

Prebankruptcy Planning¹

Introduction

In these uncertain economic times, sellers of non-consumer products must manage myriad concerns, including supply chain disruption caused by financial turmoil among companies that supply critical parts or components, rising costs for raw materials and semi-finished goods the seller incorporates into finished products, and rapidly changing customer identities and markets resulting from mergers and buyouts. One concern that seems to grow more disturbingly real each day is the possibility that a major customer will file for Chapter 11 bankruptcy protection. As a cursory glance at the business press reveals, potential bankruptcies by even America's largest industrial concerns is now openly discussed.

For most sellers of goods, the bankruptcy of a major customer can be a disaster. Thirty, sixty or more days of receivables are converted overnight to prepetition unsecured claims that may, after several years of bankruptcy process, be repaid at pennies on the dollar. A seller that fails to plan for such an eventuality may be unable to survive the loss of that expected cash flow. Some of the planning that a seller could do to ameliorate the bankruptcy of a major customer, such as adding to operational reserves, improving cash flow, and paying down debt, are beyond the scope of this article. There are additional steps that sellers can take, however, that are directly tied to the Bankruptcy Code and that will improve the seller's position in the event of a customer's bankruptcy filing.

Under the Bankruptcy Code, certain categories of unsecured creditors receive more favorable treatment in a bankruptcy, especially a large bankruptcy of the type under contemplation: claimants under §503(b)(9) of the Bankruptcy Code, creditors with setoff rights under §553 of the Bankruptcy Code, critical suppliers, and beneficiaries of guaranties from non-bankrupt parties. The following article discusses pre-bankruptcy actions that a supplier concerned about being an unsecured creditor in a large bankruptcy can do to improve its chances of obtaining one or more of these preferred statuses.

503(b)(9)

Section 503(b)(9) provides that suppliers to the debtor will have an administrative claim for the value of goods sold/delivered to debtor in the ordinary course of the supplier's business within 20 days prior to the petition date. Specifically, the section allows the seller an administrative expense claim equal to "the value of any goods received by the debtor within 20 days before the date of commencement of a [Chapter 11] case ... in which the goods have been sold to the debtor in the ordinary course of such debtor's business." In the typical large Chapter 11 case that results in the restructuring of the debtor business entity, administrative claims are paid out at close to 100%.

Under the Bankruptcy Code, only the sale of goods is covered by this section, and only goods that meet the criteria of the provision, including having been sold to the debtor within the specified time frame and in the ordinary course, create a claim to the special priority that is not afforded to other prepetition suppliers of the debtor. Since having an administrative claim can result in a much higher percentage of recovery in a bankruptcy case, sellers should strive to reduce the payment terms for

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customers known to be in financial trouble to a period as close to 20 days as possible, thereby maximizing the amount of seller's prepetition claims that will fall within the ambit of §503(b)(9).

Setoffs

Section 553 of the Bankruptcy Code provides that a creditor is permitted to setoff claims and debts with the debtor whenever such setoffs would be permitted by non-bankruptcy law. The primary caveat to that rule is that the setoffs must be mutual and between entities in the same capacity. In other words, there cannot be a triangular setoff: if Creditor C owes a debt to third party B, and debtor A owes amounts to both B and Creditor C, under §553, C cannot setoff the amount it owes B against the amount A owes B.

It is not unusual for sellers of goods to have multiple and complicated buy-sell relationships with customers and suppliers. Any post-bankruptcy setoff will have to take legal entities into account. For example, if one of seller's wholly owned subsidiaries (X) sells goods to Buyer, and one of Buyer's subsidiaries sells goods to another of seller's subsidiaries (Y), and Buyer and its subsidiary are in Chapter 11, Y cannot setoff the amount it owes to the subsidiary for the goods it purchased from that subsidiary against the amount that Buyer owes to X.

The best way to be correctly positioned for a potential Chapter 11 filing by a major customer from the setoff point of view is to obtain an agreement from the customer and all of its subsidiaries that all amounts payable between seller and all of its subsidiaries and the customer and all of its subsidiaries are subject to setoff by or against any entity with the family of companies on either side. For example:

If either party is in breach of any payment obligation under this Agreement or any other agreement between or among the parties or any of their affiliates, the non-breaching party (or any affiliate of the non-breaching party) may setoff any amount due from the breaching party to the non-breaching party (or any affiliate of the non-breaching party) against any amount due to the breaching party from the non-breaching party (or any affiliate of the non-breaching party), without regard to whether the money is owed by or to the particular entity that is the obligee of the breaching party's obligation.

If seller is able to insert language like this in all existing agreements with troubled customers, it will be able to exercise non-entity to entity setoffs despite §553, which does not prohibit such triangular setoffs if the parties have agreed to them in advance of the filing.

Critical Supplier

Typically the prepetition debts owed to a debtor's trade suppliers are paid out in small *pro rata* distributions after plan confirmation. In large business reorganizations, however, courts frequently will permit the debtor to pay some or all of the prepetition trade debt of certain critical suppliers whose goods and services are necessary for the debtor to have any chance for a successful reorganization. These creditors are therefore favored with a priority that other prepetition trade creditors do not receive – payment of some substantial portion of their prepetition claims early in the case. In return, these critical suppliers are required to make certain concessions to the debtor, generally to continue or resume selling to the debtor on normal or prepetition business terms.

In *In Re Kmart Corp.*, 359 F. 3d 866 (7th Cir. 2004), the court of appeals firmly, clearly, and in a major and carefully watched case reined in bankruptcy courts that had been routinely, indeed virtually automatically, entering critical supplier orders. The court stated that the payment of prepetition debts owing to critical suppliers is a use of property of the estate other than in the ordinary course, and therefore it must be approved under the standards of §363(b)(1) of the Bankruptcy Code. The court held that such payments could be approved, if at all, only if they “do the least damage possible to priorities established by contract or the Bankruptcy Code.”

The court of appeals held that bankruptcy courts must not enter orders permitting debtors to pay critical suppliers unless a solid evidentiary record is established showing at least the following:

1. the payments are necessary to the reorganization process;
2. sound business justification exists for the payment, such as the trade creditor will not do business with the debtor in the absence of such critical vendor status; and
3. the disfavored prepetition creditor (the non-critical supplier) will be at least as well off as it would have been if the critical supplier order had not been entered.

Dozens if not hundreds of bankruptcy courts have followed the lead of the *Kmart* case in determining whether to enter critical supplier orders. A leading case is *In Re Tropical Sportswear Int'l Corp.*, 320 B.R. 15 (MDFL 2005). Some of the critical facts the court in that case found in creating the evidentiary record that permitted it to enter a critical supplier order are the following:

1. the proposed critical suppliers had refused to continue to do business with the debtor; generally it is sufficient that the supplier will not continue to sell to the debtor on credit or on other business terms (such as extended payment terms) that the debtor deems necessary for its reorganization;
2. the goods or services supplied by the vendors were truly critical, some even unique; at a minimum, debtor must show that it would be hard or impossible timely to replace the goods or services supplied by the critical vendor;
3. the terms of the payments to the critical suppliers were the product of arms length negotiations;
4. the vendors agreed to reinstate normal business terms, including selling on credit with extended terms; typically, the vendor is not required to offer terms better than those afforded to debtor prepetition, but if a supplier had shortened or eliminated payment terms prepetition because of the debtor's deteriorating financial condition, the supplier usually will be required to improve on those terms to obtain critical vendor status;
5. since waiver by debtor of preference claims was included in the agreement with the critical vendor, the suppliers had to establish valid (or at least colorable) defenses to the claims; and
6. the debtor established that the other non-critical suppliers would be at least no worse off under the critical vendor order; the analysis typically is similar to the calculations that are required in a Chapter 11 plan – what would the other creditors receive in a liquidation of the debtor compared to what they might receive if the debtor is able to reorganize and get a plan confirmed. Since one of the threshold elements the debtor has to establish is that the goods or services supplied by the proposed critical vendors are necessary to reorganization, the analysis will assume that the debtor will not be able to reorganize without the goods and services provided by the critical suppliers.

Obviously, meeting these standards requires a supplier to be properly positioned. It must supply critical components that cannot easily be replaced or substituted for. That means that if it does not have a long term supply agreement with the debtor, it must refuse to honor further releases or purchase orders. If there is a long term supply agreement, the supplier must declare a breach of that agreement on some basis other than the mere filing of the bankruptcy petition. It must be willing to reinstate normal terms in return for payment of some portion of the prepetition debt.

A supplier should be prepared to establish its negotiating position immediately upon the filing of a customer's Chapter 11 petition. The business people who have direct contact with the customer must be trained not to offer their counterparts at the debtor any assurances of continued sales on credit, assistance, support, or any of the other generally supportive positions that a business might offer to a good customer in trouble. On the contrary, the supplier must take the hardest possible position consistent with its contractual obligations to the customer and push as hard as the law and the contracts allow for the best possible critical supplier order. The things the supplier will want are common sense: payment of as much of the prepetition debt as possible, waiver of any potential recovery actions for preferences or other transfers, and the most restrictive payment terms possible.

Finally, the critical supplier also will want to cooperate with the debtor in establishing the evidentiary record that will support entry of the critical supplier order. The creditors' committee and perhaps other constituencies will oppose preferential treatment for the critical suppliers unless they are convinced that the case will collapse without the goods and services supplied by those vendors and that the vendors will not supply further goods and services without such an order. The critical supplier will find it in its best interest to assist the debtor in making that case.

Guaranties

While a guaranty from an entity in bankruptcy does not give the supplier any priority as to that debtor, the supplier can enforce a guaranty from a non-bankrupt party even if the guaranty secures an obligation by a bankrupt party. A concerned seller should attempt to obtain cross guaranties from the parent customer and all domestic and foreign subsidiaries. Although it is likely that a Chapter 11 case involving a major customer would include all domestic subsidiaries, it might not include all foreign subsidiaries or affiliates. The parent may decide not to put a foreign subsidiary in bankruptcy for strategic reasons, because of unfavorable local laws, or because the subsidiary is profitable and does not meet the requirements for insolvency protection in that jurisdiction. If seller's sales to the parent or the domestic subsidiaries are guarantied by a non-bankrupt foreign subsidiary, there would be no reason that seller could not enforce that guaranty despite the U.S. bankruptcy filings.

Conclusion

Although a bankruptcy filing by a major customer can be devastating, there are steps a seller of goods can take to better position itself to take advantage of certain aspects of the Bankruptcy Code that will enhance the seller's recovery. The professionals in the Business and Commercial Law Practice Group at Robison, Curphey & O'Connell will be happy to assist your company in conducting such pre-bankruptcy planning.

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