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COVID, Chapter 11, Critical Vendor and Suspension Orders: The New World of Credit Risk with the Insolvent Customer

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Abstract

COVID, through state shutdown orders and social distancing, has caused severe financial strain on companies. Scores of companies deemed non-essential have closed, and only now are starting to reopen. As the government rolls out trillions of dollars to bail out companies, credit teams dealing with maturing and past due invoices are scrambling to determine whether their customers may resume operations and pay the invoices.

COVID-Impacted Customers' Essential Need to Preserve Cash and Extend Trade Credit
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, which is pushing on the supply chain by unilaterally extending suppliers' normal set terms to extended terms both for open invoices and pending POs. Customers are finding that lenders are pulling back on financing, and as a consequence are leaning on the supply chain to ease their liquidity crisis.

Credit teams are wrestling with customers both pushing out due dates of pending invoices and POs to extending terms. 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 economy to reopen. This new form of terms pushback throws out metrics, such as the cash conversion cycle and days payable outstanding, and focuses exclusively on preserving cash flow.

Wave of COVID Caused Chapter 11s and Insolvencies Forecast
COVID-impacted customers are forecast to default on their lending and bondholder obligations in the coming weeks, with a resulting avalanche of Chapter 11 filings. Economists expect the U.S. economy will shrink by 40% in Q2 following lockdowns, as more than 6.7 million U.S. companies are at severely high risk of insolvency, while unemployment may hit 25%. If the economy continues on its current trend of a recession along with a continued rise in unemployment claims, historical correlations project the same increase in business bankruptcy filings. Those most at risk include retailers and restaurants.

Economists project more than 100,000 small businesses to shut down permanently. According to the American Bankruptcy Institute, the number of bankruptcy filings has risen sharply with 560 commercial Chapter 11 filings in April alone, a 26% increase from the prior year. Stay-at-home orders have forced many brick-and-mortar businesses to shut down and file for bankruptcy.

Opportunities for Continued Sales with Chapter 11 Customers Suppliers whose customers are facing a liquidity crisis and unable to meet their creditor obligations are forecast to resort to filing Chapter 11. Post-

COVID, the sales teams for suppliers are desperately looking for sales, which may include soliciting orders from customers filing Chapter 11. To induce suppliers to sell on credit postpetition, the Bankruptcy Code provides suppliers selling on credit terms to customers postpetition are entitled to a priority claim for the unpaid postpetition invoices. Customers filing Chapter 11 recognize the value suppliers create with their postpetition credit sales to their working capital. However, credit teams are cautious to extend terms postpetition given the risk of payment, even with debtor in possession financing, especially if the supplier has prepetition invoices.

To try to bridge the reluctance of the credit teams to resume a terms relationship, customers are more frequently offering a sweetener to suppliers in the form of critical vendor. Post-COVID, retailers such as J.C. Penney and Neiman Marcus have filed motions for critical vendor (COVID) and 503(b) (9) treatment for certain suppliers.

Given the forecast of a record number of Chapter 11s to be filed, along with COVID and 503(b) (9) motions that may accompany these filings, balanced with the suppliers' need to make sales post-COVID, the doctrine of COVID is worth considering during the pandemic.

Critical Vendor and 503(b) (9) as a Source of Continued Trade Credit

Credit teams understand that pre-COVID, a customer's Chapter 11 filing meant long delays before receiving any payment on the prepetition account, which is usually only a fraction of the claim. Even with the Bankruptcy Code providing priority for a supplier's postpetition invoices, the risk to the credit team of a second risk of loss with postpetition credit sales was too much. How does COVID work post-COVID and what are the concerns for the credit team?

The fact pattern is the same for both pre- and post-COVID. A supplier provides an indispensable product or service to a customer, which files Chapter 11. Given this key trade relationship, the supplier often holds sizeable prepetition invoice balances. The supplier, selling invoice by invoice (as opposed to a long-term supply contract), may elect not to sell to the customer postpetition.

In this situation, the customer may request the bankruptcy court to authorize payment of the supplier's prepetition claim, as well as similarly situated indispensable suppliers (commonly only a portion), in exchange for the supplier selling on credit through a debtor-crafted supply contract. Under the COVID doctrine, a supplier may find the product or service it provides is essential to the debtor's continued operations. The uniqueness of the product or service may give the supplier leverage in negotiating post-bankruptcy sales.

When debtors first rolled out critical vendor motions 25 years ago, for suppliers classed as "critical" by the Chapter 11 customer, it was extraordinary for the supplier with a large balance as it meant payment in full or a substantial portion of the prepetition claim, given the alternative of waiting for years. This typically came at a fraction of the prepetition claim. The debtor's bargain with COVID is that the indispensable supplier continues to provide product or service on terms.

When debtors initially rolled out their COVID motions, supplier credit risk postpetition was less as debtors were often exiting from Chapter 11 through an operating plan. That supplier postpetition credit risk has gradually increased as debtors' Chapter 11 filing strategy is selling on their assets in the opening weeks of the filing, which results in suppliers at risk for their post-sale of assets and invoices go unpaid.

A Chapter 11 debtor's funds available for the COVID is limited, as well as scrutinized (and perhaps objected to) by lenders, bondholders, a creditors' committee, the U.S. Trustee, and even competing suppliers who want critical vendor status.

In exchange for the supplier's prepetition invoices (or a portion) being paid, the debtor conditions the supplier extending comparable credit terms postpetition. The COVID agreement is reflected in a letter agreement between the debtor and the supplier. A key for suppliers is a fundamental change in the trade relationship from PO/invoice-based, to a debtor-drafted supply contract with terms and conditions in the debtor's favor.

The COVID supply agreement also provides for a "claw back" provision that permits the debtor to recapture the COVID payment if the supplier refuses to continue to extend credit.

Post-COVID as more customers are filing Chapter 11, they must decide on a strategy to maintain the trade relationship with its most important suppliers. This means a critical vendor motion, and for suppliers it means qualifying for the COVID list. The debtor does not publish the COVID list.

Post-COVID, the leverage of the COVID request is with the debtor. This is because COVID-impacted customers' insolvency was dramatic and sudden, resulting in key suppliers with large dollar open receivable balances. The other dynamic is most suppliers are vulnerable to being replaced by competitors, which means they may have little leverage holding orders since the debtor may seek a replacement supplier.

Pre-COVID, the COVID doctrine has evolved from the debtor requesting a particular vendor be paid immediately as a COVID, to the debtor requesting a class of vendors qualify as COVIDs, to the debtor requesting the bankruptcy court establish a COVID "trade claims cap". This trade claims cap has continued post-COVID. J.Crew and Neiman Marcus are the most recent COVID-impacted retailers filing COVID motions that did not identify the suppliers it would deem critical. Rather, these retailers requested the court authorize payment of a class of suppliers it deemed irreplaceable, which represented a small percentage of the supplier unsecured claims. J. Crew and Neiman Marcus did not propose to pay each supplier deemed critical in full, but only the minimum for the supplier to continue selling on credit.

Bankruptcy courts reason that debtors gain something with a COVID motion: the supplier benefits by early payment on its prepetition claim. The debtor and its suppliers benefit by receiving the needed product or service on credit, which may lead to a successful reorganization.

Post-COVID, is the benefit to the supplier designated as a COVID in having a portion of its prepetition claim, especially as the trend is to pay suppliers a smaller percentage of their prepetition invoices, offset with the greater credit risk of the suppliers' postpetition credit extensions going unpaid?

Several Chapter 11 debtors have requested the bankruptcy courts suspend their Chapter 11s as a result of state stay-at-home orders to try to manage COVID spread resulting in closures or limitations of their non-essential businesses. The risk of a second COVID wave will increase the number of customers filing Chapter 11 and seeking suspension orders themselves, while those customers impacted by COVID are filing Chapter 11 and seeking suspension orders.

What is a Chapter 11 case suspension order, and how may it impact the credit team's decision to sell postpetition, including qualifying as a COVID?

Chapter 11 Case Suspension Orders and the Credit Team

As a result of COVID, the resulting stay-at-home orders, and social distancing, more Chapter 11 debtors are filing motions with bankruptcy courts requesting temporary suspensions of their bankruptcy proceedings. These case suspensions direct temporary freezes of those Chapter 11 proceeding as they are directly impacted by stay-at-home orders and social distancing. Retail and restaurant bankruptcy cases, whose debtors are deemed non-essential under stay-at-home orders, are those most commonly making the request.

Modell's Sporting Goods and Pier 1 Imports are retailers who filed Chapter 11 pre-COVID with a case strategy to sell their assets through going-out-of-business sales at their stores. However, COVID restrictions to non-essential businesses shuttered their sale plans, resulting in debtors' motions to suspend their Chapter 11 proceedings given their store closures based on compliance with stay-at-home orders.

Over the objection of landlords and other creditor interests, the bankruptcy courts approved Modell's and Pier 1's requests for case suspensions under Bankruptcy Code Section 305 to temporarily relieve them from paying suppliers' postpetition invoices and obligations under supply contracts, as well as rent, until after the end of their suspension dates.

Both Modell's and Pier 1 stated a need for an emergency suspension in their respective bankruptcy proceedings due to store closures. Generally, Section 305 is used to dismiss or suspend a case to best serve the interest of creditors while deferring payments owed. More Chapter 11 retailers are likely to follow Modell's and Pier 1's strategy to suspend post-petition payments to suppliers and landlords as social distance orders continue.

A variation of the suspension order is CraftWorks, a national brewery chain. Despite receiving DIP financing, CraftWorks proposed to only pay critical expenses for six-weeks, but not leases, which the court approved over objections.

With suspension motions, creditors have been objecting to those retailers that filed Chapter 11 post-COVID saying they had notice of the pandemic when they filed and should not be entitled to suspension of case relief. The court granted the suspension order.

The New World of Trade Credit and the Chapter 11 Customers

So how do credit teams evaluate the credit risk of COVID-impacted customers filing Chapter 11 and the novel case suspension order strategy? Is risk of loss greater with supplying a debtor on terms postpetition if a court suspends the bankruptcy proceedings? Given that the pandemic created immediate customer financial distress followed by Chapter 11 filings with suppliers holding large 503(b)(9) claims, are these priority claims likewise at a greater risk of non-payment as a result of a case suspension order? More broadly, does any Chapter 11 debtor impacted by COVID pose extraordinary risk for suppliers selling on credit terms?

A liquidation evaluation is central with an evaluation of postpetition credit risk, but is complicated by the pandemic risk overlay. Beyond the Chapter 11 debtor's budget supporting its cash collateral and the debtor in possession financing, the credit team may consider the following to try to measure the risk of default with postpetition credit sales:

- COVID containment, social distancing duration and risk of a second wave;
- Business reopening risk and closing risk again mandated through renewed stay-at-home orders;
- Return to normal business level timeline, including the risk of operating at partial capacity because of social distant mandates;
- Debtor in possession financing to the other side of the pandemic;
- Risk of a W-shaped recovery, where the economy improves but then turns down;
- Consumer sentiment and fear;

If qualified as a critical vendor, what of:

- The amount of the credit terms and credit line;
- The duration of the credit extensions;
- The supplier's unilateral right to hold orders upon heightened credit risk, such as renewed stay-at-home orders, case suspension order or second wave risk;
- Profit margin for sales;

The pandemic is challenging the credit team's efforts to preserve the credit terms relationships with their COVID-impacted, financially distressed customers. As more customers resort to Chapter 11 to preserve their businesses, credit teams need to reevaluate the new world of credit risk with these customers.

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