

The Lawyer's Brief

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Dealing with Financially Distressed Purchasers of Goods*

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In the current economic downturn, sellers are dealing with many formerly good customers whose financial health is deteriorating. To protect their interests, sellers should assess their rights under applicable contracts and law and develop a strategy to minimize their exposure.

I. Step 1—Assess the Parties' Contractual Rights

Sellers with long-term obligations to distressed buyers first should assess their contractual rights to cancel or restructure those contracts as well as the terms of any credit insurance safeguarding the seller's accounts receivable. Even sellers without long-term contracts should review their contractual obligations, particularly if there is a risk that the buyer will file for bankruptcy.

A. Review the Credit Insurance Contract

Many sellers purchase commercial credit insurance to insure against uncollected accounts receivable. Although such insurance is a valuable hedge against defaulting accounts, insurers typically retain broad discretion to cancel in-force policies, a right that they have begun to exercise with greater frequency during the recent economic crisis. This trend has been observed most readily in certain manufacturing sectors, such as the automobile industry.

Credit insurance policies may provide that the coverage is cancelled automatically if a supplier continues to sell to a customer who previously has failed to

meet payment deadlines. Policies also may permit the insurer to cancel "at any time and for any reason" or when the seller's risk of not collecting its accounts receivable has "measurably increased" since the insurer accepted that risk. Having paid a premium for its insurance, a seller faced with a purported cancellation of coverage should assess whether it has a basis to challenge the cancellation.

Furthermore, a cancellation may not be immediately effective. For example, precancellation installment contracts obligating the seller to continue to deliver goods or services beyond the cancellation notice date may still be covered by the insurance. Alternatively, a cancellation may be effective with respect to installment contracts and other long-term obligations only after a fixed period of time has elapsed following the delivery of the cancellation notice.

B. Review the Supply Contract

In general, sellers should ascertain what type of contract they have with a financially distressed buyer: is it a long-term contract, a contract with open and continuous purchase orders, or a "one-off" purchase order? Sellers seeking to renegotiate payment terms have more flexibility with the last of the three than with the first two.

Sellers also should review three types of clauses in their contracts:

- force majeure clauses;
- default clauses;

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- clauses relating to damages calculations.

A force majeure provision allocates the risk of nonperformance when performance becomes impossible or impractical because of an extreme and unforeseeable event beyond the parties' control. Events that constitute force majeure depend on the language of the clause itself; ordinarily, however, the clause must reference specifically the event that is claimed to have prevented performance. Because such provisions are not intended to shield a party from the normal risks of a contract, general words in a force majeure clause are interpreted narrowly and are confined to the same kind or class of events specifically mentioned.

Generally, force majeure clauses do not protect against fluctuations in market demand or increased economic hardship. Unless a force majeure clause specifically provides otherwise, even severe and widespread market collapses usually would not trigger the clause.

Default clauses, by contrast, may afford sellers greater rights to cancel or to renegotiate contracts with distressed buyers that fail to perform in a timely manner. However, if a buyer historically has paid late or has engaged in other routine breaches and if the seller has failed to effectively assert its rights, the seller may be found to have waived strict compliance with contractual terms. Nonetheless, certain waiver clauses may trump the parties' course of dealing.

Sellers also should review their contracts to determine the damages that a buyer may be entitled to if the seller takes action that a court later determines constitutes a breach. For example, if a contract permits the buyer to recover only "cover damages"—in other words, the difference, if any, between the contract price and the price the seller would have to pay to buy replacement goods on the open market—sellers should assess whether current market conditions would lead to liability.

Contractual terms that exclude "consequential" and/or "incidental" damages also may affect the seller's calculus. "Consequential" damages are damages that the seller knew or had reason to know at the time of contracting could arise as a consequence of its breach and that the buyer could not prevent reasonably by cover or otherwise. These can include lost profits and can be quite significant. "Incidental" damages are damages incurred by the buyer to effect cover

and any other reasonable expenses incident to the delay or other breach.

II. Step 2—Assess the Seller's Rights Under the Uniform Commercial Code (UCC)

In addition to the rights set forth in a contract, sellers enjoy those rights under the UCC that do not conflict with the contract's terms. Section 2-609 of the UCC, for example, permits a party to a contract for the sale of goods to demand "adequate assurance of future performance" if it has "reasonable grounds for insecurity" with respect to the other party's performance and to suspend performance while awaiting such assurance if it is commercially reasonable to do so. Although courts assess whether a seller had "reasonable grounds for insecurity" based on customary commercial standards, their analysis tends to be fact-specific. They have found, for example, that sellers had reasonable grounds for insecurity in cases where: (a) the buyer's debt to the seller was mounting; (b) the buyer failed to take advantage of a 10-day payment discount as it had done for many years; (c) the seller mistakenly believed that the buyer was insolvent; (d) the buyer's credit had been downgraded; (e) the buyer lacked financing; or (f) the buyer suddenly expanded its use of credit. On the other hand, courts have been skeptical of requests for assurance that appear to be a pretext for seeking to excuse performance, including where a seller requests assurance after receiving a late payment following its acceptance of repeated late payments in the past. Because the analysis is fact-specific and the law can vary from state to state, sellers should review their contracts and course of dealing with distressed buyers in light of the court decisions from the state whose law applies to the contract before requesting adequate assurance of future performance.

When requesting adequate assurance of future performance, the seller should deliver a writing to the buyer referencing UCC §2-609. That writing may specify the grounds for the seller's insecurity, demand particular assurances from the buyer, and advise that failure to comply with the request will be considered a breach by the buyer. The "adequacy" of the buyer's response, however, is determined by commercial standards, regardless of the seller's specific demands. In other words, a court may find

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that a buyer's response was "adequate" even if it did not satisfy the seller's precise demands.

If a buyer does not respond to a seller's request for adequate assurance within a reasonable time, not to exceed 30 days, courts consider the buyer to have repudiated the contract. Such a repudiation relieves the seller of its obligation to perform. Alternatively, if a court finds that the seller did not have the right to request adequate assurance of future performance or that the buyer provided adequate assurance and the seller wrongfully cancelled or refused to perform, the seller may be held liable for the buyer's damages, if any.

Additionally, under section 2-702 of the UCC, if a seller discovers that its buyer is insolvent, the seller may refuse to continue to deliver goods except in exchange for cash, including payment for all goods in transit. Section 2-705 also permits a seller to stop delivery of goods in transit upon discovering a buyer's insolvency. Although determining the insolvency of a buyer is a question of law, a bankruptcy filing likely satisfies this element of the code.

III. Step 3—Assess the Buyer's Creditworthiness

Whether it is a new buyer or a buyer with whom the seller has a long-term relationship, a seller should conduct a credit check to determine the buyer's financial ability to perform under its agreement. Given recent market conditions, a seller may want to do this with some frequency. The results may inform the seller's decision making as to whether to seek to renegotiate the contract or to request adequate assurance of future performance.

IV. Step 4-Determine a Course of Action

After undergoing the above analysis, the seller should decide upon a course of action. An advisable first course of action would be to seek to reinstate any cancelled credit insurance, although reinstatement likely will require an additional premium, and to consider separately whether the seller should seek adequate assurance of future performance. If neither of these avenues produces favorable results, a seller should then consider whether it should cancel its supply contract, if possible, or seek to restructure it. Of these last two alternatives, each has its advantages.

By restructuring the contract, the seller may seek to renegotiate the price based upon the actual or perceived increased credit risk; limit or further limit the buyer's damages for the seller's breach; clarify or tighten default provisions; shorten credit terms or require the buyer to pay

cash on delivery (COD); require the buyer to post a letter of credit or other form of security, such as a guaranty from another entity; shorten the term of the contract; reduce the quantity of goods being sold; and have the buyer agree that it will not object to the seller's motion for relief from a stay if the buyer files for bankruptcy. In other words, if the seller has the right to cancel the contract, it may seek to renegotiate the contract's terms.

If a seller wants to cancel the contract, it is advisable to do so before the buyer files for bankruptcy. Although many businesses believe that they are protected if a customer files for bankruptcy because the parties' contract contains a provision stating that it automatically terminates upon a bankruptcy filing, that provision is unenforceable. Cancellation also may mitigate the seller's risk if the buyer seeks bankruptcy protection. Additionally, if a seller cancels a long-term contract but continues to do business with the buyer on separate and distinct purchases, a seller may gain leverage in a buyer's bankruptcy case to compel the debtor to seek critical vendor status for the seller. Critical vendor status may enable the seller to receive payment of any prebankruptcy claim that it may have against the buyer.

In a Chapter 11 bankruptcy, although a debtor is required to perform its postpetition obligations under a contract for the sale of goods in which both parties have outstanding obligations as of the commencement of the bankruptcy, as a practical matter, debtors often do not perform and creditors must seek relief from the court. Additionally, a debtor has until confirmation of its plan of reorganization to decide whether to assume or to reject the contract. This delay may leave the seller uncertain for an extended period of time as to whether the debtor wants to continue the contract.

V. Conclusion

In the current market, sellers should be proactive in taking steps to protect themselves from a distressed buyer's nonpayment. Assessing contracts and reviewing applicable law to determine the seller's rights and the extent of its exposure for breach are essential steps in formulating a sound strategy. It is best to implement that strategy before the buyer defaults or, even worse, files for bankruptcy.

ENDNOTES

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