Vigilant Monitoring Can Provide Long-Term Protection Against Bankrupt Customers

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The U.S. economy has enjoyed an unprecedented era of growth. Some people have never worked during an economic downturn, while others may not have had to think about customer distress for a long time. Now, however, there is an emerging consensus that the U.S. economy is beginning to soften, with some predicting a recession could occur. Whether or not this prediction is correct, it is always advisable to revisit your company's protocol for dealing with distressed customers. This article will address monitoring practices unsecured creditors could consider with respect to potential and actual customer distress.

The practices discussed are important to help protect a company if a customer files for bankruptcy. In a bankruptcy, payments made by a debtor during the 90 days preceding a bankruptcy proceeding (longer for creditors who are insiders) may be "clawed back" if those payments were made to pay existing debt, while the debtor was insolvent, and would result in the creditor receiving more than it would have received in a liquidation of the debtor—commonly referred to as a preference. 11 U.S.C. § 547. Simply put, preference liability, in some cases, allows a bankrupt company to recover funds that had been paid to an unsecured creditor in the months preceding the bankruptcy filing.

Preference liability is not absolute, and certain transactions may be protected, such as payments made in the ordinary course of business of a debtor, made according to ordinary business terms. Because of this, establishing a course of dealing with a customer is extremely advisable for protecting against a "claw back" of pre-bankruptcy payments. Additionally, if a company is aware that a customer is in financial distress, there are proactive steps the company could consider taking to protect itself in the face of a bankruptcy proceeding. This is why an effective monitoring program is essential.

An important note is that every situation and every industry is different, and no monitoring protocol should take a one-size-fits-all approach.

Vigilance Is Key

The cornerstone of any distress protocol is vigilance. Awareness of initial signs of financial distress can help a business proactively deal with a troubled customer and help limit exposure in the event of a customer bankruptcy. Additionally, vigilance can help a company protect against preference liability if a bankruptcy filing occurs. The baseline for vigilance is actively monitoring accounts and understanding the business model of customers.

Internally, among other things, an organization should track the payments received from its customers and flag any situations in which a payment was made late or, in some cases, early. If there has been a change in how or when a customer remits its payments, this could be an indication of financial trouble, but it could also be as innocuous as a new person handling accounts payable for the customer. The key to vigilance is identifying the cause and developing a plan if financial distress is detected.

As a part of any material contract with a customer involving the extension of credit, it is a good idea to require receipt of the customer's audited financials and even quarterly reports, and to review for any significant changes in the customer's bottom line. Further, if a small number of customers account for a large portion of a company's revenues, it might be helpful to closely monitor the financial health of those customers, including even contracting with third parties to monitor those customers' financial wherewithal.

Finally, it can be very useful to look to external reports and news articles about a customer. Products exist that collect and provide notice of any article published on any given topic or company. Alerts can also be set up on web-based search engines that provide notice of when a customer is mentioned in the news. This outside monitoring is important to help identify risks or issues developing with respect to a customer's financial health. For instance, a news aggregation service could uncover that a customer has had a catastrophic data breach that could cause its balance sheet to quickly deteriorate. This information can be used to develop a plan for dealing with the customer if financial distress does occur.

Consistency Is Key

One of the most important aspects of protecting against a customer's default is consistency, which can help to protect against preference liability in a customer's bankruptcy proceeding. To establish a course of dealing with a customer, for instance, invoices should be sent in a timely fashion on a standard schedule established between the parties. If, for instance, a contract exists between the parties, invoices should be sent as established by that contract. If goods or services are provided to a customer, a consistent method for billing for those goods or services should be established.

The same applies to receipt of payments. A standard time period for payment of invoices should be established, and the parties should adhere to that time period. If a customer begins to deviate from this payment time period, the customer should be asked about it, and steps should be taken to ensure consistent payment by that customer.

Payments made in the ordinary course of business of a debtor, made according to ordinary business terms may be protected from preference liability in a bankruptcy. This is why consistency is key. Even when a customer is not distressed, it is important to create and maintain a consistent course of dealing so that if a customer becomes distressed, an easily accessible record exists to help protect against a preference attack. Thus, as a part of creating a baseline, accurate and contemporaneous records of invoices and payments should be maintained and retained.

Protections in Distressed Situations

Once it becomes known through vigilant monitoring or otherwise that a customer is distressed, additional steps could be taken to ensure payment and to protect against potential bankruptcy liability. An important note is that each situation is different and there is no standard approach. For example, a supplier of goods could require cash on delivery (COD) before permitting a customer to receive goods ordered. In other situations, such as where services are provided, a business could request a retainer, and then draw on the retainer to pay costs and expenses when they are incurred. Additionally, when funds are received from a distressed customer, the funds should be applied to the goods or services provided at the time of payment, rather than an older, unpaid invoice. While a company may still be pursued for receiving a preference, these actions would help to greatly reduce the likelihood of being required to return the funds in question to the bankruptcy estate. Similarly, personal guarantees from a customer's principals or a letter of credit could be requested.

Conclusion

Although a situation involving a distressed customer can be difficult, an established protocol can help to ease the burden. With vigilance and consistency, a company can greatly reduce its exposure to distressed customers and improve its bottom line. Vigilance and consistency can help a company determine whether or not a customer is in financial distress early in order to assess the circumstances and take the steps necessary to protect itself.

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