain cash flow levels from timely payment of invoices by customers. Companies may also seek extended terms with suppliers to enhance liquidity.

Customers will request:

- Extension of credit terms
- Acceleration of rebate payments or "pre-bates"
- Possibly price concessions

Customers may seek cancellation or suspension of:

- Purchase orders
- Contracts

Suppliers may request:

- Shortened payment terms or cash before delivery
- Security for payment
- Additional financial information

Suppliers may also seek cancellation or suspension of:

- Purchase orders
- Contracts

Customers and suppliers may be impacted by various government orders restricting the ability to do business, unless exempted as an Essential Business.

Customers and suppliers may:

- Suffer adverse impact on liquidity
- Violate covenants with their lenders
- Lose important customers or supplier relationships
- Lose support of lenders or private equity

Customers' and suppliers' financial statements and projections are not reliable.

Customers and suppliers are more likely to meet the "insolvency" requirement of the U.S. Bankruptcy Code, precipitating more Chapter 11 filings.

- Insolvency occurs when liabilities exceed assets, or there is an inability to pay debts as they come due in ordinary course.

Lenders and private equity sponsors of customers and suppliers will likely restrict cash and liquidity.

Various government stimulus initiatives may allow some customers and suppliers to postpone insolvency or a Chapter 11 filing even though insolvent.

In such cases, customers and suppliers may linger in the "zone of insolvency" without a formal declaration of insolvency or Chapter 11 filing.

Some customers and suppliers will remain viable but challenged, others will enter in to the zone of insolvency and some will file Chapter 11.

- Note that companies' normal business counterparts very likely have restricted or nominal decision-making authority, as lenders, private equity or restructuring officers are likely making or participating in key decisions.

HOW COMPANIES CAN BE PROACTIVE

Understanding that companies' business goals with their customers and suppliers may not be a "one size fits all", companies need a flexible strategy to negotiate and push-back, based on the unprecedented circumstances and companies' legal rights.

Just say “no” may be the first push back to contract concessions requests.

As a condition to a company’s consideration of contract concessions, customers and suppliers should be willing to

- Increase financial and operational transparency
- Have realistic discussions about the impact of COVID-19 on existing financials, projections and liquidity
- Disclose its exemptions as an Essential Business in various jurisdictions (within the U.S. or globally)
- Disclose loan covenant violations or restrictions on borrowing or liquidity imposed by lenders and private equity sponsors.
- Under the circumstances, providing security is a fair discussion point. Possibilities include consignment, letter of credit, cash deposit, etc.

Legal rights and issues

- Exercising legal rights will allow companies to minimize loss, or can be used as leverage to push back in contract concession discussions.
- Much has been recently written about force majeure (see below) and indeed it is important. However, the UCC Article 2 remedies below have a lower bar to access.

UCC 2-609. Uniform Commercial Code (UCC) Article 2 (sale of goods).

Section 2-609 allows a seller of goods who has reasonable grounds of the customer’s ability to perform, may demand written assurances of performance within 30 days and pending receipt of assurances, suspend the seller’s performance obligations.

UCC 2-609 is an effective tool to promote quick communication with customers, in addition to a pause in performance to mitigate risk.

Given the unprecedented circumstances, sellers should demand assurances in 2-3 days.

UCC 2-609 may be utilized even if the customer is current in payment.

UCC 2-702(1). Cash before Delivery upon Insolvency.

UCC 2-702 (1) allows a seller, upon learning that a customer is insolvent, may ship goods only on a cash before delivery basis, regardless of a contract that provides for credit terms.

A Chapter 11 filing is not required to establish insolvency.

UCC2-702(2). Reclamation.

Upon learning that a customer received goods on credit while insolvent, a seller may reclaim such goods upon 10-day demand.

UCC 2-705. Stoppage of Delivery.

Upon learning of the customer’s insolvency, a seller may stop delivery of goods in transit.

Again recognizing the need for a flexible approach with customers and suppliers, companies should consider the following in contract discussions:

- Just say “no”
- Ongoing financial transparency as a condition of discussions
- Interest upon default
- Payment of attorneys’ fees
- Elimination reduction or suspension of rebates or other sales incentives
- Commitments for additional business (for viable customers)
- Setoff of existing rebates against existing invoices owed
- Waiver of any claims and indemnification for all losses arising from concessions

Drafting tips

- Any changes should be memorialized in a temporary concessions addendum, not as an amendment to an existing contract.
- Concessions should automatically expire on a date certain, subject to extension if warranted.
- Addendum should expressly recite the customer concession request as a result of COVID-19, and the company’s agreement.
- Strict compliance with revised payment terms, which automatically revert to original terms upon a default in payment.
- Include a “hell or high water” clause, which requires performance regardless of any adverse circumstances, for any extended terms granted.

Supply Chain Rescue

- The Institute for Supply Management estimated 75% of U.S. businesses have experienced COVID-19 related supply chain disruption.
- To stabilize the supply chain, companies may need to be creative.
- Companies should immediately identify all key players in their supply chain. Then assign levels of risk to each key player.
- For all key suppliers, companies should initiate ongoing communications on the topics indicated above. The key is financial and operational transparency, and to identify early the risks of non-performance or delayed performance.
- Companies can provide financial accommodations to critical suppliers with prepayments, early payment, and temporary business loans, etc. which could be repaid over time or through shipment of additional products.
- Companies’ accommodations should be temporary, and subject to automatic termination.
- Companies could use “accommodation agreements” to keep suppliers temporarily afloat, which could include a premises and employee lease agreement.
- Ultimately, suppliers may be acquired by a competitor or by the company, as economic conditions will likely cause industry consolidations.

CUSTOMERS IN THE ZONE OF INSOLVENCY

For customers in the zone of insolvency, who may ultimately file Chapter 11, the most prudent action may be to aggressively reduce the accounts receivable balance.

This requires a change to cash before delivery, or a reduction in terms, which can be accomplished by utilizing UCC Sections 2-609 and 2-702 discussed above.

Changes in terms prior to a Chapter 11 filing normally adversely impacts one of the three vendor defenses to a Chapter 11 preference claim, the ordinary course of business defense.

For this reason, it is advisable to not accelerate payment of existing invoices (unless circumstances warrant), rather restricted terms for new invoices.

Depending on the circumstances, the goal to minimize a potential preference claim should not drive otherwise rationale business objectives.

FORCE MAJEURE AND IMPRACTICABLE PERFORMANCE

Force majeure

- Force majeure contract clauses are narrowly construed to cover specifically identified events.
- Common law force majeure is also narrowly interpreted.
- Notice must be provided to the counter-party.
- The claiming party has the burden of proof that the force majeure event specifically prevents performance.
- There is also a burden of proof to prove that party exercised skill, diligence and good faith to attempt performance.
- Courts may excuse, if any, partial or temporary performance.
- Change in market demand is usually insufficient to trigger force majeure.
- However, during the Avian Flu, courts ruled that a major unpredictable event that causes a shift in market conditions was sufficient.
- 2008 financial crisis was generally not a force majeure trigger.

UCC 2-615. Performance Impracticable. A seller's delay in delivery or non-delivery is not a breach (excused) if performance has been made impracticable by unforeseeable occurrences. Sellers must provide notice and exercise good faith in attempting to perform all or a portion of its obligations.

UCC 2-615 is also narrowly construed, and like force majeure, is a high bar for parties seeking relief in performance.

DOING BUSINESS WITH A CHAPTER 11 DEBTOR

Credit Risk.

Selling to a Chapter 11 debtor is a high credit risk, analysis of which goes beyond normal credit risk analysis. Rather, many "first day" motions, including for debtor-in-possession (DIP) financing, "pre-packaged" Section 363 sales or plans of reorganization, materially limit vendors' rights and the ability to be paid.

It is very important for vendors to review, and possibly object to, "first day" motions.

Administrative Expense Priority Claim.

Post-petition sales to a Chapter 11 debtor can have administrative expense priority.

To qualify, post-petition shipments must arise under a post-petition contract and goods or services must be delivered post-petition.

If there are pre-petition purchase orders, they will need to be re-issued post-petition or, the debtor must obtain a court order addressing this issue.

Where lenders have liens on all assets and proceeds, debtors may not use cash unless there is a court order approving DIP financing or use of cash collateral.

Payments to vendors without such court order may be disgorged as unauthorized post-petition transfers.

Transactions with a debtor must be in the ordinary course of business, or have court approval.

If there is no sales or supply agreement, rather sales are on a purchase order and invoice basis, a vendor is not required to sell or extend credit terms to a Chapter 11 debtor.

Executory Contracts.

Executory Contract is the Bankruptcy Code term given to essentially any contract between a debtor and a non-debtor party where both parties owe performance to the other. A promissory note would NOT be an executory contract since the holder of the note has no performance obligation. However, a supply contract or other sales agreement would almost always meet the requirements of an executory contract under the Bankruptcy Code. The Bankruptcy Code Rules for rejecting executory contracts are debtor-friendly which is often incentive for Chapter 11 filings.

The Bankruptcy Code provides debtors the unfettered right to assume or reject executory contracts and leases. If a debtor rejects an executory contract, the non-debtor party receives a general unsecured claim for damages arising from the debtor's "breach" of contract. Thus, a debtor escapes the contract with little cost. On the other hand, the debtor also has the right to assume or assign a contract. In this instance, the Bankruptcy Code requires that the debtor "cure" the contract by paying existing defaults. Presumably, debtors would assume contracts that they deem to be valuable either because they insure an uninterrupted supply of goods or contain favorable pricing or terms. For a creditor who is a party to an executory contract, the assumption of such contract can be an effective vehicle to obtain payment of pre-petition debt.

Debtors in Chapter 11 must assume an executory contract before or in conjunction with the confirmation of the Chapter 11 Plan. The non-debtor party to the contract can ask the court to set a shorter time if it will be harmed by the delay in the debtor's decision.

The Bankruptcy Code requires that the non-debtor party to an executory contract must continue to perform its obligations under the contract pending the debtor's decision to assume or reject such contract, and provided that the debtor is in fact performing its obligations of the contract post-petition.

Generally, the obligation to continue performance is subject to a seller's UCC Article 2 rights including UCC 2-609 and UCC 2-702, though Chapter 11 debtors often challenge this (usually at the behest of their financiers).

A supply agreement impacts a creditor's rights as a critical vendor since the leverage of not shipping is arguably eliminated in the context of an executory contract.

CHAPTER 11 CLAIMS/REMEDIES

20 Day Administrative Claim.

- Under Section 503(b)(9) of the Bankruptcy Code, sellers of goods are entitled to an administrative expense priority claim for the value of goods delivered to and received by a debtor within 20 days prior to the bankruptcy filing.
- In cases where the debtor's Chapter 11 proceeding is "administratively insolvent", the likelihood of

payment of administrative expense priority claims is compromised.

Critical Vendor.

- Critical vendor is a creditor remedy based on a theory that a particular vendor is so essential to a debtor's ability to continue operating that without the uninterrupted flow of the seller's goods, the debtor cannot continue to operate and thus has no realistic chance of a successful reorganization. A bankruptcy court has broad authority to order relief that facilitates a successful reorganization.
- Only a debtor can make the determination that a particular vendor is critical and seek court approval of same. A creditor cannot independently impose its critical vendor status on a debtor.
- Some jurisdictions refuse to entertain critical vendor motions. However, Delaware and New York continue to be jurisdictions where critical vendor payments can be approved in appropriate circumstances.
- Vendors who are truly critical to a debtor-customer should continue to seek critical vendor status as a means of getting paid. In doing so, vendors should be careful to not violate the **automatic stay** by conditioning future business on payment of pre-petition debt. Moreover, vendors should be aware that getting paid as a critical vendor will likely be conditioned on providing normal lines of credit, pricing and terms, or other "customary trade procedures."

Setoff and Recoupment.

- An often overlooked remedy, setoff arises from the settlement of mutual debts or accounts owed between a debtor and a creditor. Simply, if A owes B \$100 and B owes A \$50, then the debts can be resolved as follows: $\$100 - \$50 = \$50$, so A pays B \$50 and the accounts are settled. The Bankruptcy Code codifies this common law remedy and in fact provides that the creditor has a secured claim to the extent of the value of its setoff claim.
- The debts owing must be owed to and from precisely the same legal entities and the debts must arise either both pre-petition or both post-petition. The debts do not, however, have to arise out of the same transaction.
- The exercise of a setoff remedy requires relief from the automatic stay from the Bankruptcy Court. Moreover, there are somewhat complicated rules regarding exercise of setoff during the 90 days prior to the bankruptcy filing, which if not followed, could result in preference exposure.
- Recoupment is similar to setoff, except that the mutual debts must arise from the same transaction.

Sale of Claims.

- A possible opportunity to monetize claims early.
- There has been a vigorous market for the purchase of bankruptcy debt, particularly in larger bankruptcy cases. The purchasers are usually private equity or hedge funds that are in essence seeking to purchase claims at a discount in hopes that the ultimate dividend, whether in the form of cash payments or stock in the reorganized entity, will provide a return on such investment.
- Claim purchasers will only purchase claims that are not disputed or contingent as to liability. Claim purchasers will usually agree to buy claims based on the debtor's schedules of assets and liabilities. However, purchasers will not buy claims based on a creditors' proof of claim if it is materially greater than the claim listed on the debtor's schedules, at least until the claim is resolved in the claims reconciliation process.
- Creditors who sell claims should carefully review the claims assignment contract for pitfalls and potential risks.

Preferences.

- Bankruptcy Code Section 547 allows the debtor to recover pre-petition payments to third parties that were made within 90 days prior to filing as to non-insiders and within one (1) year prior to filing with respect to insiders. The requirements to assert a preference are that the payment in question be made within the appropriate time period, made while the debtor is insolvent, the payment is on account of antecedent debt and the payment allows the creditor to receive more than it would in Chapter 7 liquidation. Debtors or trustees pursuing preference claims rarely have difficulty establishing these basic requirements.
- The statute of limitations on preference actions is two years from the petition date.
- Creditors who have received allegedly preferential payments have several defenses, the most common three being that the payment was made in the ordinary course of business, that the creditor provided subsequent new value after the payment at issue, or that the payment constituted a contemporaneous exchange for value.
- The Small Business Reorganization Act of 2019 (SBRA) contained amendments to preference laws, applicable to all Chapter 11 cases. In asserting preference claims, the Chapter 11 debtor now must exercise reasonable due diligence, taking a creditor's defenses into account. Also, for claims \$25,000 or less, the Chapter 11 debtor must assert the claim in the creditor's jurisdiction.

Fraudulent Transfers.

- Fraudulent transfers are a partial misnomer because fraud is not required. The debtor can recover payments made to creditors for transfers occurring within one year prior to bankruptcy. The debtor can recover transfers that were made "less than reasonably equivalent value".
- A statute of limitations on asserting fraudulent transfer claims is two (2) years from the petition date.

NOVEL CHAPTER 11 ISSUES

Section 305 Suspension of Chapter 11 Case.

- On March 11, 2020, Modell's Sporting Goods filed Chapter 11 cases in New Jersey to close its 153 stores through controlled liquidation sales. As a result of COVID-19, Modell's filed a motion under Section 305 of the Bankruptcy Code to suspend the Chapter 11 proceeding. Section 305 allows a bankruptcy court to dismiss or suspend a Chapter 11 proceeding if it is in the best interest of creditors. On March 25, 2020, the Bankruptcy Court suspended the Chapter 11 cases through April 30, 2020, with the possibility of an extension of the suspension.
- Section 305 may encourage companies to seek Chapter 11 protection, but immediately suspend the proceeding as a result of COVID-19.
- There are rumors of additional Federal stimulus package, where the U.S. Treasury would facilitate DIP financing to certain Chapter 11 debtors, presumably for key industry sectors.
- The Small Business Reorganization Act of 2019 was amended by the CARES Act on March 27, 2020, to increase the debt cap for qualifying debtors from \$2,725,625 to \$7,500,000.