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Our 12 Most Common Insolvency Questions in Receivables and Payables Finance

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Supply chain finance products have a well-deserved reputation of being fairly low risk propositions. The majority of facilities are uncommitted, exposures are typically short-term and many counterparties are highly rated and well capitalized. However, even in this product segment, as the COVID-19 pandemic continues to spread and most developed economies face the real prospect of a prolonged economic recession, banks and other investors in this product segment ("Investors") are becoming increasingly concerned about how these supply chain finance structures would behave in an insolvency scenario of either a supplier of goods and services (a "Seller") or the buyers of those goods and Services (an "Obligor").

In the last thirty days our team has fielded more questions around potential insolvency scenarios in the supply chain finance space than in the last five years combined.

We have prepared this client alert to summarize the most common insolvency related questions we have received and some brief answers. Given the large variety in products, structures and approaches used in the supply chain finance segment, any summary is bound to be overbroad and incomplete, but we hope that this client alert will serve as a good starting point when considering these issues.

This client alert is geared towards a U.S. audience and uses U.S. terms and concepts. Should you be interested in non-U.S. issues, please contact us at your convenience.

A company needs to be insolvent to file bankruptcy, correct?

Although it is true that most companies that file for bankruptcy are insolvent, the terms "insolvent" and "bankrupt" are not equivalent. An insolvent company is a business entity that is unable to honor its financial obligations as they come due or whose liabilities exceed the value of its assets. Such an entity may emerge from its financial difficulties (or may cease to exist) without ever declaring bankruptcy. A bankrupt entity, on the other hand, is an entity that decides to file for bankruptcy to take advantage of the legal protections afforded by the Bankruptcy Code. That decision is only limited by the requirement that the filing be in good faith. Such entity (the "Debtor") may or may not be insolvent at the time of filing.

Almost all business entities qualify to petition for bankruptcy (e.g., corporations; partnerships; individuals and sole proprietorships), but the Bankruptcy Code excludes entities subject to specialized regulatory schemes such as banks and insurance companies.[1]

This distinction between bankrupt and insolvent is important because most U.S. law non-recourse receivables purchase agreements are written such that the purchaser of receivables takes the insolvency risk and financial credit risk of the Obligor and not merely bankruptcy risk.

What about involuntary bankruptcy?

An involuntary bankruptcy can be commenced by the unsecured creditors of a Debtor. In general, a petition for involuntary bankruptcy must be signed by at least three creditors of the Debtor who hold non-contingent, undisputed, and unsecured claims in an aggregate amount of at least $16,750.[2] In order to prevail, the petitioning creditors must show that the Debtor is generally not paying its debts as they become due.[3] Involuntary bankruptcy petitions are typically resorted to when creditors are aware of the Debtor making transfers that the creditors wish to have clawed back by a bankruptcy trustee. Involuntary petitions are relatively uncommon for larger Debtors, both because the petition may be challenged by such Debtor and because if the petition is dismissed, the petitioners may be liable for costs and, if the petition is filed in bad faith, damages caused by the filing and potential punitive damages.[4]

Will I know immediately after a company files for bankruptcy?

In our experience, most Investors learn about a bankruptcy filing quickly, and will have been aware that a case is likely to be filed long before it commences. However, this may not necessarily be the case for a number of reasons. While the U.S. has a federal system of bankruptcy laws and procedures that are applicable to any given case (i.e., the Bankruptcy Code and the Bankruptcy Rules), Debtors have a great deal of flexibility in choosing in which State to file their case. Thus, it may be difficult to determine which court's records to check. The Bankruptcy Court is required to send a notice of the commencement of the bankruptcy case to all creditors (including trade creditors), but this requirement has two limitations. First, Bankruptcy Rule 2002(f) only requires the notice to be sent by mail. Thus, there will be a gap between the time of filing and the receipt of notice. Second, the list of creditors to whom the notice is sent is provided by the Debtor. As most Seller-led transactions in the U.S. involve the sale of receivables on a silent basis to the Obligor, if the Obligor is the insolvent party, it may have no way of even knowing that an Investor was involved and needs to be notified.

To the extent an Investor is concerned about a potential insolvency of a Seller or an Obligor and wants more information, both legal counsel and various non-legal vendors can assist in monitoring bankruptcy court dockets on an almost real-time basis.

What's the "automatic stay" (and why should I care about it)?

The automatic stay is one of the reasons why most companies initiate bankruptcy proceedings. Once it is in place, the race to collect debts from the Debtor effectively ends. This is because a bankruptcy filing imposes a broad stay of actions against the Debtor and its property, including: (a) any foreclosure on property of the Debtor; (b) termination of contracts with the Debtor; (c) commencement or continuation of legal actions against the Debtor or its property; and (d) setoffs.5 It protects the Debtor's property wherever located throughout the world. Notably the automatic stay also prohibits actions against property in the possession of the Debtor without court relief, even if not owned by the Debtor.6

Actions in violation of the stay are void and there are significant consequences attached to such violation, including the payment of actual and punitive damages.7 There is no statutory cap on damages.

In the supply chain finance context, the most common situation where the automatic stay would come into play is in connection with collection accounts. In the securitization world, bank accounts receiving collections on purchased receivables are typically transferred to a "bankruptcy-remote" special purchase company to avoid the effects of the automatic stay. By contrast, in the Seller-led receivables purchase facilities most common in the supply chain finance space, while collection accounts are often pledged to the Investor they are typically left in the name, and under the control, of the Seller.

Because such collection accounts remain the property of the Seller, they would by definition become subject to the automatic stay in the event of a Seller bankruptcy. In that case, the Investor would likely be restricted from exercising any rights and/or security interests over the collection accounts even if all of the collections received into those accounts would be proceeds of receivables purchased by the Investor.

Given that I bought my receivables in a "true sale" and own them outright, how can I free my money from this automatic stay?

The automatic stay should not prevent the Seller from turning over collections of receivables that have been sold. The Seller may refuse to do so without a comfort order from the Bankruptcy Court. If the Seller refuses to do so, the Investor would be required to seek stay relief from the bankruptcy court confirming that automatic stay does not apply to the sold receivables. Although stay relief motions are generally heard on an expedited basis, such a request may take some time to be heard in situations where another creditor of the Seller is challenging the validity of the Investor's interest. In the interim, the Investor (as a purchaser of receivables) could ask the bankruptcy court to order the segregation of any proceeds arising from its purchased receivables, pending later adjudication on the merits of the Investor's interest.

The receivables I purchased are still outstanding. Can't I still enforce and collect against the Obligor directly so the proceeds are never sent to the Obligor's collection accounts?

The automatic stay would not prohibit sending notice to Obligors with respect to receivables that the Seller sold to the Investor. The automatic stay does prohibit actions against property of the Seller or in the possession of the Seller, actions to enforce a lien against property of the estate, and actions to enforce a lien against property of the Seller.8 Because the sold receivables are not property of the Seller and notice to Obligors does not involve an action against the Seller, those provisions of the stay would not apply. Of course the Seller may object to such an action, but would have to seek injunctive relief from the Bankruptcy Court rather than rely on the automatic stay.

We have a lien over the Seller's collection accounts but they are general accounts that receive a lot of transfers that don't represent collections on my purchased receivables. Should I be worried?

It depends.

A high level of "commingling" of collections is always a negative factor for true sale analysis with respect to the underlying receivables. High levels of commingling may also make it more likely that a bankruptcy court would permit the bankrupt Seller to use those collections as "cash collateral" in its restructuring.

Once proceeds of the receivables have been commingled with cash belonging to the Seller, you may only assert a property interest if the collections on the sold accounts are identifiable.9 The process of identifying proceeds in a commingled account is referred to as tracing under UCC Section 9-315(b)(2).10 Tracing requires not only showing that proceeds of the sold receivables went into the relevant collection account, but that they are still there. Courts will generally hold that an Investor's interest in collections in the collection account is limited to the lowest balance of the collection account between the time the collections were deposited in the account and the time of the determination. Thus, if the balance of the commingled collection account remains higher than the amount of collections on the receivables, the collections can be traced. However, if the total balance falls below the amount of collections deposited into the account, the Investor's property interest may be deemed limited to that lowest balance, even if the account balance later goes up.

My payables facility is really important to the Obligor. Will the invoices I've financed be given "critical vendor" status?

In bankruptcy, a Seller may seek to recover unpaid pre-petition amounts through "critical vendor" payment programs. Critical vendor motions usually are filed by a Obligor on the first day of its reorganization case. An Obligor typically asks the bankruptcy court to allow the Obligor to make immediate and substantially full payments of prepetition debt to vendors whom the Obligor deems vital to its continued business operations during the pendency of the Obligor's Chapter 11 case.

The critical vendor concept is "judge-made" law. As a result, application of the concept varies depending on jurisdiction. While such orders are commonly entered in bankruptcy courts in New York and Delaware, the standard for its application may vary from jurisdiction to jurisdiction. Some courts have limited the power of an Obligor to make critical vendor or essential supplier designations because the Bankruptcy Code contains no explicit authorization to grant such designations.11 Bankruptcy courts that allow critical vendor payments have done so using their equitable powers under the so-called "doctrine of necessity" to allow the Obligor to designate some vendors as necessary to the Obligor's reorganization. Critical vendor orders are typically authorized under Section 105(a) of the Bankruptcy Code, which provides that a court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provision" of the Bankruptcy Code.

In order to pay vendors, courts often impose a three-factor test: (a) it must be critical that the Obligor deal with the vendor; (b) unless the Obligor deals with the vendor, the Obligor risks the probability of substantial harm, or, alternatively, loss of economic advantage to the estate or the Obligor's going concern value, which is disproportionate to the amount of the vendor's pre-petition claim; and (c) there is no practical or legal alternative by which the Obligor can deal with the claimant other than by the payment of the claim. Payments are typically limited to: (a) sole source vendors; or (b) existing service providers, where an alternative source would be cost-prohibitive.

If a Obligor were to make such a critical vendor motion and if the relevant bankruptcy court were to grant that motion with respect to receivables that are owed to the Investor as a result of the Investor purchasing them from the Seller, then the order would certainly still apply to the receivables owned by the Investor. However, we believe that it would be difficult for Obligor to convince a bankruptcy court to designate a supplier as a critical vendor if the supplier has sold all of its receivables owing from the Obligor to the Investor through the payables program.

Do I need to worry about payments I received prior to the bankruptcy filing?

One of the primary goals of the Bankruptcy Code is to provide for an orderly and equitable distribution of funds to creditors. To accomplish this goal, the Bankruptcy Code gives the bankruptcy trustee power to bring assets into the bankruptcy estate through the avoidance of certain transfers that occurred prior to the bankruptcy filing. The most common avoidance actions are (a) preference actions under Section 547 of the Bankruptcy Code and (b) fraudulent transfer actions under Section 548 of the Bankruptcy Code.

Preference claims are actions to recover: (a) a transfer of an interest of the Debtor in property to a creditor for an antecedent debt owed by the Debtor before such transfer was made, but which is made while the Debtor was insolvent; or (b) a transfer made on or within 90 days before the date of the filing of the petition (or, for insiders of the Debtor, one year), and that enables the creditor to receive more than it would receive in a Chapter 7 liquidation if the transfer had not been made. Key defenses to preferences generally state that the payment and/or transfer was: (a) a payment made in the ordinary course of business; (b) a transfer for new value, or value given by creditor to Debtor after an otherwise preferential payment; or (c) a payment to a "fully secured" creditor, which does not improve the creditors position; or contemporaneous exchange for new value, not related to any antecedent debt.

Fraudulent transfer claims are actions to recover (a) transfers made or obligations incurred with the actual intent to hinder, delay, or defraud a creditor of the Debtor; or (b) transfers for which the Debtor did not receive reasonably equivalent value in exchange for the transfer or obligation and were made at the time when (1) the Debtor was insolvent, (2) engaged in a business or transaction for which any remaining property of the Debtor was an unreasonably small capital, or (3) the Debtor intended to incur debts that would be beyond the Debtor's ability to repay as such debts matured. The provisions of the Bankruptcy Code permit the Debtor or trustee to avoid fraudulent transfers made by the Debtor within two years before the filing of the Debtor's bankruptcy case. The Debtor or trustee can also invoke state law fraudulent conveyance statutes, which typically permit avoidance of fraudulent conveyance transactions for periods longer than two years, typically four-years to six-years.

What if I failed to perfect the transfer of my receivables?

A sale of receivables, like a security interest in receivables, is governed by Article 9 of the Uniform Commercial Code. Therefore, in order for a purchaser of receivables to prevail in any dispute with another party claiming a right to the receivables, the purchaser must perfect its security interest by filing an UCC financing statement. This is particularly important because another avoiding power of a bankruptcy trustee is the so-called "strong arm" power.[12] This provision gives a Seller or bankruptcy trustee the rights of a judicial lien creditor as of the date of the bankruptcy filing. As a result, the trustee's rights would be superior to the rights of any unperfected interest in the receivables and the purchaser would be treated as an unsecured creditor in the bankruptcy case of the Seller.

Why are you telling me any of this? The Obligor under my payables facility has agreed to pay me directly, unconditionally and irrevocably, if I fund any supplier invoices. That's all I need, isn't it?

In our experience there are more variations on payables programs than there are days of the year. Investors should carefully review the contractual terms of their program documents to determine exactly who bears what risks in the event of a Seller insolvency.

The overwhelming majority of payables programs in the United States utilize a reverse factoring model where the Investor purchases Obligor receivables from one (or, more likely, many) Sellers. In the majority of those programs the Investor rather than the Obligor bears the risk that the Investor has not effectively perfected the purchase of the Obligor's receivables under applicable law and that those receivables have been acquired free and clear of existing liens.

In some cases, a program may instead utilize a different funding model that, while contractually more robust for the Investor, may not have yet been tested in the courts.

Finally, in many cases Investors are participating in payables programs through a third party administrator or a third party funding vehicle. Investors should carefully review the underlying program structure so that they are comfortable with any additional counterparty risk that those arrangements may pose.

Is it going to be OK?

Yes. Supply chain finance is critical to supporting the needs of the real economy. There is written evidence that trade finance was in use as early as 4,000 years ago. It will surely outlive us all.

Also, please visit Mayer Brown's Coronavirus COVID-19 webpage for additional insights on and analysis of the virus's impact on business worldwide.

If you wish to receive regular updates on the range of the complex issues confronting businesses in the face of the novel coronavirus, please subscribe to our COVID-19 "Special Interest" mailing list.

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1 11 U.S.C. §109.

2 11 U.S.C. §303(b)(1).

3 11 U.S.C. §303(h).

4 11 U.S.C. §303(i).

5 11 U.S.C. §362(a).

6 11 U.S.C. §362(a)(3).

7 11 U.S.C. §362(j).

8 11 U.S.C. §§362(a)(3), (4), and (5).

9 Uniform Commercial Code Sections 9-205(a)(1)(D) and 9-315(a)(2) (a security interest or in the case of a receivables purchase transaction, an ownership interest, in commingled proceeds of collateral can be established if such proceeds are "identifiable").

10 Tracing principles are derived from trust law. See Bank Leumi Trust Co. of N.Y. v. Klein, 1993 WL 403967 (S.D.N.Y. 1993) (to establish constructive trust over commingled funds, claimant must trace such funds to his own property to support recovery); In re Felton's Foodway, Inc., 48 B.R. 106 (Bankr. M.D. Fla. 1985) (commingled funds must be "sufficiently traced" to establish trust supporting restitution).

11 In re Kmart Corp., 359 F.3d 866 (7th Cir. 2004), cert. denied 125 S.Ct. 495 (2004).

12 11 U.S.C. §544(a).

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