

**Credit Research Foundation
White Paper Brief**



COVID and the Delinquent Account:

**The Repayment Agreement as a Strategy to Improve the
Quality of Accounts Receivable (and Reduce Preference Risk)
and Preserve the Trade Relationship**

By: Scott Blakeley

COVID has transformed from a medical crisis to an economic crisis and has wrought an unprecedented liquidity crisis on companies as states attempt to manage the health crisis through stay-at-home orders. Deteriorating economic conditions may have long run damage brought on by COVID. Notwithstanding the federal government and federal reserve funding trillions of dollars in relief packages for companies' immediate cash needs, these companies, not deemed to provide an essential product or service under stay-at-home orders, are freezing payments to suppliers to preserve cash.

In the face of this unprecedented economic downturn, customers are taking aggressive steps to preserve liquidity, improve their balance sheets and improve their cash position by pushing on the supply chain and unilaterally extending supplier's normal set terms to extended terms both for open invoices and pending POs. Credit teams dealing with maturing and past due invoices are facing extraordinary credit risk, even with those customers that were scored as low credit risk.

Many companies that were profitable pre-COVID and should be again when the health crisis passes, may not survive that long. Complicating the credit evaluation is whether the customer's business model has so changed as a result of COVID, that even if the customer reopens, the demand may not be sufficient to resume normal operations, or the customer is not able to

operate profitably because of social distancing. The credit team must determine whether the customer is one that survives. Part of the challenge is determining if the economic crisis will continue until the virus spread is controlled.

An avalanche of Chapter 11s, out-of-court workouts and liquidations are forecasted in the coming months. Companies that are staging their reopenings are leaning on the supply chain to assist their cash positions by rescheduling payment of invoices that are due and extending terms of pending POs. The customers' post-COVID supply chain strategy is to buy time, and offload credit risk, on the backs of suppliers through terms pushback as they await the reopening of the economy. Credit teams are balancing preserving the credit relationship for when customers resume operations with the responsibility to preserve the value of the A/R portfolio as customers freeze payments based on the COVID crisis.

Credit teams are drawing lines for invoices that are past due as a result of COVID, so-called COVID invoices, and crafting documents that produce the greatest leverage for payment on delinquent accounts in order to minimize later disputes for these invoices. Without a repayment agreement that sets out a payment schedule, the credit team has not created a contractual obligation for payment over time, which may result in a pay-when-paid setting. This results in a shortfall with the credit team creating an expectation for payment and reporting to management as to when payments will resume. A repayment agreement improves the quality of the A/R and reduces preference risk.

A. The COVID Repayment Agreement and Due Diligence

In assessing whether the customer is a candidate for a COVID repayment agreement as a method to cure the delinquent account, as opposed to collection litigation alternatives, the starting point for the credit team is to determine whether the customer is not just facing a liquidity crisis, as all customers rescheduling their invoices are in this cash crisis, but a solvency crisis. A liquidity crisis is where customers, even those with strong balance sheets, cannot access financing or credit. A solvency crisis is where customers cannot generate sales.

If the customer is insolvent, then additional time provided under a COVID repayment agreement, as well as agreeing to a terms pushback demand for pending POs, will not result in repayment of the invoices. Many companies that were profitable pre-COVID and should be again when the health crisis passes, may not survive that long. The credit team must determine whether the customer is one that survives and merits a COVID repayment agreement.

This means the credit team must determine the customer's ability to obtain financing to reopen and meet an operating budget and forecast to pay down the past due balance over time. This means customers must share their budget and projections for reopening to create transparency for credit risk. If the customer's source of financing is the government or the federal reserve, whether the CARES Act or Payroll Protection Program, that information should be provided.

Even with the customer sharing these financials, it is a complicated evaluation given the reported probability of a second wave of COVID in the fall, which may spur further state stay-at-home orders, and the resulting business closures. GDP reporting for Q2 will come out in July and is expected to show the fastest rate of decline in history.

From all of this customer financial information and economic data, the credit team will attempt to gauge the time it takes for the economy to return to normal and consumer fear to ebb, and how all of this ties with customer risk and the duration of a COVID repayment agreement, if credit criteria is met. Added to the credit team's risk evaluation is that under the CARES Act, the Bankruptcy Code's Small Business Chapter 11 has expanded the eligibility to file Chapter 11s to include small- and mid-sized businesses with total debts of \$7 million. This means that more small- to mid-sized insolvent customers may elect to file Chapter 11 to work through their financial difficulty.

B. COVID Repayment Agreement in Action

Repayment agreements 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 may give the supplier greater protection for payment, given the supplier is agreeing to reschedule payment of the invoices. Those terms and conditions for the credit team to consider:

Fixing the Indebtedness

In active trade relationships, where the supplier company offers trade concessions to make sales and where the customer may take deductions, unauthorized and otherwise, the amount owing the supplier may be disputed. The customer may also dispute the debt through offsets such as defective product or late deliveries. Given the uncertainty of the amount of the debt with some customers, the supplier may use the COVID repayment agreement to eliminate this dispute. A COVID repayment agreement should fix the amount owed, including fixing the amount of customer concessions and disputes. By fixing the amount owed, the credit team eliminates later disputes that may arise as to the application of payments and concessions. Fixing the indebtedness can be helpful if the customer fails to honor the terms of the repayment agreement and seeks to enforce the debt.

Fixing the Payment Schedule

The COVID repayment agreement should provide a fixed schedule for repayment of the debt. The payment schedule may be on a monthly basis. The credit team may also increase the price of pending orders but surcharging the pending order, say 10%, which is disclosed through a line item, and the surcharge is used to pay down the past due. The benefit of a fixed schedule is that it provides the credit team with a clear timetable for repayment of the delinquent account, rather than a mere understanding that the customer will pay the amount owing when the

customer has free cash. This can be important where the customer files bankruptcy and the supplier received payment within the 90 days prior to the bankruptcy filing.

Discounting the Face Amount of Invoices

The COVID repayment agreement requires the customer's consent, and therefore may result in heated negotiations. Issues such as: the term of the repayment agreement, the balance owing, additional credit sales, security, and a guaranty, balanced with collection alternatives must be considered by the credit team before entering into the agreement. For some customers evaluating reopening, this may press the credit team to discount the face amount of past due invoices, say 10% or 15%, to assist the customer's cash needs to reopen. The COVID repayment agreement may provide that in the event of a default by the customer, the face value of the past due invoices becomes due and payable causing the customer to lose the discount.

Waiver of Counter Claims and Disputes

The COVID repayment agreement protects the supplier from challenges later brought by the customer. The customer may contest the amount owing stating that it is in dispute, that the product or service provided is defective, or that the documentation supporting the debt is incorrect. By waiving all defenses, the customer's acknowledgement allows the supplier to promptly proceed to judgment should the customer default.

Taking Collateral

Another method to have the customer focus on the repayment schedule is to negotiate on collateral to back up the COVID repayment agreement. This can take the form of the customer granting a junior security interest in all of its assets. Whether the customer grants such an interest will depend on the customer's existing lender's consent, as well as the customer's perception of other suppliers' reactions to granting a security interest.

Clean Up Documents

During your initial credit evaluation, there may be times where a customer refuses to sign a credit application, or in the rush for an initial sale, a credit application is never taken. In these settings, the credit team may find the documentation may not be in order. Incomplete credit application information may lead to mislabeled invoices and often disguises the kind of business organization the supplier has sold. Should a dispute with the customer arise, or invoices otherwise go unpaid, the credit team may find needless defenses raised by the customer as to the documentation, which may slow payment on the account.

The COVID repayment agreement may also help the credit team discover the surprise of finding new owners of the customer. Without the repayment agreement, the customer's new owners may dispute their liability with the existing documentation. Depending on the duration of the repayment agreement, you may include a notice requirement that the owners must notify you

or your company in writing of any change in ownership or the name or business structure under which the initial credit was established.

If as part of the initial account evaluation the credit team has taken a security interest in the customer's assets, such as a purchase money security interest or junior security interest in all of the customer's assets, or have a consignment agreement, the credit team must comply with Article 9 of the Uniform Commercial Code. If the credit team fails to comply with the UCC, they may find the credit team's security interest or consignment agreement subject to challenge. The COVID repayment agreement can also clean up what otherwise may be considered improperly perfected security interests or consignment agreements.

- **Guaranty**

To back up the COVID repayment agreement for the small- and mid-sized customer, the credit team may insist that the customer's principal personally guaranty the COVID repayment agreement, as well as future credit sales. The personal guaranty is an inducement not to take collection action. If the customer is part of a family of companies, the credit team may seek a cross corporate guaranty. The credit team will want a corporate board resolution from the guarantying company.

- **Preference Defense**

Although the customer may enter into the COVID repayment agreement and honor the payment terms, the customer may still be forced into bankruptcy. The credit team does not negotiate a COVID repayment agreement and forebear on more immediate collection alternatives, only to find some or all of those payments clawed back in a bankruptcy. If the credit team does file a collection suit and enacts a levy on the customer's assets within 90 days of the bankruptcy filing, that levy can be recaptured as a preference. Thus, a question is: Do payments received under the COVID repayment agreement during the 90 days prior to the bankruptcy filing qualify as a preference and not subject to a defense? The credit team's defense to a preference is the COVID repayment agreement and payment schedule that replaces the delinquent invoices. Therefore, if the customer pays according to the payment schedule of the COVID repayment agreement, the credit team may contend that a payment during the preference period was made in the ordinary course of business under section 547(c) of the Bankruptcy Code and in conformance with the repayment agreement, not past due invoices.

- **Favored Supplier Clause**

If the credit team and customer commit to the COVID repayment agreement, the credit team does not want the customer repaying other suppliers on more favorable terms. Therefore, the COVID repayment agreement should provide that if the customer does favor a supplier, it constitutes a default.

- **Fees and Costs**

The COVID repayment agreement should include an attorney's fees provision, as well as late fees and default interest should the credit team enforce the default provision of the COVID repayment agreement and seek to collect the past due balance.

- **Venue**

If the customer is out-of-state, or out-of-country, the COVID repayment agreement should provide that the venue favors the supplier in the event of a default.

- **Default**

The customer must strictly comply with the payment schedule or face a finance charge or late fee for the first late payment. If the customer pays late a second time, it may result in a default that is not curable, and the credit team can obtain a judgment for the balance.

- **Acceleration Clause**

Should the customer fail to pay, there should be a provision that the entire balance is due.

- **Stipulated Judgment**

A stipulated judgment is a judgment where the customer agrees to a judgment in the event of a default. The credit team can file an affidavit of default where the judgment can be entered. Enforcement of the judgment can take many forms but can include recording liens and levies.

- **Confession of Judgment**

A confession of judgment provides that the customer admits liability and agrees on the amount of debt that must be paid. A confession of judgment may be filed as a court judgment against the customer who does not honor the COVID repayment agreement. The confession of judgment provision attempts to minimize the need to resort to legal proceedings to resolve the delinquent account. The enforcement of a confession of judgment depends on state law. Some states may not allow them, while others give protections to the debtor by requiring that they must obtain consent from the customer's counsel to be enforceable.

Second Wave COVID Closure

Health care professionals are warning of a likelihood of a second wave of COVID outbreak in the fall. The credit team may consider a provision in its COVID repayment agreement that, in the event of renewed state stay-at-home orders, forcing the customer to limit or close its operations, the open balance may be reclassified as a second repayment schedule. This requires a rescoring of the credit risk tied with a second closure.

Extended Terms with Pending POs

Customers are not only freezing payment on open invoices, but many are demanding extended terms with pending POs. The credit team may consider including a provision in the COVID repayment agreement for extended terms. This provision requires vigilance of the customer's payment pattern, and a provision that the credit team has the unilateral right to covert pending extended terms POs to cash-in-advance if the credit team flags a substantial increase in credit risk, say with a spike in COVID and the possibility of renewed state stay-at-home orders.

C. COVID Repayment Agreement Alternatives

The COVID repayment agreement requires the customer's consent. Given the health and economic crisis, the spirit of attempting to negotiate a fair repayment schedule is in the interest of both the supplier and customer. However, the credit team may encounter customers that have closed and gone silent in response to their requests to negotiate a repayment schedule. In the event of customer silence, the credit team needs to evaluate whether to employ a go-it-alone collection strategy or a supplier group strategy.

Alternative Collection Strategy Where Customer Does Not Qualify for COVID Repayment Agreement—Supplier Pact

If the credit team's due diligence indicates a customer's credit risk profile is too high to agree to accept payment over time, what are the collection alternatives available for the credit team? With the high credit risk or insolvent customer that is not responding to the credit team's request for information and payment, is the credit team more likely to collect if they go it alone or instead join with other suppliers with past due invoices to collect? The matrix considers the benefits and risks of these alternative collection strategies:

ALONE	SUPPLIER PACT
Benefits <ul style="list-style-type: none">• Unique claim• Negotiate repayment plan• Race to courthouse: First to the assets	Benefits <ul style="list-style-type: none">• Same priorities• Threat of an involuntary petition• Share costs (legal + administrative)
Risks <ul style="list-style-type: none">• Expense and resources to act alone• Too late to the liquidation. Debtor's assets sold off• Customer silence• Preference risk• Complaining about customer's silence: defamation and libel	Risks <ul style="list-style-type: none">• Anti-trust risk• Share distribution with others• Freerider risk• Credit team's support by sales and management

Collection Litigation and Arbitration

The challenge with a go-it-alone collection strategy post-COVID is that the customer may not respond to payment demands. The credit team may elect to file suit for breach of contract, coupled with a prejudgment remedy such as a writ of attachment. The challenge with this collection strategy post-COVID is many courts have restrictions with filing suit and hearings to advance a collection advantage. However, the collection suit may prompt the customer where the credit team is pursuing a COVID repayment agreement in hopes of avoiding the suit. If the customer consents in this setting, the credit team should add the collection costs and interest to the past due balance.

If the credit team has an arbitration provision in a credit application or supply contract, the credit team may invoke this where the customer refuses to negotiate a COVID repayment agreement. As with the collection suit alternative, the customer may respond to the arbitration demand by consenting to the COVID repayment agreement.

D. Repayment Agreements post-COVID

With forecasts estimating corporate defaults in the hundreds of billions dollars, and headlines of an expected avalanche of Chapter 11s, credit teams must consider strategies to reduce credit risk with past due invoices for those customers that have closed as a result of stay-at-home orders and consumer fear, yet attempting to preserve credit terms with pending POs. All of these novel risk factors are new territory for the credit team, including the longer-term economic impact of COVID on customers' payment prospects. A COVID repayment agreement may assist the credit team with its objectives of mitigating credit risk.