RetailLawBCLP

AVOID A CATASTROPHIC LOSS FROM A CUSTOMER'S BANKRUPTCY -- FIVE TIPS

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One day, you get a notice in the mail that an important customer has filed chapter 11. Your customer recently paid $250,000 on invoices that were delinquent for several months and still owes you $500,000. The customer, a brick-and-mortar store, sent form letters to its vendors expressing optimism that the chapter 11 process will allow the store to continue to operate while it locates a buyer which will continue to operate the store.

A few weeks later, no buyer has been located and the customer seems headed into a liquidation. Your inventory will probably be dumped on the market at bargain prices – potentially depressing the price of your product. You may not see any of the proceeds of the liquidation, which will most likely go to pay the customer’s bank lenders. Lastly, you are losing a significant customer.

Not only are you looking at potentially writing off $500,000 in uncollectable accounts receivable, but, after speaking to bankruptcy counsel, you discovered that you may have to repay the $250,000 you recently were paid.

Given the size of your business, this outcome is serious, if not catastrophic.

If you are facing or have ever faced this scenario, you are not alone. This is an increasingly common situation, particularly in the current, challenging retail environment.

How can this situation be avoided or mitigated? Here are 5 tips.

1. Recognize the warning signs

- When a customer files bankruptcy, vendors who are owed money will often say there were warning signs for months if not years before. These signs include increasing degrees of lateness in paying invoices and communication anomalies. Communications might be irregular in a variety of respects, ranging from uncharacteristic unresponsiveness to effusive assurances that all is well and “the check is in the mail.”
- A troubled customer may also try to appeal to the vendor’s sense of loyalty, in order to lull the vendor to continue to supply goods despite growing delinquencies.

2. **Use terms and conditions**
    - Terms and conditions which provide for interest and legal fees if payments are delinquent, or damages if the conditions are violated, potentially increase the amount you can claim and recover in the event of a bankruptcy.
    - It is important that each invoice attach, or at least refer to, the terms and conditions.
    - The terms and conditions should expressly provide that in the event of a conflict between your terms and the customers' terms, your terms control.
3. **Track deliveries**
    - State law generally gives vendors a right to reclaim goods from an insolvent buyer within 20 days of delivery. If the buyer files bankruptcy, the reclamation period is extended to 45 days. Payment for goods delivered within 20 days of the bankruptcy may be entitled to a priority of payment.
    - Bankruptcy law, however, prohibits a vendor from actually seizing inventory. Moreover, reclamation rights are subject to the rights of senior secured creditors with liens in inventory.
    - Typically, a debtor will not actually return the goods, but in many cases, creditors with valid reclamation claims may be given priority claims.
    - It is important to track and retain proof of delivery of inventory, so that potential claims can be preserved.
4. **Don't let delinquencies build**
    - This is easier said than done. Given the prevalence and expectation of credit terms in an increasingly competitive environment, a 45-day payment period can easily turn into 60 or 90 days. Shipping often continues as the payments slide.
    - Once payments are delinquent, consider moving to COD (cash on delivery) for new orders, or declining to ship further goods until the account is brought current.
    - Another protective option is to move to consignment terms. A consignment is an arrangement where the seller retains title to the goods until they are sold to a third party. There are specific legal requirements which must be followed in order for a consignment to be effective. Merely having language in terms and conditions is not sufficient. However, in the event of a customer's bankruptcy, a consignment may make the difference between a minimal loss and a catastrophic one.
5. **Keep lines of communication open**

- It's always better to be communicating regularly with a customer. Even if things head south, vendors who are regularly in touch with a customer fare better in a bankruptcy than those who do not.
- Frequent communication with a customer will allow you to know more about the customer's circumstances (and to know it earlier). This knowledge will allow you to make more informed decisions to manage the account.

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