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PRACTICE AREA PROFILE: BANKRUPTCY LAW

Trade creditor tips: Preparing for financially distressed customers

By Tom Maxson

Since the onset of the pandemic, experts have repeatedly warned of a coming surge in business bankruptcies, but they have repeatedly been wrong. Government lending programs, low interest rates, forbearance and adjustments from lenders and landlords and vaccine-inspired economic growth actually reduced the number of business bankruptcy filings in 2021 compared to 2020.

But it's now 2022, government programs are winding down and creditor patience may be waning. High inflation, interest rate increases, supply and labor shortages and turmoil in Ukraine present new challenges to business, while the pandemic lingers. New warnings of a coming bankruptcy boom should not be dismissed as crying wolf because the fundamentals could be different this time. Business leaders have operated in a historically low interest rate environment for the past 20 years and most have never experienced high inflation. Financial distress for some is likely. That's why suppliers and their counsel should prepare now for more financially challenged customers and bankruptcies. The good news is there are steps to take and rights to remember which can improve seller recoveries.

Start planning for payment defaults at the beginning of the relationship and work your way backwards. Credit applications for new customers should not only facilitate a credit decision at the outset, but also provide useful information if collection issues later arise. It should include banking and credit references, financial information, key customers, express obligations to pay interest on late payments and attorneys' fees incurred in collection, and a consent to jurisdiction, with an officer signing on behalf of buyer. Many of these same provisions are appropriate in a formal sales agreement, but for the many sales conducted solely on a purchase order-invoice basis and for customers leery of formal long-term sales agreements, a signed credit application can be useful in more ways than one.

Seller invoices/order acknowledgements should include pro-seller terms including the right of seller to change credit terms and the provisions mentioned above. However, for sales of goods in the U.S., sellers should be aware that the "battle of the forms" provisions in Section 2-207 of the Uniform Commercial Code (UCC) may render some of these terms unenforceable if they differ materially from language in buyer's purchase order/request for quote.

If possible, better to have buyer sign the order acknowledgement or, better yet, enter into a signed sales



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agreement for larger orders or repeat customers. If a signed supply agreement is possible, seller should require buyer representations on solvency and acknowledgements that the sale terms are in the ordinary course of buyer's business and that the value of the goods is reasonably equivalent to the sale price. These terms can be helpful if payments for the goods are subsequently challenged in "claw back" actions such as preference or fraudulent conveyance lawsuits in a buyer bankruptcy.

Also helpful is a grant of a lien covering buyer's property or at least the goods sold. The

latter can have senior priority over all other liens in the goods sold if it qualifies as a purchase money security interest (PMSI) under the UCC. This requires, at a minimum, a signed agreement granting the lien, a properly filed UCC financing statement and (if the sold goods are buyer inventory) written notification of seller's PMSI to buyer's secured creditors, all prior to delivery of the sold goods.

Sellers and their counsel should also reacquire themselves with seller protection sections 2-609, 2-702 and 2-705 of the UCC. UCC 2-609 allows sellers to demand from buyers adequate assurance of performance (payment) when seller has objective "reasonable grounds" to suspect that buyer will not perform. Sellers can suspend supply until adequate assurance is received, such as a deposit or proof of solvency.

Upon discovery of buyer's insolvency, UCC 2-702 allows seller to refuse delivery of goods except for cash payment, not only for the goods suspended but for all unpaid shipments already received. In addition, UCC 2-702 provides a seller on credit the right to reclaim, or demand return of, goods previously delivered to an insolvent buyer within ten days prior to seller's demand. If the buyer misrepresented solvency to the seller in writing within three months prior to delivery, the 10-day limitation does not apply. If the buyer files for bankruptcy, section 546 of the Bankruptcy Code enables reclamation demands to cover goods delivered within 45 days before the bankruptcy filing and extends the deadline for notice up to 20 days after bankruptcy. UCC 2-705 empowers a seller to stop transit of goods in route to an insolvent buyer provided the buyer does not have physical possession. This is so even if title has passed to the buyer or if the buyer has hired the carrier.

If the buyer files for bankruptcy, all is not necessarily lost, even for the unsecured seller. Section 503(b)(9) of the Bankruptcy Code generally provides sellers with a priority administrative expense claim for unpaid goods delivered

within 20 days of the bankruptcy, the buyer may deem the seller a “critical vendor” thereby enabling a better recovery for the seller; or the buyer could “assume” a seller contract which is not fully performed requiring a cure of all pre-bankruptcy defaults. The key is coordinating with experienced counsel as early as possible to protect the seller as much as possible in an uncertain and bad situation. ■

Maxson counsels clients in various aspects of commercial finance, bankruptcy, the Uniform Commercial Code, and creditors’ rights including secured lending transactions, preference and fraudulent transfer actions, mortgage foreclosures, enforcement of judgments, import and export control matters, collection matters, commercial lien disputes and general corporate transactions. He is a shareholder at Dentons Cohen & Grigsby P.C.

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