

What Can I Do to Protect Myself When I Think My Customer Is About to File for Bankruptcy?

Your customer, who has always paid on time, has started to fall behind on payments and maybe has even started to short pay invoices. When you inquire about what is going on, your customer has a million excuses but assures you that everything is fine. On the one hand, you want to continue to do business with this long-standing customer. On the other hand, you are worried about the growing accounts receivable and a potential bankruptcy filing by your customer. How can you protect your business?

Key Issues

- **Obtain a Deposit.** If the customer files for bankruptcy, you may be entitled to net the amount owed to your business against the deposit. By obtaining the deposit, you become a secured creditor to the extent of the deposit. This is important because whereas secured creditors often get paid in full in a bankruptcy case, unsecured creditors normally receive pennies on the dollar, if anything at all, on account of their claims.
- **Obtain a Purchase Money Security Interest (PMSI) in the Goods.** A PMSI is created when a party loans money to a company to finance the purchase of certain goods and in return the party is granted a first priority lien in those goods. A PMSI creditor gains priority over previously perfected security interests as long as such creditor complies with Article 9 of the Uniform Commercial Code.
- **Establish Payment in Advance Terms.** Establish payment in advance terms for goods or services. This arrangement eliminates the risk of nonpayment. Additionally, if the customer does file for bankruptcy, such pre-payments cannot be clawed back as a preference since the payment was not on account of a pre-existing debt.
- **Require COD Payments.** Alternatively, establish cash on delivery (COD) terms for the provision of goods or services. Again, this will ensure that payment is timely received. Moreover, as long as the parties intend for the payment to be substantially contemporaneous with the provision of the goods or services and such payment actually is substantially contemporaneous, COD terms will also create a defense to a preference claim.
- **Institute 20 Payment Terms for Goods.** Section 503(b)(9) of the Bankruptcy Code grants an administrative expense claim for goods (but not services) received by the debtor within 20 days of the bankruptcy being filed. By modifying your payment terms to require payment within 20 days or less for goods, you increase the likelihood that any goods that remain unpaid as of the filing of

the bankruptcy will qualify as a Section 503(b)(9) administrative expense claim. It should be noted that changing payment terms can affect an ordinary course of business defense in connection with a preference claim¹ therefore it is important to talk to experienced bankruptcy counsel about this issue.

- **Carefully Document Settlement of Outstanding Amounts.** It is not uncommon for a business and its customer to reach a settlement on outstanding amounts. For example, you are owed \$100,000 and agree to take \$75,000 paid in three equal installments in full satisfaction of the \$100,000. You are thrilled when all three installment payments are made. However, if the settlement payments occur in the 90 days before the bankruptcy is filed, the customer, as part of the bankruptcy, may seek to claw the payments back as a preference claim. Moreover, having agreed to take less than you are owed, you are left filing a claim in the bankruptcy case for the settlement amount rather than the full amount owed, which can substantially reduce your recovery since claims in bankruptcy often only receive pennies on the dollar. To avoid this outcome, in negotiating any settlement of outstanding amounts, you should ensure that your business has the right to assert the full claim (*i.e.*, \$100,000) and not the settlement amount (*i.e.*, \$75,000) if you are or may be required to disgorge any of the settlement payments or if any of the settlement payments are not made. If a bankruptcy is filed and creditors receive a distribution on their claims, you would then get a distribution based on the full amount of the claim rather than the reduced settlement amount.

Takeaway

All insolvency situations are unique, so the foregoing list should not be used in lieu of consulting with experienced advisors. However, these considerations should be useful when making business decisions concerning financially distressed customers.

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¹ See How Can You Protect and Defend Your Business from Preference Actions? [tp_creditors-rights-toolkit_protect-and-defend-your-business.pdf](https://www.troutman.com/tp-creditors-rights-toolkit_protect-and-defend-your-business.pdf) (troutman.com)