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White Paper Brief

COVID-Impacted Customer's Liquidation Alternatives, Including Private Sale of Assets, and Self-Help Supplier Collection Strategies in Response

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State lockdown orders and social distancing required to contain the virus disrupted otherwise healthy customers and their ability to pay lenders and suppliers. Given the immediate and widespread nature of the pandemic, those customers with leveraged balance sheets and cash restrictions have forced them to scramble for liquidity and put them in extreme financial distress, threatening their viability.

Two months after nonessential customers shut down, customers continue to suffer severe declines in revenue, little cash reserves and are out of compliance with lender covenants. With the largest customers, the pandemic has exposed extraordinary leverage and ability to meeting its debts.

The federal government and federal reserve, through bail outs and grants, is attempting to flatten the curve of customer insolvencies and prevent customers who may be suffering a cash crisis, from tumbling into insolvency.

As significant payment obligations come due, many customers are not in a position to prove to lenders they can still meet financial requirements - or will meet them when they reemerge as states loosen their stay-at-home orders. Lenders are scrutinizing the viability of customers applying for suspensions to their covenants.

Just when customers need more financing to offset the pandemic cutting off cash flow, lenders are pulling back and evaluating the customer's financial wherewithal to reemerge, and considers such criteria as:

- How is the customer impacted by consumer uncertainty to venture out?
- What is the customer's reopening strategy and how do they navigate different state and local reopening plans?
- Will there be a second COVID wave and how will the customer be impacted?
- What of the added expense tied to safety protocols, such as personal protective equipment and distancing guidelines?

The pandemic has driven up the customer's operating costs, shrunk margins and limited sales.

Lenders are asking the challenging question of whether borrowers can honor their borrowing commitments as states lift their stay-at-home orders:

- Is this a borrower that has a pathway for reopening, especially if they are in breach of a leverage ratio covenant, and so deeply in debt they cannot pay down the debt?
- What about those customers that so far have managed to stave off liquidation by conserving cash, drawing on banks' lines of credit and qualifying for federal programs, such as the CARES Act and the Payroll Protection Program?
- Will lenders play a waiting game with borrowers, hoping for an economic recovery, but uncertain when a recovery might occur?
- What happens when a customer's CARES Act and Payroll Protection Program funding is exhausted and cash flow is burned through?
- Has COVID created such uncertainty for lenders, that there is substantial doubt in their view of many borrowers' ability to reopen and continue as a growing concern?

Indeed, many small- to mid-sized customers have closed as a result of the pandemic and are not attempting to reopen as states loosen restrictions. The creator of the Z Score, Edward Altman, predicts a record number of megabankruptcies (assets and liabilities in excess of $100 million).

If lenders don't grant the pandemic forbearance request, then customers are forced to liquidate, especially the small- and mid-sized customer, who don't have access to alternative sources of capital. Liquidating a customer's assets through private sales or forced going-out-of-business sales has dramatically increased post-COVID. Suppliers are facing losses of their entire receivables through these undisclosed liquidations, as these lender-led liquidations do not invite supplier participation, let alone disclosure.

What collection strategies can a supplier or group of suppliers adopt to maximize payment, especially given the accelerated liquation timetable brought on by the pandemic? What are the risk flags the credit team should consider that may identify an undisclosed liquidation?

Post-COVID, the out-of-court liquidation, often through a private sale, poses unique challenges for the credit team in getting basic financial information regarding the customer's liquidation, including payment on open invoices. A supplier's go-it-alone collection strategy likely will be met by silence to the demands for payment and even basic information regarding the liquidation. This is especially true given the courts have limited their operations in response to COVID, resulting in dragging out this collection strategy. Thus, the starting point for the credit team is to force transparency of the liquidation where there is no legal requirement for the customer or lender to do so.

Post-COVID, more customers are burying their liquidation strategy from suppliers, but the credit team can organize with other suppliers to deal with their customer's insolvency or backslide into insolvency. The supplier team approach, a Supplier Pact (SP), can change a supplier's approach to their delinquent accounts and their approach to negotiate with insolvent customers. In the pandemic, many customers are in a cash crisis and do not have lender support for a pathway to continue to operate.

A SP reinforces the value of industry groups, even though stay-at-home orders have moved the customer account sharing online. During the pandemic, SPs are often formed by industry group online discussions. However, the credit team should still evaluate the threshold of whether they are better served by a collection strategy of going-it-alone, as opposed to a team approach to collect the past due debt.

Supplier Pacts Forming in Response to COVID-Impacted Customers

The pandemic has resulted in COVID-impacted customers all refusing to pay suppliers at the same time. SPs are forming across industries as COVID-impacted customers fail to pay March through May 2020 invoices as a result of state stay-at-home orders, forcing nonessential businesses to shut down. The suppliers come together through a SP with a singular voice to negotiate with the customer for internal financial information and payment on the invoices. Although not disclosed, the customer is often insolvent post-COVID and is liquidating its assets. A SP can attain cost savings through synergy of goals with a single counsel representing the SP, demanding the customer pay the SP's expenses. The payment of the SP's invoices is from the lender's collateral, who is commonly undersecured, especially given the resulting financial crisis.

COVID Insolvency: Sudden and Dramatic

Customers can encounter a calamitous financial event that may require an emergency Chapter 11 filing for the protections of the automatic stay, such as when a key customer terminates the trade relationship or litigation results in an unexpected judgment. The profile of most customer insolvencies is a deterioration of cash flow and a buildup of short-term liabilities, often as a result of lost sales, commonly over months. This means that this type of customer has a greater opportunity for insolvency planning, and more time to adopt a liquidation strategy with no involvement by the supplier class. A customer's common afterthought for excluding the supplier class is that the lender is undersecured and, therefore, the unsecured creditors are out of the money.

There is also a customer's owner's self-interest dynamic with small- and mid-sized customers. Lenders financing the business commonly require the owners or officers to enter a personal guaranty loan. As a personal guaranty carries significant individual liability, most principals want to maximize the company's assets in insolvency and repay the lender to release the guaranty.

Although a principal's individual liability to a lender does not directly concern suppliers, credit teams appreciate the self-interest of loading up on inventory on terms and liquidating the inventory as a method of repaying an undersecured lender.

Identifying the Risk Flags of a Freshly Hatched Liquidation for the Benefit of the Lender and Insiders, to the Detriment of Suppliers

In this environment, credit teams continuously identify, monitor and evaluate credit risk. The challenge is that most customers in the zone of insolvency do not share internally-generated financials with suppliers or otherwise disclose their financial condition, as they are trying to convince suppliers to continue to ship on terms or otherwise buy time from suppliers.

COVID Credit Score to Detect Insolvency Risk

A problem with traditional information sources is they report pre-COVID historical financial information. With a COVID-impacted insolvent customer that is rushing to roll out a liquidation strategy that imperils supplier payments, the reliance on pre-COVID financials, where the customer is silent as to their financial condition, does not provide a path for payment.

Because of the pandemic's sudden and immediate impact on a customers' operations and cash flow, traditional information sources, such as customer historical financials, to evaluate risk are irrelevant. A COVID credit scoring model may more accurately capture the risk of the relationship with pending POs. Those factors to consider are: availability of capital; cash on hand; leverage ratios prior to shut down; pathway for reopening.

Using Social Media Sites to Detect COVID Insolvency

In addition to the traditional methods of evaluating credit risk, credit teams may look at social media and other news sources for red flags about their small- and mid-sized customers, such as the customer is not operating.

Industry Group Information Sharing: A Key to Early Detection of COVID Insolvency

Zoom (and other on-line platforms) allows industry group members to conduct their meetings and account discussions virtually during the pandemic. Industry group trade data and account discussions may be the most effective way to identify and validate a COVID-impacted customer's immediate backslide into insolvency, especially when a customer's liquidation strategy is not to share their financial condition with suppliers because of the dramatic downturn in their business due to stay-at-home orders and consumer uncertainty. Current industry group trade reporting may show the customer's failure to pay the supply chain, even in the face of customer silence.

Insolvency Confirmed: Supplier Collection Strategy -- Alone or Team Approach

COVID-impacted customers that move from a cash crisis to insolvency, force credit teams to evaluate collection strategies: Is the credit team with a delinquent account more likely to collect if they go-it-alone or form/join a SP? The matrix considers the benefits and risks of these alternative collection strategies.

ALONE	SUPPLIER PACT
Benefits • Unique claim • Negotiate repayment plan • Race to courthouse: first to the assets	**Benefits** • Same priorities • Threat of an involuntary petition • Share costs (legal + administrative)
Risks • COVID-impacted court closures and restrictions • Expense and resources to act alone • Too late to the liquidation - customer's assets sold off • Customer silence • Preference risk	**Risks** • Antitrust risk • Share distribution with others • Freerider risk • Credit team's support by sales and management

A Go-It-Alone Collection Strategy Post-COVID

A key factor to support a go-it-alone collection strategy is the swiftness the supplier is able to get a judgement. Timing is crucial as a customer's liquidation strategy is to rush through the liquidation before suppliers can organize and negotiate a distribution. COVID has dramatically impacted courts. Courts have issued COVID administrative orders restricting collection case filings and pre-judgment remedies, such as a writ of attachment. Court closures and restrictions means a supplier cannot rush to judgment, which would create leverage for payment in an undisclosed liquidation.

Rather, the customer's liquidation strategy in response to a supplier's go-it-alone collection action is to ignore the payment demand. By the time the supplier obtains a judgment, the customer's assets have been liquidated for the benefit of the lender, and insiders have had their personal guaranties released, and no assets remain for suppliers.

Given the court restrictions because of COVID, the credit team may not be confident with a successful outcome of a go-it-alone collection strategy. They can join forces with similarly situated suppliers with past due invoices and form a SP. A SP gives members a unified voice and creates the leverage to negotiate with the customer. A SP gives smaller suppliers a voice - an option a smaller supplier might not have pursued otherwise due to lack of resources or the amount owed. The SP carries with it the implication to the customer that the SP has standing to file an involuntary petition, something an individual supplier pursuing a go-it-alone collection strategy does not have.

The Supplier Pact and the COVID-Impacted Customer

Industry Groups: The Common Starting Point for Forming a SP

Credit teams value their membership to industry groups, as they provide key information regarding the COVID-impacted customer. Group members provide real time reporting of customers, including their payment status, order status and whether they have a reopening strategy, which can be used to better assess credit risk.

Given the pandemic has had a dramatic impact on customers' payment of suppliers and a dramatic increase in undisclosed customer liquidations, more suppliers are considering the option of acting together when dealing with the COVID-impacted customer. The industry group provides the unique forum for members to collectively identify supply chain delinquency.

While the industry group provides members with both access to current customer account payment status and the forum to discuss accounts and how the pandemic is affecting their financial standing, the federal antitrust law, the Sherman Act, may include restrictions on how members use the information in a group setting, even during a pandemic.

Formation of the SP in a Pandemic

The impetus for industry group members or suppliers to consider forming a SP following a delinquent account can be a number of factors, such as: customer silence; industry rumors as to customer financial difficulties; customer closing and reopening timetable; customer's customer demands; going concern alert; and delinquent accounts of industry members. These considerations are a starting point for a supplier to consider when determining whether to form a SP.

Unlike a customer's Chapter 11 filing, where the Office of the United States Trustee may appoint a statutory creditors' committee, a SP is formed where the customer may liquidate its assets outside of a Chapter 11 or formal liquidation proceeding, as discussed below, or as a prelude to an insolvent customer commencing a court-supervised liquidation proceeding.

Formation of the SP usually starts with an industry group member contacting another, and quickly moves by email to several other group members selling to the customer. The impetus to form the SP usually is shown in the need to promptly act in calling a meeting with the customer. The pandemic has accelerated the timetable for credit teams to form a SP given the sudden and dramatic financial downturn of the customer, which leads to an acceleration of a lender calling in the loan and forcing a liquidation.

SP Bylaws

At the formation stage, the SP needs to promptly adopt bylaws so as to create structure for the SP and set out the duties and responsibilities of SP members. The bylaws set out the conditions for participation and adherence to the antitrust laws. The pandemic does not reduce compliance requirements of the Sherman Act antitrust law among SP members.

Qualifications to Serve on a SP

The bylaws should establish restrictions to serve, such as potential conflicts of interest. Does the supplier hold a personal guaranty or a security interest? Does membership include creditors that are not suppliers, such as landlords, unions or bondholders? The pandemic requires the SP members to vet conflicts at the earliest opportunity so the SP can negotiate with the customer and lender.

Scope of the SP

Is the SP negotiating payment for the entire class of unsecured creditors or only for the SP members? For example, if the SP negotiates a payment with the customer and its lender to pay 50% of the SP claims, SP members do not have a duty to non-SP members for a distribution. However, the SP should define the scope.

Mission of the SP

The first order of business is to access the customer's financial forecast and their strategy to liquidate. With that information, the SP can strategize payment.

Closing the SP

Tied to the scope of the SP is closing the SP. The SP invites suppliers to participate, but if a supplier does not respond by a specific date then the SP may consider closing the membership. Given the acceleration of the liquidation timetable forced by the pandemic, SP members should move quickly to close membership.

Duties of SP Members

All members of the SP should assist the SP with investigation of facts to expedite and maximize recovery. In addition to determining whether the customer has reopened, and to what extent, the members should research assets, liabilities and financial conditions of the customer. This due diligence of asset values must take into account the impact of COVID on the customer's tangible and intangible assets and those declining values.

The asset valuation, coupled with a payment history and asset transfers in the past 90 days, assists a SP to determine whether it wants to file an involuntary bankruptcy petition. All communications among members should be treated as confidential. With the pandemic and the fleeting asset values of customers, the SP's responsibility to maximize values means acting in an expedited way to negotiate a payment.

Counsel Advising the SP

Counsel for the SP's responsibilities in advancing the SP's interests and agenda should include:

- Compliance with antitrust laws;
- Demand information and payment from customer;
- Evaluate lender liens for avoidability risk;
- Evaluate insider actions and claims against insiders;
- Prepare SP term sheet;
- Negotiate preference releases; and
- Negotiate a carve-out payment from lender's collateral to pay SP's professionals.

As noted, one of the benefits to SP members is having one counsel represent the group's interests, and that counsel looks to the customer first for payment of SP's expenses.

SP Deal Term Sheet

After all issues have been worked out and the SP has negotiated an agreement to satisfy the debts, the SP should enter into a Term Sheet to memorialize the agreement into writing. This agreement should be between the SP, the customer and the customer's lender, and should encourage transparency amongst the parties. Additionally, the Term Sheet should address the following:

- Reconciliation of claim amounts;
- Who will be paid: supplier or supplier class;
- Payment amount and method;
- Preference risk: source of payment;
- Releases; and
- Confidentiality agreement.

COVID-Impacted Customer's Liquidation Alternatives

As customers (especially small- to mid-sized) succumb to the impact of COVID, lender influenced liquidations are on the rise. What liquidation alternatives do the customer (and insiders) have?

Private Sale of All Assets

COVID has forced more customers to immediately sell their assets, but not liabilities, through a private sale. The lender commonly has the leverage in supporting a sale, especially where the lender's secured claim exceeds the value of the assets, a common setting post-COVID. Often, the principals of the customer or an entity affiliated with the principals of the customer, are the purchasers. On these facts, suppliers should be concerned whether the purchase price was maximized, or instead the insiders took advantage because there is no transparency and suppliers are not vetted.

Neither the customer nor the buyer is legally obligated to give notice of the sale to suppliers. Rather, suppliers often learn of the sale when the buyer of the customer's assets submits a PO. The buyer declines payment demands by suppliers, contending they acquired the assets, not the liabilities, of the customer.

A SP's greatest leverage is to demand payment prior to a sale of assets. This requires the credit team to use their detective skills to look for clues for a proposed sale, given the customer has likely gone silent. The SP's implied threat of an involuntary petition can create traction for a negotiation with the customer and lender.

If the customer refuses to negotiate, or the SP views the negotiations as non-productive, the SP may elect to file an involuntary petition to force court supervision over the customer's sale of assets, which may require a showing of marketing the sale of the assets, bid procedures and competitive bidding for the asset sale. The involuntary petition may have further appeal for the SP if members have meaningful section 503(b)(9) claims.

Alternatively, the SP may consider successor liability claims if permitted under state law, even though the customer has a purchase contract that describes only the assets being purchased. The legal theory is that the buyer of the customer's assets should be responsible for the seller's suppliers' debts if there is a continuation of the business and no legal cut-off of supplier claims.

Close Doors

If the COVID-impacted customer does not reopen from stay-at-home orders, the SP should press the customer for payments and asset transfers in the past 90 days. This inquiry is to confirm the integrity of the business closing and that the customer did not prefer insiders or creditors. If the customer refuses, then the SP may consider an involuntary bankruptcy petition to force transparency over the business closing by having a bankruptcy trustee appointed to oversee the liquidation.

Negotiated Settlement with Suppliers

The customer seeks to negotiate some payment to suppliers, whether the business is liquidating or reopening, usually done on an *ad hoc* basis, with suppliers holding the most leverage of getting paid first. A SP can create uniformity of treatment for its members. The involuntary petition can again force the customer to negotiate or force an involuntary petition.

Assignment for Benefit of Creditors

Thirty-nine states have enacted some form of liquidation statutes, referred to as Assignment for Benefit of Creditors (ABC). A fiduciary, the Assignee, takes title to all of the assets and liquidates them for the benefit of the creditors, generally distributing the proceeds in a manner similar to that established in the Bankruptcy Code. The Assignee can sell business as a going concern. The problem with ABCs for suppliers is the lack of mandated disclosure. A SP can be key to forcing disclosure of financial information. If the Assignee does not cooperate, the SP can file an involuntary petition.

Article 9 Foreclosure

The lender who holds a security interest encumbering the customer's assets may foreclose on the assets subject to Article 9 of the UCC and sell the assets, provided it's done in a commercially reasonable manner. Suppliers do not get notice of the lender's foreclosure. Post-COVID, Article 9 foreclosure is not a preferred liquidation strategy for lenders as the going concern value is lost, as is the delay with a foreclosure and auction of the assets. Rather, post-

COVID, lenders prefer a private sale to capture the going concern value for the benefit of the lender.

Receivership

A secured creditor may seek the appointment of a receiver through a state or federal court action to liquidate the customer's assets for the benefit of the secured creditor. Depending on the receivership order, the receiver may share limited information with suppliers. The SP may use their leverage to force financial information to be shared or consider an involuntary petition.

Antitrust Overlay for the Supplier Pact

In its broadest definition as it relates to the supplier trade relationship, the Sherman Act prohibits any person, including a supplier, from conspiring to restrain trade. The following may constitute questionable activity under the Sherman Act as they relate to the credit team:

- Agreement between competitors or credit group members to fix credit terms;
- Agreement between competitors or credit group members to "blacklist" or refuse to extend credit;
- Agreement between competitors to secure a particular outcome with new POs; and
- Agreement between competitors to allocate specific customer demographics or geographic territories.

The Sherman Act has the same force during the pandemic.

The Grounds for Creditors to Act Collectively to Deal with Delinquent Accounts, Pre- and Post-COVID

Although suppliers cannot agree with competitors to fix price or credit terms, the U.S. Supreme Court recognizes that suppliers may meet and share factual, historical customer account information. And with this customer information, the Sherman Act does not prohibit cooperation among creditors to collect under competitively negotiated POs or supply contracts.

When bringing a claim under antitrust laws, the plaintiff needs to show actual collaboration because parallel acts, not counter to economic self-interest, are insufficient to rise to the level of price/term fixing under the Sherman Act.

The SP and Distinguishing Between Group Members Negotiating POs (Terms or Otherwise) vs. Collecting on a Delinquent Account, Pre- and Post-COVID

SP members should treat collectively negotiating POs differently than collecting on a delinquent account, pre- and post-pandemic. With respect to collections, courts hold that the Sherman Act does not prohibit cooperation among creditors to collect under competitively negotiated contracts. By contrast, where suppliers collectively negotiate terms of a new order, an alternative evaluation may apply.

For example, in 2012, a federal court found that book publishers colluded to collectively set prices for the sale of e-books in violation of the Sherman Act. The suit was in response to a major customer in the industry, Amazon, selling the books at a discount. The publishers collectively agreed to sell their e-books only through Apple at a substantially higher price.

What is the distinction between the antitrust limits on suppliers collectively negotiating with a customer for a sale as opposed to allowing group action to collect a delinquent account? Competitive negotiation during the contract that creates the accounts receivable is the distinction.

Conclusion

COVID has resulted in an unprecedented disruption in customer operations, especially the small- to mid-sized customer, resulting in an immediate liquidity crisis as they comply with stay-at-home orders. With an avalanche of customers in financial distress because of COVID, lenders are calling loans to collect payments and foreclose on collateral, to the detriment of suppliers. This forces customers to consider their liquidation alternatives, including working with lenders to negotiate a liquidation of the assets for the benefit of lenders, and the insiders that have furnished personal guaranties, with no disclosure of the liquidation strategy to suppliers.

Credit teams must consider strategies in dealing with COVID-impacted insolvent customers. Suppliers have learned that sitting back in an out-of-court liquidation means that the customers, insiders and lenders will take all of the value. The SP can give members a voice in the liquidation and an opportunity for payment. If the customer, insider and lender refuse to negotiate, the SP has the leverage to consider an involuntary bankruptcy petition to create access to information and oversight.