

# The **Trump** Card: Effectively Using Demands for Adequate Assurance of Performance

Part I – Dealing with the Troubled Customer

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# AGENDA

## Part I – Dealing with Troubled Customers

1. Identifying
  - Economic forecasts indicate financial stress in supply chain
  - Identifying troubled customer warning signs
2. Analyzing
  - Commercial and financial information requests
  - You got trouble! – informal actions
  - You got trouble! – formal actions
  - Financial information requests
  - Other sources of information
3. Taking Action
  - The adequate assurance demand – UCC Section 2-609
  - The demand letter
  - Discovering your customer is insolvent – UCC Section 2-702
  - Intensifying the pressure – threats to stop shipping
  - Preparing for court – Defending against motions for injunctive relief
  - Negotiating resolutions
  - Protecting your settlement – bankruptcy issue
4. Best Practice Tips
5. Q&A

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# ECONOMIC FORECASTS SHOW FINANCIAL STRESS IN THE MANUFACTURING CHAIN

- Warranty and recall exposure
- Anticipated volume fluctuations
- Expansion and investment
- Increased complexity
- Global economy
- Pricing give-backs
- Stricter regulations
- Cancellation of platforms/models

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# UNCERTAINTY MAY LEAD TO UNANTICIPATED CONSEQUENCES

- Personal & corporate tax policies
- Fiscal stimulus
- Employment and income growth
- Consumer confidence
- Monetary, trade and energy policies
- CAFÉ/GHG/ZEV mandates
- Safety regulations

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# PART I – TROUBLED CUSTOMERS: IDENTIFYING WARNING SIGNS

Classic signs of trouble:

- Slow payment
- Changes in long-standing payment terms
- Changes in method of payment
- Changes in source of payment
- Changes in purchasing patterns
- Cancellation of shipments and/or purchase orders
- Discovery that accounts receivable are being paid to lockbox
- Downsizing
- Sales team departures
- Involvement of turnaround/crisis manager or Chief Restructuring Officer and retention of other insolvency professionals
- Downgrading of debt
- Under forbearance agreement with lenders
- Excessive use of premium freight
- OEM customer accommodations and on-site representatives
- Other suppliers changing payment terms to COD or CIA
- Notification of appointment of receiver
- Failure to produce financial projections timely
- Lack of timely communication

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# HALLMARKS OF TROUBLE

<b>Sales</b> <ul style="list-style-type: none"><li>▪ Sales team departures</li><li>▪ Customers not communicating with sales or sales/engineering</li></ul>	<b>Purchasing</b> <ul style="list-style-type: none"><li>▪ Cancellation of shipments/P.O.s</li><li>▪ Excessive use of premium freight</li><li>▪ Out of balance raw materials and inventory levels</li><li>▪ Other vendors relying on CIA and COD</li><li>▪ Changes in purchasing patterns</li></ul>
<b>Production</b> <ul style="list-style-type: none"><li>▪ Overtime</li><li>▪ Workforce reductions</li><li>▪ Excessive machine downtime</li></ul>	<b>Finance</b> <ul style="list-style-type: none"><li>▪ A/R being paid to lockbox</li><li>▪ Downgrading debt</li><li>▪ Lack of timely financial projections</li><li>▪ Changes in method, timing or sources of payment</li></ul>

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# BEST PRACTICES TO LIMIT TROUBLE

<b>Sales</b> <ul style="list-style-type: none"><li>▪ Goals by production platform team, individual operator, etc. -- monitor appropriately</li></ul>	<b>Purchasing</b> <ul style="list-style-type: none"><li>▪ Flexible terms and conditions</li></ul>
<b>Production</b> <ul style="list-style-type: none"><li>▪ Use of statistical process control and production standards</li><li>▪ Incentives</li><li>▪ Public posting of results</li></ul>	<b>Finance</b> <ul style="list-style-type: none"><li>▪ Policies updated related to credit worthiness</li><li>▪ Automatic Alerts for Failures</li><li>▪ If public company, on-going monitoring of public filings (i.e., 10K, 10Q, 8K)</li></ul>

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# YOU'VE GOT TROUBLE! – INFORMAL ACTIONS

**Informal efforts** – If adequate time to pursue:

- Communicate awareness of problem to customer
- Request meeting with the relevant people at customer (i.e. CFO, controller, purchasing, etc.). Request *current* and *historical* commercial and financial information (discussed *infra*)
- Customer's refusal to meet or provide information can provide grounds for formal adequate assurance demand



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# YOU'VE GOT TROUBLE! – INFORMAL ACTIONS

## Formal Efforts:

- Retain legal and financial professionals – anticipate court action
- Make formal written demand for adequate assurance (discussed *infra*)
- Send non-disclosure agreement and request for commercial and financial information (discussed *infra*)

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# FINANCIAL INFORMATION REQUESTS

- Most companies will not provide confidential financial information without some assurance of confidentiality, send a standard non-disclosure agreement together with your information request. This way, buyer cannot use confidentiality as a way to buy time or deflect requests.
- Financial information to request immediately:
  - Financial statements for the trailing 12 months by month
  - Performance vs. budget for trailing 12 months by month
  - Projections for next 12 months by month
  - Purchasing records to insure that purchases have not been delayed due to an inability to fund
  - Audited financial statements for the most recent fiscal year
  - Copies of forbearance agreements

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## OTHER SOURCES OF INFORMATION

- Don't just rely on customer-provided information
- In addition to customer-provided information:
  - Search federal and state court records for other lawsuits and judgments, particularly actions taken by or against other suppliers
  - If customer is a public corporation, search public filings (8-Ks, 10-Ks, 10-Qs, etc.). Public customer is required to report
  - Search press and industry reports
  - Moody's, Standard & Poor's, Dunn & Bradstreet, Capital IQ and other rating/credit evaluation agencies
  - Reach out to other known suppliers or common vendors (use caution, as this may open you up to potential tort liability).
  - Have other suppliers placed customer on CIA or COD payment terms?

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# ANALYZING THE INFORMATION -- KEY THINGS TO LOOK FOR

- Purchases and/or shipments not following predictable/historical patterns. If not, do P.O.s match production records and/or shipments?
- Incomplete financial records, especially actual vs. budget not completed for past months
- Line item increase in expedited shipments
- Low (raw) material inventory levels
- Deferred maintenance and repair budget allocations for equipment
- Workforce reductions
- Plant closing and deferred capital expenditures
- Absence of audited financial statements

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## KEY METRICS

- **Debt to Sales Ratio:** An often overlooked metric that can be a good portal into the health of a company. If debt exceeds 50% of sales, then cash flow may be hampered due to debt service.
- **EBITDA:** If EBITDA is decreasing or is falling short of target, this will impact cash flow availability. Look for EBITDA that deviates from normal/historical patterns.
- **Debt to Equity Ratio:** Any narrowing of this ratio is a warning sign that the amount of debt or debt service requirements may be impacting the customer's ordinary course of business.

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# THE ADEQUATE ASSURANCE DEMAND UCC SECTION 2-609

UCC Section 2-609 provides:

- “ § 2-609 -- Right to Adequate Assurance of Performance
  1. A contract for sale imposes an obligation on each party that the other's expectation of receiving due performance will not be impaired. When reasonable grounds for insecurity arise with respect to the performance of either party, the other may in writing demand adequate assurance of due performance and, until he receives such assurance, may, if commercially reasonable, suspend any performance for which he has not already received the agreed return.
  2. Between merchants, the reasonableness of grounds for insecurity and the adequacy of any assurance offered shall be determined according to commercial standards.
  3. Acceptance of any improper delivery or payment does not prejudice the aggrieved party's right to demand adequate assurance of future performance.
  4. After receipt of a justified demand, failure to provide, within a reasonable time not exceeding 30 days, such assurance of due performance as is adequate under the circumstances of the particular case is a repudiation of the contract.” <sup>14</sup>

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# THE ADEQUATE ASSURANCE DEMAND UCC SECTION 2-609 (CONT.)

This UCC section recognizes that:

- The essential purpose of a contract is *actual* performance. A continuing sense of reliance and security that the promised performance will be forthcoming when due is an essential feature of the bargain.
- Three main aspects of 2-609:
  - Aggrieved party has the right to require adequate assurance
  - Aggrieved party may, if commercially reasonable, suspend performance and any preparation pending outcome of demand
  - Aggrieved party may treat contract as repudiated if his or her reasonable grounds for insecurity are not cleared up within a reasonable period of time

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# THE TEST FOR REASONABLENESS UNDER UCC SECTION 2-609

In essence – your grounds for insecurity must be **“reasonable”**

- What constitutes reasonable grounds for insecurity is **a question of fact** determined in light of all of the circumstances of the particular case
- The **reasonableness of the demand is defined by commercial, rather than legal, standards** subject to the UCC’s requirement of good faith. A breach of one contract, for example, may give grounds to demand assurances with respect to other contracts even though legally separate. *MCL 440.2609*, Official UCC comment 3.
- **There must be an objective factual basis for the insecurity**, rather than a purely subjective fear of non-performance. *Puget Sound Energy, Inc. v. Pacific Gas and Electric Co.*, 271 B.R. 626, 640 (N.D. Cal. 2002).
- Party **cannot use an adequate assurance demand as a subterfuge** to escape an improvident contract or to rewrite contract terms. *Pittsburgh-Des Moines Steel Co., v. Brookhaven Manor Water Co.*, 532 F. 2d 572, 580-582 (7th Cir. 1976). Courts will examine ulterior motives.
- Events giving rise to insecurity must not have been in existence or known to aggrieved party at or before the time contract was entered into



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# EXAMPLES OF REASONABLE GROUNDS FOR INSECURITY

Examples of reasonable grounds for insecurity:

- Failure to timely pay under one or more contracts. *In re Amica, Inc.*, 135 B.R. 534 (Bankr. N.D. Ill. 1992).
- Growing amount of credit extended by seller, coupled with inquiry of national commercial credit reporting agency and failure of buyer's president to respond to seller's attempts to discuss matter. *Erwin Weller Co. v. Talon, Inc.*, 295 N.W.2d 172 (S.D. 1980).
- Seller learns that, in addition to arrearages, buyer ran fly-by-night operation. *Turntables, Inc. v. Gestetner*, 382 N.Y.S.2d 798 (1st Dept. 1976).
- Buyer's failure or refusal to take delivery of goods. *Ward Transformer Co. v. Distringas Corp.*, 779 F. Supp. 823 (E.D.N.C. 1991).
- Financial distress of buyer. *Clem Perrin Marine Towing, Inc. v. Panama Canal Co.*, 730 F.2d 186 (5th Cir. 1984).
- UCC Section 2-210(6) expressly provides that assignment or delegation of performance by one party creates reasonable grounds for insecurity allowing other party the right to demand adequate assurances. MCL 44.2210(6).

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# EXAMPLES OF UNREASONABLE GROUNDS FOR INSECURITY

Examples of unreasonable grounds for insecurity:

- Seller's insecurity unreasonable where seller mistakenly believed buyer was in arrears and, in response, seller unilateral modified contract. *Design for Business Interiors, Inc. v. Herson's, Inc.*, 659 F. Supp. 1103 (D.D.C. 1986).
- Buyer's failure to secure financing did not give rise to reasonable ground for insecurity where contract did not contain any terms requiring buyer to obtain financing within set period of time. *Pittsburgh-Des Moines Steel Co. v. Brookhaven Manor Water Co.*, 532 F.2d 572 (7th Cir. 1976).
- Seller's bankruptcy did not reasonably give rise to insecurity where, at the time of demand, seller had already fully performed under contract. *Beeche Sys. Corp. v. D.A. Elia Constr. Corp. (In re Beeche Sys. Corp.)*, 164 B.R. 12 (Bankr. N.D.N.Y. 1994).
- Where buyer stood ready to perform if seller refused, buyer's request for modification of contract did not reasonably give rise to insecurity. *UMIC Government Security, Inc., v. Pioneer Mortgage Co.*, 707 F. 2d 251 (6th Cir. 1983).

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# TEST FOR ADEQUACY OF ASSURANCES

What's the test for adequacy of assurances:

- The adequacy of the assurances offered is also **defined by commercial, rather than legal, standards** again subject to the UCC's requirement of good faith. Factual intensive inquiry.
- If commercially reasonable, the demanding party may **suspend performance** pending receipt of adequate assurances.
- After receipt of a justified demand, failure to provide adequate assurance of performance within a reasonable time not to exceed 30 days is a **repudiation** of the contract.
- Unless the aggrieved party has materially changed his or her position or otherwise indicated that the repudiation is final, the repudiating party can retract the repudiation "by any method which clearly indicates to the aggrieved party that the repudiating party intends to perform, but must include any assurance justifiably demanded under the provisions of this article (section 2609)." MCL 440.2611.

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# THE ADEQUATE ASSURANCE DEMAND LETTER

1. Adequate assurance demands must be in writing
  - Some courts construe the writing requirement liberally, See e.g. *Smyers v. Quartz Work Corp.*, 880 F. Supp. 1425, 1433 (D. Kan. 1995)
  - Other courts require a clear demand specifically referring to UCC Section 2-609 so that all parties are aware that, absent receipt of adequate assurances, the demanding party may withhold performance. *Puget Sound Energy, Inc. v. Pacific Gas and Electric Co.*, 271 B.R. at 642.
2. Include the following in your demand (**Best Practices**):
  - Set forth the commercial grounds giving rise to your insecurity. Err on the side of caution; spell it out.
  - To the extent possible, specify which contract terms or contractual performance issues you are demanding assurance with respect to.
  - Give a specific deadline by which assurances must be received. Otherwise, you risk giving recipient the full 30 days to respond.

Note: What constitutes a reasonable time for providing assurances depends upon the circumstances of the case, including the purpose of the demand and the nature of the transaction. *Ball Banking Corp. v. UPG, Inc.*, 985 F.2d 685,702 (2d Cir. 1993).

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# DISCOVERING YOUR CUSTOMER IS INSOLVENT

## UCC SECTION 2-702

UCC Section 2-702 provides:

- “§ 2-702. Seller's Remedies on Discovery of Buyer's Insolvency.
  1. Where the seller discovers the buyer to be insolvent, he may refuse delivery except for cash including payment for all goods theretofore delivered under the contract, and stop delivery under this Article ( Section 2-705).
  2. Where the seller discovers that the buyer has received goods on credit while insolvent, he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery, the ten day limitation does not apply. Except as provided in this subsection, the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.
  3. The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course or other good faith purchaser under this Article (Section 2-403). Successful reclamation of goods excludes all other remedies with respect to them.”

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## DISCOVERING YOUR CUSTOMER IS INSOLVENT UCC SECTION 2-702 (CONT.)

- Definition of insolvent found in UCC Section 1-201(b)(23) (MCL 440.1201(2)(w))
- ***“Insolvent”*** means:
  - Having generally ceased to pay debts in the ordinary course of business other than as a result of a bona fide dispute;
  - Being unable to pay debts as they become due;
  - Being insolvent within the meaning of federal bankruptcy law (which employs a “balance sheet” test).

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# INTENSIFYING THE PRESSURE STOPPING SHIPPING

- Under UCC Section 2-609, aggrieved party may stop shipping:
  - When commercially reasonable, pending receipt of adequate assurances, or
  - When, after receipt of a justified demand, assurances provided are inadequate
- Under UCC Section 2-702, upon discovery that customer is insolvent, seller may:
  - Refuse delivery except for cash (cash in advance or cash on delivery), including payment for all goods previously delivered,
  - Stop delivery of goods in transit (See UCC Section 2-705), and
  - Demand to reclaim goods delivered within the previous 10 days
- Whether an adequate assurance demand is justified, whether the assurances given are reasonable, or whether buyer is insolvent are all questions of fact. For this reason, sellers will typically give a buyer a stop shipping drop dead date. The length of time given depends on a variety of factors including the seller's financial exposure and the likelihood that the buyer may, among other things, file bankruptcy, go out of business, etc.
- Buyer will often use this time to prepare emergency court filings, including motions for temporary restraining orders or motions for preliminary injunctions, to prevent seller from stopping shipments which may threaten buyer's on-going operations and financial viability.
- As discussed *infra*, obtaining injunctive relief is not easy. Moreover, a hearing on a motion for injunctive relief often gives the seller a quick opportunity to test the factual questions above before the buyer incurs significant business interruption damages.

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# PREPARING FOR COURT – DEFENDING AGAINST MOTIONS FOR INJUNCTIVE RELIEF

- Exhaust attempts to obtain adequate assurances in writing
- Prepare a response to a TRO Motion filed by your Customer by demonstrating that:
  - You are likely to succeed on merits of your defenses
  - Your Customer will not be irreparably harmed if injunctive relief not granted
  - In balancing the harms, your company will suffer greater harm if an injunction issues
  - The public interest militates against granting injunctive relief



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# CRITICAL ELEMENTS OF SUCCESS

- How do you prove you are likely to succeed?
  - It does **not** require you to prove your case
  - It **does** require you to provide facts and a law that support your position
- How are you irreparably harmed?
- If monetary damages are adequate, customer should lose

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## IF YOU LOSE THE MOTION – OPTIONS

- Even if injunctive relief is granted, you still have options and tools
- Involuntary bankruptcy with three creditors
- Another bite at the apple
  - Show cause
  - Expedited discovery track
  - Early facilitation

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## WHETHER TO TEAM UP

- There are situations when a number of suppliers are in alignment seeking adequate assurances from a customer
- Whether you work together depends on several considerations:
  - Advantages
  - Disadvantages

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# NEGOTIATING RESOLUTIONS

- Particularly in automotive and other “just in time inventory” industries, the stakes are often very high. Damages caused by shutting down a customer or end user’s assembly line can be significant. As the issues involved are often intensely factual, negotiated resolutions are encouraged by the court and other affected parties (i.e., OEMs). Time constraints play an important role.
- Resolution will depend on the grounds for insecurity giving rise to the adequate assurance demand.
- For example, concerns over the long term financial viability of the buyer may be addressed by shortening payment terms and by being brought current on outstanding accounts receivable and a transition out of credit situation.
- More serious concerns about an imminent cessation of business may require more draconian remedies such as cash in advance or cash on delivery payment terms.
- Where the buyer is likely to file bankruptcy, either to restructure or to sell its assets under Section 363 of the Bankruptcy Code, supplier needs to understand the bankruptcy implications of any settlement. Outstanding receivables may be paid only a percentage of their face amount some time in the future or not at all. Supply contracts may be assumed or rejected, and the resulting rejection damages will be treated as an unsecured claim.
- Receivables resulting from a delivery of goods in the 20 days preceding a bankruptcy filing are entitled to a higher, administrative expense priority. In order to confirm a bankruptcy plan, all administrative claims must be paid in full. Therefore, in potential bankruptcy situations, it is important to shorten payment terms such that amounts outstanding are always for goods delivered within the previous 20 days.
- In bankruptcy cases, executory contracts must be assumed or rejected in their entirety. The debtor cannot cherry-pick only those favorable provisions to assume. Therefore, as part of any negotiated resolution, contractual modifications should be executed before any bankruptcy filing.
- Are there opportunities to obtain third party guaranties, OEM guaranties, or direct payment from the ultimate customer/end user?

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# PROTECTING YOUR SETTLEMENT -- BANKRUPTCY ISSUES

- Understand your contract
- Bankruptcy Code Section 503(b)(9) priority claim for goods received by debtor in the 20 days immediately preceding bankruptcy filing
- Impact of assumption or rejection of contracts
- Proof of claim litigation
- Preferential transfer exposure

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## QUESTIONS?



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# THANK YOU

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