Credit Research Foundation
White Paper Brief

Blakeley LLP

# The COVID Recession and the Credit Terms Relationship:

# Using Credit Enhancements to Mitigate A/R (Past Due and Pending) and Preference Risk

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COVID, through state shutdown orders, has caused a severe financial and liquidity strain on companies. Despite the federal government and Federal Reserve's rollout of trillions of dollars of programs, such as the CARES Act and the Paycheck Protection Program to bailout companies, credit teams dealing with maturing and past due invoices are facing extraordinary financial risk. An avalanche of Chapter 11 filings, out-of-court workouts and liquidations are forecast for COVID-impacted customers. The COVID recession is forecast to be deeper and longer lasting than the 2007 financial crisis.

Customers' post-COVID supply chain strategy is to buy time and offload credit risk through a two-fold strategy: (1) reschedule the past due invoices, often the March through May maturing invoices; and (2) extend the credit terms of pending POs and future POs. The customers' strategy of buying time is the hope that business resumes as stay-at-home orders are lifted. COVID-impacted customers are often slow to respond to credit team inquires as to status of payment, given the new dynamic of customer A/P team members working from home.

## The Credit Team's Due Diligence

The supplier bears the risk of loss as it considers its response to preserve the credit terms relationship. Even customers with excellent payment histories and a strong balance sheet may be on the verge of insolvency because of the financial crisis.

Many COVID-impacted customers may have access to federal government funds, but is it sufficient to ride through the health crisis? If the customer does not qualify for federal government funding, is there private lending available? Credit teams are finding that their COVID-impacted customers may have limited access to federal funds or private lending, resulting in customers pressing the supply chain to provide terms to meet their working capital shortfall and liquidity crisis. Therefore, a credit team's evaluation of whether to extend or refuse terms requires balancing a number or risk factors, even where the customer is past due, in an effort to preserve the terms relationship.

Credit teams that experienced the 2007 economic downturn appreciate that there may be few assets that are available with a customer's insolvency.

An insolvency evaluation is key with many COVID-impacted customers. That evaluation includes: (1) COVID containment, social distancing duration and risk of a second wave; (2) customers' forecast of future cash flows, liquidity, capital resources and going concern risk; (3) business reopening risk and closing risk again; (4) return to normal business level timeline, including the risk of operating at partial capacity; (5) bridge financing to the other side of the health crisis, whether government, private lending or supplier terms; (6) risk of a W-shaped recovery, where the economy improves and then there's a second downturn; and (7) calculating bad debt reserve, especially with repayment agreements.

Part of the evaluation depends on the industry, but one question is: How long will consumers be afraid to venture out? Credit teams will closely monitor going-concern opinions with their publicly held customers and the likelihood to remain in business. A credit team's response to a demand for continued terms, even extended terms, to bridge the credit risk and preference gap may be to demand credit enhancements.

What credit enhancements may best protect the supplier with the account, and what documents are needed to enforce the enhancement? With credit enhancements, the credit team has three asset options: (1) third parties, such as guaranties, letter of credit, credit insurance and receivable puts; or (2) the supplier's assets, such as consignment or purchase money security interest; or (3) the customer's assets, such as a deposit or junior security interest. This is new territory for the credit team as they are on the front line of preserving the company's most valuable asset - its A/R portfolio.

**Bankruptcy Concerns**

The financial crisis has created an unprecedented liquidity crisis with COVID-impacted customers. This liquidity crisis is expected to lead to an extraordinary level of customer insolvency, with suppliers taking the risk of loss. As a result of the financial crisis, an avalanche of business bankruptcies and liquidations is predicted.

COVID-impacted customers, from the small to mid-sized to the largest, are facing a threshold of whether they have the cash flow and access to credit to emerge from the liquidity crisis and resume operations. Some portion of customers will not have the financial wherewithal and backslide into insolvency. The credit team must be mindful of either customer setting or the impact of insolvency with the account, such as:

- Preference claims
- Fraudulent conveyance claims
- Turnover actions
- Strong-arm powers, which are sometimes referred to as the avoidance powers or Bankruptcy Code Chapter 5 powers

1. **Bankruptcy Risk**
   For the supplier selling on credit, a customer's bankruptcy, whether Chapter 11, 7 or 13, usually means years of delay of payment with a nominal distribution after the delay. Adding to the A/R loss, the supplier may be a target for a preference, or other avoidance power claims. Credit enhancements are intended to reduce this risk.

2. **Automatic Stay**
   The automatic stay is an injunction that automatically and immediately goes into effect as soon as a bankruptcy is filed, without the bankruptcy court entering an order. The automatic stay prohibits a supplier from attempting to collect its debt.

3. **Avoidance Powers**
   a. ***Preference Claim***
      The Bankruptcy Code vests the customer (or trustee if one is appointed) with far-reaching powers to avoid transfers of assets prior to a bankruptcy filing, including payments to suppliers. The power to avoid preferential transfers is one of the most powerful weapons a trustee has. The Bankruptcy Code defines a preference expansively to include nearly every transfer by an insolvent customer 90 days prior to bankruptcy.

   b. ***Fraudulent Transfer Claim***
      A transfer may be deemed fraudulent, whether intentional or constructive. A customer, whether individual, corporation, LLC, or partnership, with sinister intent may devise a scheme to channel assets away from suppliers. Under state and federal law, these types of transfers are referred to as intentional fraudulent transfers.

      Whether a transfer may be deemed fraudulent requires the consideration of several factors, including the fraudulent intention of the parties, the financial condition of the customer, the value exchanged, and the relationship of the customer and the recipient of the transfer.

      A constructive fraudulent transfer is where reasonably equivalent value is not given in exchange for the transfer.

*c. Turnover Action*

Where a party, other than the customer or trustee, is holding the customer's property, that party may be required by the bankruptcy court to return the property. The property may be recovered through a Motion for Turnover, where the party holding the property is acting as a custodian of the property, which can be an ordered turnover.

*d. Strong Arm Powers*

The avoidance powers may allow for unseating a lien not properly perfected prior to the commencement of the bankruptcy filing, as well as a lien that was properly perfected but recorded during the preference period.

As a general rule, outside of bankruptcy, an unperfected security interest is binding between a customer and suppliers. Thus, a secured supplier has priority over unsecured suppliers, even if the supplier has not strictly complied with Article 9 of the Uniform Commercial Code to perfect its interest. The lack of compliance with Article 9 creates a problem for the alleged secured supplier primarily with a bankruptcy filing.

This means that upon the bankruptcy filing, a customer (or a creditor's committee) may act as a hypothetical judgment lien creditor withstanding to unseat unperfected liens. This means a supplier's alleged secured claim may be unseated if the supplier has not strictly complied with Article 9.

**Looking for Guaranteed Payment from a COVID-Impacted Customer**

In dealing with the COVID-impacted customer, the credit team should look for the credit enhancement tool that is most readily converted to cash and is least likely to be affected by a customer's out-of-court liquidation or bankruptcy. The challenge for the credit team with evaluating credit enhancements is that the health crisis has transformed into a financial crisis within weeks. Customers who had strong balance sheets and consistent payment history pre-COVID, are now in a liquidity crisis.

Given the immediacy of the customer financial crisis, credit teams are rushing to evaluate credit enhancements that best fit the credit risk and customer profile as a bridge to preserve the terms relationship. The chart below considers the effects of various avoidance actions and the automatic stay on credit enhancements, which is part of the credit team's evaluation.

| Effect of Bankruptcy on Credit Enhancements | | |
|---|---|---|
| **Credit Enhancement** | **Avoidance Action** (preference, turnover action, fraudulent, conveyance, strong arm powers) | **Automatic Stay** |
| Terms and Conditions | | |
| Letter of Credit | No | No |
| Certificate of Deposit (at transaction outset) | No | Yes |
| Guarantee | Possibly | Possibly |
| Consignment | Possibly | No |
| Purchase Money Security Interest | No | Yes |
| Security Interest in Assets | Possibly | Yes |
| Repayment Agreement | | |
| Credit Insurance | No | No |
| Supply Chain Finance | No | No |
| Accounts Receivable Factoring | | |
| Receivable Puts/Options | No | No |

**1. Terms and Conditions**

Given the uncertainty surrounding the economic recovery because of COVID, the terms and conditions contained in the credit application or supply contract provide the credit team greater protections in the event of a default. Given customers are demanding rescheduling payment on past due invoices, as well as demanding extended terms with future POs, the credit team needs protections from a COVID second wave to immediately protect pending and future POs. Those key terms to consider:

Bank reference consent;
Unilateral right to terminate credit prior to default;
Unilateral right to hold orders;
No waiver to enforce credit terms if payments are outside of terms;
Duty to inspect order and complain;

Force majeure provision to protect supplier in the event of inability to fulfill order because of COVID;
Attorney's fees and venue; and
Arbitration/mediation provision.

**2. Letter of Credit**

For the largest customers, a letter of credit (LC) provides the supplier with the greatest protection from customer payment and preference risk. However, because the financial crisis has so badly hit these customers' balance sheets, many may not accommodate the LC, but it's worth the credit team requesting one.

An LC is a contract between the supplier and an issuing bank, wherein the bank pays the supplier, as beneficiary, if the customer defaults on the supplier's invoice. The customer pledges its assets as collateral for the LC, which makes this enhancement so difficult to obtain as COVID-impacted customer asset values have dramatically and immediately declined. If the supplier submits proper documents upon a customer's default, the bank pays the LC and the customer reimburses the bank.

As stay-at-home orders are lifted and customers resume operations, the credit team should negotiate the amount of the LC equal to the amount of the line of credit. This may be especially important with mitigating credit risk given the health professionals forecast of a risk of a second COVID wave and possible reintroduction of stay-at-home orders.

The LC's independence of contract allows a supplier to avoid the impact of a customer's bankruptcy as a general rule. The supplier is paid by the bank and the customer's automatic stay does not interfere with the supplier's payment demand on the bank.

Should the credit team draw down on the LC within 90 days prior to the customer's bankruptcy filing, known as the preference period, courts generally do not view the drawdown as a preference.

**3. Certificate of Deposit**

Cash is king for COVID-impacted customers. Therefore, the credit team demanding a cash deposit to limit credit risk may face a tough negotiation. If a successful negotiation, the credit team may instruct the customer to have the CD issued in the supplier's name, or the credit team may hold it directly. The CD is unconditionally payable to the supplier upon demand, and automatically renews for the length of the credit line. The credit team should have a written agreement that states the deposit arrangement.

The CD should be entrusted to the supplier and thus not part of the bankruptcy estate if one is filed. The credit team would likely need relief from the automatic stay from the bankruptcy court to draw down on the CD.

Should the supplier draw down on the CD within 90 days prior to a bankruptcy, courts should not view the drawdown as preferential since the supplier did not receive more than entitled under a liquidation of the customer's assets.

If the CD is documented as a customer/supplier arrangement, the CD may withstand a customer's motion for turnover as the supplier has a greater right to the CD. A written agreement between the supplier and customer is crucial for the supplier to prevail.

**4. Guaranty, Personal and Corporate**

With the small- and mid-sized customer, a personal guaranty can provide leverage to pay if the customer fails to do so. Smaller customers are especially vulnerable to not having access to credit to reopen or stay open, even with the federal government's Paycheck Protection Program. Small businesses are especially susceptible to not reopening after being closed for so long and missing out on sales. Small- and mid-sized customers may have an added incentive to resort to a small business Chapter 11 filing if they are unable to work through debt problems, as the CARES Act has expanded the eligibility to file for those whose debt does not exceed $7 million.

A guaranty, whether personal or corporate, is not the preferred credit enhancement, as it may require the credit team to take collection action against the guarantor for payment. However, a guaranty may be used as leverage to force the customer to pay by threatening to pursue the guarantor.

The guarantor's undertaking is independent of the customer's promise to pay. Merely because both contracts are on the same paper, for example the credit application - the customer's promise to pay for the supplier's goods or services, and the guarantor's promise to pay if the customer does not - does not change the independence of the agreements.

The guarantee's independence of contracts may allow a supplier to avoid the effects of a customer's bankruptcy. A supplier does not need relief from the automatic stay from the bankruptcy court to sue on the guaranty, provided neither guarantor is in bankruptcy.

**5. Consignment**

Suppliers providing goods may consider a strategy to retain ownership of the goods shipped until the customer sells them in order to limit credit risk. Consignment is the method to maintain ownership of the goods, which can be key as customers resume operations.

Article 9 of the Uniform Commercial Code requires compliance for the credit team to maintain ownership of its goods, even when delivered to the customer. The agreement between the supplier and customers describes the relationship of the parties (the supplier owner is consignor and the customer is consignee), a description of the goods, and agreement that title to the product only passes to third-party buyers. The credit team files a

UCC-1 financing statement, which describes the goods and makes clear they are on consignment.

The credit team must give notice to creditors asserting a security interest in the customer's inventory to avoid any appearance that inventory coming to the customer is free from ownership claims.

A challenge for the credit team with a consignment request is that it requires customer consent, which means the customer’s lender must consent.

With a bankruptcy filing, consignments are challenged if the credit team does not adhere with Article 9. While the Chapter 11 customer may have possession of the supplier's product, title to the product does not pass to the customer under a consignment agreement. However, the supplier may have to get relief from the automatic stay from the bankruptcy court to recover its product.

If the supplier untimely records its UCC-1 during the preference period, the consignment agreement may be challenged as a preference. Likewise, should the supplier have failed to properly record its consignment interest, a bankruptcy trustee may be able to unseat the consignment agreement.

**6. Purchase Money Security Interest**

Like consignment, the supplier of goods is looking to mitigate credit risk with customers reopening. Under a purchase money security interest (PMSI), the customer signs a security agreement describing the goods, which gives the supplier a security interest in those goods. The supplier perfects the security interest when it files a financing statement with the filing office (usually the Secretary of State), which adequately describes the goods.

The supplier's PMSI will prime the inventory secured creditor's lien only if: (1) the PMSI is already perfected at the time the customer receives possession of the goods; and (2) the supplier gives written notice to any other preexisting inventory secured creditor. If the supplier fails to perfect the PMSI, including giving notice, the supplier's priority is governed by the "first to file" rule. This means that an inventory secured creditor will prime the supplier's PMSI.

The supplier holding a PMSI should be entitled to adequate protection with the customer filing bankruptcy.

A supplier must seek relief from the automatic stay from the bankruptcy court to foreclose on its collateral. Payments to the supplier within the 90 days prior to the customer's bankruptcy filing should not be viewed as preferential as the supplier did not receive more than entitled under a liquidation of the customer's assets. The question of whether there is a preference may turn on whether the supplier was fully secured (the value of its collateral equals the amount of its debt). If the supplier records its UCC-1 during the preference period, the recordation of the UCC-1 may be a preference if not timely filed.

## 7. Security Interest in Assets

Credit teams are dealing with scores of customers closing to comply with stay-at-home orders, leaving large dollar past due invoices pending. In a negotiation with the customer for repayment of the past due, the credit team may negotiate a repayment schedule secured by the customer’s assets. The supplier's priority to the customer's assets is generally chronological to preexisting secured creditors (first to file), and does not require notification to prior secured suppliers, as the supplier's interest is junior to theirs.

If the credit team can negotiate an all assets security interest, the supplier's lien is perfected at the time of filing the UCC-1. The customer must sign the security agreement and the security agreement must describe the collateral.

A supplier perfects the security interest when it files a financing statement with the filing office (usually the Secretary of State) that adequately describes the collateral. The main purpose in filing a financing statement is to guarantee that any third parties will have been notified of existing security interests in the collateral. The filing supplier thus takes priority over other non-secured suppliers and has the right to take possession of and sell the collateral if the customer defaults.

The supplier holding a secured claim in the customer's assets should be entitled to adequate protection with the customer filing bankruptcy. Adequate protection provides that the supplier's property interest is entitled to protection from depreciation and is insured against risk of loss.

A supplier must seek relief from the automatic stay from the bankruptcy court to foreclose on collateral. Payments to the supplier within the 90 days prior to the customer's bankruptcy filing should not be preferential as the supplier did not receive more than entitled under a liquidation of the customer's assets. The question of whether there is a preference may turn on whether the supplier is fully secured (the value of its collateral equals the amount of its debt). If the supplier records its UCC-1 during the preference period, the recordation of the UCC-1 may be a preference if not timely filed.

If the supplier has taken a security interest to secure a delinquent account during the preference period, the lien may be challenged by a trustee or suppliers' committee as a preference.

## 8. Repayment Agreement

COVID-impacted customers are requesting their suppliers reschedule the March and April invoices, given stay-at-home orders and the closing of nonessential businesses. A repayment agreement is an agreement between the supplier and customer to reschedule the customer's past due invoices. The credit team's strategy for a repayment agreement is to fix a payment schedule rather than relying on a customer's representation that they will pay when customer's pay them. Those terms are a product of negotiation between the credit team and the customer. The credit team should attempt to include as many terms and conditions to create leverage that the customer will focus on while honoring the COVID repayment agreement. Those terms and conditions for the credit team to consider:

Fixing the Indebtedness
Fixing the Payment Schedule
Discounting the Face Amount of Invoices
Waiver of Counter Claims and Disputes
Taking Collateral
Clean Up Documents

- Guaranty
- Preference Defense
- Favored Supplier Clause
- Fees and Costs
- Venue
- Default
- Acceleration Clause
- Stipulated Judgment
- Confession of Judgment

Second Wave COVID Closure
Extended Terms with Pending Pos

## 9. Credit Insurance

A supplier purchases credit insurance (CI) to avoid loss on a high-risk customer but retains the accounts receivable. CI may cover a variety of credit risk, such as a customer's bankruptcy, a default or dispute. The policy may cover up to 90% of the balance, with a set deductible. The insurer has the unilateral right to pull coverage over the account where the account is deemed high risk.

As COVID-impacted customers may be deemed high risk accounts, credit teams are dealing with limited availability for continued coverage, as well as seeking coverage for new accounts. Insurers are applying comparable credit risk evaluation as credit teams do for suppliers.

The CI contract is not affected by a customer's bankruptcy. Bankruptcy courts recognize that the proceeds of a CI policy are not property of the customer's bankruptcy estate, and that a bankruptcy court does not have authority to interfere with payment under a CI policy.

A supplier does not have to obtain relief from the automatic stay from the bankruptcy court to receive payment on the CI policy after the bankruptcy filing.

Should the supplier receive payment from the credit insurer within 90 days prior to the customer's bankruptcy filing, courts do not view the payment as preferential as the supplier did not receive payment from the customer, but from a third party.

**10. Supply Chain Finance**

Customers are pushing out the supply chain’s normal terms to extended terms as a strategy to preserve cash in dealing with a liquidity crisis. Large customers are offering suppliers, agreeing to extended terms, an alternative to holding the invoices until maturity.

Supply Chain Finance (SCF) allows a supplier to be paid from a bank designated by the customer as if a normal terms relationship, subject to a discount. Post-COVID, SCF can be a credit enhancement for a supplier. The supplier can negotiate with the bank that it assumes the risk of loss after the supplier is paid by the bank, say 30 days after shipment, but until the extended terms invoice matures, say 31 days to 120 days. For example, if the customer files bankruptcy 45 days after the supplier invoices the customer, the supplier will have been paid by the bank under the SCF program, and the bank assumes the risk on the 31st day. In this example, the bank would have the unpaid balance. The supplier must negotiate the risk of loss with the bank. The credit team may use the Supply Chain Finance as risk mitigation, like a letter of credit or credit insurance.

**11. Accounts Receivable Factoring**

Where the customer insists on rescheduling the past due invoices as well as agree to extended terms because of COVID, the credit team may consider a third party to assume the receivable risk. A/R factoring provides for the supplier to sell its customer account receivable at a discount to a factor, who is usually a financial institution. The sale is often nonrecourse, which means that the factor is responsible for the A/R in the event of default. The supplier usually invoices the customer, but the invoice is payable to the factor. The supplier sends the invoice to the factor, who pays the supplier.

As factoring is an independent agreement between the supplier and the factor, it allows the supplier to avoid the effects of a customer's bankruptcy. Depending on whether the factoring agreement is recourse, it may be the factor that is the party in interest in the bankruptcy. Bankruptcy courts recognize that the factor's payment of a supplier's invoices is not property of the customer's bankruptcy estate, and that the automatic stay does not stay payment to the supplier. Where the supplier receives payment from the factor within 90 days prior to the customer's bankruptcy filing, the payment is not preferential, as the payment is not property of the estate.

**12. Receivable Puts/Options**

Like credit insurance and factoring, Receivable Puts and Options are credit enhancements that provide the supplier the ability to offload bankruptcy risk to a third party, commonly a financial institution. The Put is a contract between the supplier and third party, wherein the third party has the option to buy the supplier's A/R at a later date for a specific price, both predetermined by the contract. Options Contracts are in two categories: (1) Put Contract; and (2) Call Contract. Each can be purchased and includes the underlying A/R, current date in which the contract is being enforced, the strike price, and expiration date.

If the customer files bankruptcy, the supplier exercises the Option Contract. Put Contracts can provide protection for the supplier selling on open terms post-petition as well.

If a customer files bankruptcy, a supplier does not need to obtain relief from the automatic stay from the bankruptcy court to receive payment on Receivable Puts after the bankruptcy filing. Should the supplier receive payment from the contract/option holder within 90 days prior to the customer's bankruptcy filing, such payment is not preferential as the supplier did not receive payment from the customer, but from a third party.

**Takeaways for the Credit Team Managing Credit Risk in the COVID Age**

Credit teams are at the forefront of an extraordinary balancing act: mitigating risk and attempting to preserve terms relationships, as customers try to find a pathway to the other side of the health and financial crisis. Credit enhancements may be a path for the credit team to achieve the continued balance.