



FINANCIAL RESTRUCTURING,
REORGANIZATION AND BANKRUPTCY PRACTICE

CREDIT RISK MANAGEMENT AND RECOVERY STRATEGIES FOR POTENTIALLY INSOLVENT CUSTOMERS

Many steps can be taken to minimize or eliminate exposure resulting from an extension of unsecured credit to a customer that fails to pay and then seeks relief under the Bankruptcy Code. Certain steps are discussed herein.

PRE-BANKRUPTCY

An obvious step is to avoid extending unsecured credit, at least when the customer does not appear to be solvent. Obtaining: an Irrevocable Letter of Credit, a guarantee from a solvent affiliate or principal or some other pledge of collateral (coupled with a subordination agreement if there are pre-existing liens on the pledged assets) or shipping C.O.D. when there's any doubt about the customer's ability or willingness to pay are each prudent steps. If these steps are not taken, there are other options.

Segregated Accounts

A less obvious step is to remove a "credit risk" customer as a link in a chain of payments. If payments are to be made to the "credit risk" customer and then to your company, a written agreement should state that the payments to the "credit risk" will be through joint checks payable to your company and the "credit risk" or that funds paid to the "credit risk" will be deposited in an account from which disbursements cannot be made without your company's approval (monitoring the arrangement for compliance is crucial). Once payments to the "credit risk" are deposited into the "credit risk's" general account, your claim to the funds is a general unsecured claim, whereas, funds deposited into a special account pursuant to contract may be paid to your company instead of becoming property of the "credit risk's" Bankruptcy Estate and being paid pro rata to all creditors in order of priority.

Financial Reporting, Credit Insurance

Requiring financial information periodically from customers allows the making of a more informed decision regarding extension of credit. Many companies have to report cash flow information and collateral bases to their secured lenders fairly frequently. Accordingly, no additional work may be required to produce the information requested. Further, requesting notices of defaults with the customer's secured lenders (and where possible, eliciting the agreement of the secured lender to notify you when it receives notice of, or becomes aware of a default), particularly as to financial covenants or payment defaults, may give you advance notice sufficient to avoid risky extensions of credit. In certain circumstances, credit insurance can also be purchased.

POST-BANKRUPTCY

Stoppage of Goods in Transit/Reclamation

Upon a Bankruptcy filing, certain remedies must be immediately considered. First, under the Uniform Commercial Code and Bankruptcy Code (as amended by the Bankruptcy Abuse and Consumer Protection Act of 2005), the seller of goods to a potentially insolvent buyer has the right to stop the goods in transit and the right to "reclaim" goods delivered within 45 days prior to receipt of written demand for reclamation of the goods or 20 days after buyer filed bankruptcy if within the 45 day period. Goods should be stopped in transit until satisfactory arrangements are made to ensure payment. Further, a reclamation demand should be made immediately for all goods delivered within 45 days prior to a Bankruptcy filing (and if possible, an inspection should be made to determine and document

what goods are in the possession of the buyer when the reclamation demand was received and debtor's sign off on the inspection should be obtained). If there are goods on hand at the time of the reclamation demand that were delivered within the 45 day period, the reclaiming seller may have a priority claim for the value of such goods (the existence of a creditor with a lien on the goods sold, the amount owed that creditor and the value of the creditor's collateral all impact whether the reclaiming seller has a priority claim).

The recent amendments to the Bankruptcy Code provide administrative expense priority for claims arising from goods sold to debtor within 20 days prior to its Bankruptcy filing if reclamation notices are provided as referenced above, the goods were on hand on the date of receipt of notice and there are no claims against debtor secured by all of Debtor's assets and such assets are worth less than the claims. Trying to keep a Debtor within 20 day terms, then, may prove beneficial.

Critical Vendor Treatment

In most large cases, a Debtor will seek and obtain authority to pay pre-petition claims of certain vendors deemed critical to Debtor's continued operation—generally sole suppliers of key parts or goods that cannot quickly or readily be replaced and for which there is no backlog of inventory in the Debtor's

possession. Suppliers that own specialized tooling may qualify as well.

What you need to know is that the Debtor seldom pays any pre-petition debts, even to critical vendors, unless the critical vendor demands such treatment in order to continue to ship. The Debtor's designated employees or agents are generally adept at talking shipments out of suppliers with little to no payment on pre-petition claims, sometimes indicating that debtor's entire operation will come to a grinding halt if the requested shipment is not made and you, the supplier, will have to answer to the Court. Once the shipment is made, leverage will be lost so payment on the pre-petition debt has to be extracted at the outset.

Assumption of Contract and Cure

A related remedy is attempting to cause an assumption of an "executory contract" (generally defined as a contract under which performance remains due at the time the Bankruptcy petition is filed). A non-Debtor party to the contract can seek a deadline by which the Debtor must assume the contract or reject it. If the Debtor assumes, arrearages under the contract must be cured within a reasonable amount of time. As a practical matter, if goods or services are readily available from another source, there's no incentive for the Debtor to cure and therefore, the Debtor will likely reject the contract.

If you have any questions regarding this material, please do not hesitate to call your regular Armstrong Teasdale contact or the individual listed below.

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