

# Before it's too late

## Managing a customer's risk in financially uncertain times

By Edward Middleton



When coping with a downturn, company executives need a different mindset, particularly in protecting their own businesses against customer risk. All corporations are now facing pressure amid the financial crisis and it's important that they work with their customers – communicating and negotiating with them on products, pricing, supply chain and credit terms.

Companies need to watch out for any signs of troubles their customers may have. Once a customer files for bankruptcy, its creditors are dependent

on the bankruptcy process to deliver insolvency dividends; these can be slow and low. Late paying customers can be equally destructive in damaging a company's cash flows. Mitigating such potential risk is therefore critical.

### Re-focusing on credit control

Revisiting a company's credit control is a top priority for maintaining healthy cash flow. There should be a dedicated team charged with the following responsibilities:

- Analyze the past payment history of all customers.

- Identify high-risk customers: Look for any who are paying more slowly than they used to or who are suddenly cancelling orders and returning more goods than before for reasons that were not previously problematic.
- Revise credit terms: 120-plus-days terms are not beneficial for companies in the current environment, but companies cannot expect customers who are used to this practice to suddenly start paying in 30 days. They should leverage past good relationships to get payment terms down in gradual stages.

## When it's too late

### *How to minimize losses when your U.S. customer files for bankruptcy*

By David D. Johnson

A large U.S. customer has just threatened to file for bankruptcy and it owes you a lot of money for delivered goods. To make matters worse, you are in the process of filling another large purchase order for this customer. What can you do to avoid millions of dollars in potential losses?

Depending on the circumstances, there are strategies that a Hong Kong supplier can use, both before and after a U.S. customer has filed for bankruptcy, to minimize or completely avoid losses.

#### **Suspend deliveries**

Even though a supplier has agreed to a contract, it is usually not obligated to ship goods if the buyer cannot pay for them. In general, the only way a buyer can hold the seller to the contract is if the buyer pays for all goods previously delivered under the contract and agrees to pay for all future deliveries on a collect on delivery basis or provides other types of protection to the supplier.

Before suspending delivery to a customer that has not yet filed for bankruptcy, a seller should first send a notice to the customer requesting assurances that it can pay.

A supplier also has a right to stop deliveries of products that are currently in-transit and have not been physically received by the U.S. customer or persons acting on the customer's behalf. The right to stop delivery extends even to goods that have been sold under terms such as FOB (free on board) factory or FOB shipping point, and those that have already been given to a freight company for shipment to the buyer.

The seller must send a notice to the freight company with sufficient information to enable it to identify

the goods. The freight company is required to halt delivery and deliver the goods as instructed by the seller.

#### **Reclaim received goods**

U.S. laws permit a seller to reclaim or retrieve goods sold on credit to an insolvent buyer even after they have been delivered to the buyer, but only for a limited time.

The seller must send a written notice to the buyer demanding reclamation. For an insolvent buyer who has not declared bankruptcy, the seller must send this notice within 10 days of the buyer's receipt of the goods. If the buyer declares bankruptcy within 45 days of receiving the goods, the seller must send the notice within 45 days after the buyer receives the goods, or within 20 days after the buyer files for bankruptcy – whichever date is later.

#### **Court-approved return of goods**

A supplier may recover shipments made to a bankrupt customer if the bankruptcy court concludes that a return of the goods is in the best interests of the bankrupt company.

To qualify for this relief, the creditor and debtor must both agree on the return, and show the court that the return assists in the debtor's reorganization efforts or maximizes the value of the debtor's estate for the benefit of all creditors. This request must be made to the court no later than 120 days after the buyer files for bankruptcy.

#### **Administrative expenses treatment**

Recent changes in the U.S. bankruptcy code allow credit sales of goods made within 20 days of a buyer's bankruptcy to get special treatment as "administrative expenses." Such expenses are often paid in full and only a few months

after a bankruptcy case is filed. To get this treatment, the seller should file a claim with the bankruptcy court as soon as possible to ensure payment before the buyer's assets are dissipated.

#### **Critical supplier status**

A supplier may also be able to get its pre-bankruptcy debts paid in full and months or years ahead of other creditors if the court concludes that it is a "critical supplier," and that payment of its debts is necessary to secure its continued help in keeping the customer's business alive.

For example, in the bankruptcy case of U.S. sportswear retailer Just for Feet, Inc. in 1999, the debtor told the court it needed to make large purchases from shoemakers such as Nike, New Balance and Reebok for an upcoming Thanksgiving Day weekend sale, which marks the beginning of the biggest retail shopping season of the year in the U.S. in the run-up to the Christmas holiday. These suppliers were all owed large sums for products shipped before Just for Feet filed for bankruptcy and refused to ship additional products until debts were settled. The court found that payment to these suppliers was "essential to the survival of the debtor" and ordered their pre-bankruptcy claims be paid. However, the court also required that in exchange, each of these vendors extend credit to the sportswear retailer on similar or better terms than in the past.

Critical supplier motions are often made at the outset of a bankruptcy case. If you want to pursue critical supplier status, talk to your customer sufficiently in advance of a bankruptcy filing, as getting such status has become harder in recent years.

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- **Make tough decisions:** The worst offenders may need to be crossed off the customer list and slow payers moved to a lower priority on the production schedule. New supplies may be withheld until past bills are paid.
- **Collect cash:** Engage with customers regularly to chase overdue payments. If contracts allow for interest to be charged for late payment, charge it.
- **Buy insurance:** One of the biggest risks Hong Kong exporters face is overseas buyers defaulting on payments. If possible, invest in export credit guarantee insurance.

### Managing cash

Since it's important to unlock cash from their business, companies should prepare proper budgets and cash forecasts, and anticipate the worst scenarios: What if my biggest customer goes bankrupt? What if my orders booked for the next quarter is 25 percent less than the forecast? What if my average debtor days lengthen? Is my business over-dependent on one or two customers? Can I spread that risk?

- **Look closely at discretionary spending** – now may not be the best time to set

up a new office or factory, or invest in new technology.

- If possible, renegotiate rent terms with landlords.
- Inspect non-core assets, consider renegotiating terms with suppliers and reduce large inventory stocks, all of which tie up significant portions of cash.
- Maintain quality control standards to limit goods returned.

### Transparency and communication

Maintaining good communication and a high level of transparency with your customers is essential. For those who rely heavily on one or two customers, make sure you are fully aware of their financial position. Each party needs to be well informed about the risks involved in transactions.

If you are uneasy about a customer's financial standing, ask it to provide a banker's credit reference, or even a guarantee. Conduct credit checks to verify the risk level of the customer. Common signs of internal distress include evasive management and requests for extended payment terms. Empty office space and workstations are

hints that a company may not be in the best financial shape.

### Post-bankruptcy measures

Once a customer files for bankruptcy, there is little a company can do to recover lost money for undelivered goods and services.

For those in the manufacturing sector holding undelivered inventory or work-in-progress material, there are two options: Firstly, approach the insolvency administrator and inquire whether he or she wants to buy the goods. You may have to be flexible as to the terms of the trade, but you may get a better price from a liquidator, especially if they have an end-buyer. Secondly, you may try to sell any held inventory at alternative outlets. But either approach may lead to intellectual property issues, which may hamper your ability to sell the inventory.

Finally, if you are able to assert reservation of title claims, check with your lawyer to ensure there are no gaps in such claims as the claims can often be defeated in insolvency cases because the documentation does not stack up. A company whose reservation of title claim is accepted can take back any goods that are unpaid for, giving it an opportunity to sell them for more than they are likely to get in liquidation.

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