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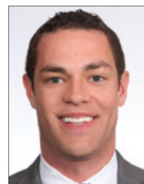
BANKRUPTCY

Advice for Financially-Distressed Businesses and Their Creditors



By Michael J. Riela

And Richard W. Trotter

The economic fallout of the COVID-19 pandemic has left businesses reeling and bankruptcy will become an unfortunate reality for some. Many have faced dramatically falling revenues, liquidity constraints and difficulty satisfying their existing loan obligations. Financially-troubled businesses can take several steps to buttress their balance sheets, boost near-term liquidity, and enhance their financial flexibility. On the other side of the table, creditors that deal with distressed customers can take measures to reduce their risk of being subject to litigation brought by bankruptcy estates to recover so-called "preferential transfers."

The Distressed Company's Perspective

As revenues decline and previously-available sources of credit dry up, businesses that face financial distress should conserve their cash to the greatest extent possible. Officers and managers should create cash flow projections by determining how much cash their companies have on hand, how much they expect to collect in the near-term, and how much they will need to operate over the next several months.

Companies should also consider drawing on currently-available sources of cash, such as existing lines of credit or revolving loan agreements in anticipation of a decrease in future revenues. Businesses should follow up with customers to collect as many outstanding receivables as possible. Customers will likely be making difficult choices about what expenses to pay, and may prioritize payments to those creditors that are persistent. Businesses should also request that customers make payments by wire transfer so they receive the funds immediately, while also eliminating the risk of customers filing bankruptcy before their checks clear.

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On the expense side, companies that are facing cash constraints may consider what expenses can be reduced or delayed, and cancel unnecessary orders. They should prioritize payments to creditors most important to their business (i.e., critical vendors), and significant vendors that are most likely to stop doing business with them if they are not paid. Companies may also need to consider terminating or furloughing a portion of their workforce in order to reduce labor costs. However, companies should be careful not to run afoul of their legal obligations, such as their obligations under the federal WARN Act and any state and local analogues.

Businesses with pressing short-term liquidity needs should determine whether they qualify for government-sponsored grants, loans and other relief. For example, the Coronavirus Aid Relief and Economic Security (CARES Act) created the Paycheck Protection Program loan program. The initial $349 billion that was allocated to the program was quickly exhausted, but Congress recently allocated an additional $310 billion to that program. In addition, the Federal Reserve recently released its term sheets for its two "Main Street Loan Facilities," under which the Federal Reserve will purchase 95% participation interests in eligible private loans that are made to qualified borrowers.

Finally, some state and local governments have imposed (or are contemplating imposing) moratoria on certain actions, such as evictions and foreclosures. If a distressed company

MICHAEL J. RIELA *is a partner and* RICHARD W. TROTTER *is an associate at Tannenbaum Helpern Syracuse & Hirschtritt.*

has operations in any jurisdiction with such a moratorium, it should determine whether it can benefit from that moratorium.

The Creditor's Perspective: Mitigating Preference Risk

Creditors that transact with ailing customers are less likely to collect on their accounts receivable from them. Moreover, to the extent that creditors do collect anything, they risk having payments clawed back as "preferences" if their customers and clients ultimately file bankruptcy.

The U.S. Bankruptcy Code allows debtors and other bankruptcy estate representatives to avoid and recover "preference" payments from their creditors, if all of the following elements exist: (1) the payment was made to a creditor; (2) the payment was made for or on account of an antecedent debt that the debtor owed to the creditor at the time of payment; (3) the payment was made while the debtor was insolvent; (4) the payment was made during the 90 day preference period (that period is extended to one year if the creditor is an "insider" of the debtor); and (5) because it received the payment, the creditor was able to receive more than it would have received in a Chapter 7 liquidation.

There are several practical steps that creditors can take to reduce their risk of preference liability. First, creditors can request that financially troubled customers pay in advance for future goods or services, or that those customers pay you on "C.O.D." (aka, cash on deposit) terms. Alternatively, creditors can obtain retainers from their customers and clients. These retainers are used to fund payments for future goods or services. By securing some form of payment in advance, creditors can avoid preference liability because the transfers will not have been made in satisfaction of a pre-existing debt.

In some cases, creditors may also request that their customers and clients pledge collateral to secure future payments owed. If collateral is pledged, and the creditor properly perfects its security interest in that collateral, the bankruptcy estate would be unable to demonstrate that the future payments allowed the creditor to receive more than what it would have obtained in a Chapter 7 liquidation. However, a pledge of collateral, in and of itself, can be considered a preference if the debtor files bankruptcy within 90 days after that pledge is secured.

If customers and clients are unwilling to pay for goods and services in advance or on C.O.D., creditors can nevertheless shorten the timeframe for payment of their invoices. If customers pay more quickly, there is a better chance that the customer will not file bankruptcy within 90 days of making that payment. Transfers made outside that 90-day window are not recoverable as preferences, unless the creditor is an "insider" of the debtor (in which case the look-back window is one year).

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Businesses may also be able to take certain steps to bolster their potential defenses to a claw-back claim that may help them avoid liability even if the transfers in question qualify as preferences under the Bankruptcy Code. For example, businesses may able to avoid preference liability by establishing an "ordinary course of business" defense. This defense will apply if the payments that the debtor made to the creditor during the 90 days before its bankruptcy filing (the Preference Period) were similar in timing, amount and method of payment to the payments that the debtor made to that creditor before the Preference Period.

In addition, creditors can assert a "subsequent new value" defense to the extent that they provided new value to the debtor after the preference payment was received. For example, if a creditor receives a preference payment of $100,000, but subsequently provides $80,000 of goods or services for which it does not receive an otherwise voidable transfer, then that $80,000 cannot be avoided as a preference.

Creditors can possibly also defend against preference actions by demonstrating that the preferential payments were made as part of a contemporaneous exchange for new value provided by the transferor. In order to do so, the creditor would need to show that the payments were intended by both parties to be contemporaneous exchanges for new value given to the debtor, and that the payments were in fact substantially contemporaneous exchanges.

Conclusion

Businesses are facing a wide range of unprecedented challenges, and so much about the COVID-19 pandemic is beyond their control. However, distressed businesses that take proactive steps to preserve cash, cut costs, and increase liquidity will be better positioned to endure such an uncertain economic environment. Similarly, creditors that act to limit their exposure to preference litigation can decrease their risk of surrendering the payments they received.

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