SQUIRE PATTON BOGGS

Managing Commercial Relationships in Distressed Circumstances

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In the wake of the COVID-19 pandemic, we are often asked what clients should do if a business counterparty (such as a vendor, customer or other contract counterparty) is suffering distress and may be contemplating, or be at risk of, falling into external administration. It is impossible to anticipate every potential scenario, but here are several general do's and don'ts to consider.

Recognising that the facts and circumstances differ as to each situation, it is best to consult your restructuring and insolvency (**R&I**) advisors as soon as possible if you believe a business counterparty is suffering financial distress and may be close to external administration.

Before External Administration

Stay on top of on payment terms. Distressed companies often fall behind on payables. If you believe a customer or other counterparty is suffering distress, then you should monitor collections carefully to avoid slippage in payment. We frequently hear of client concerns regarding accepting late payments that might be subject to clawback as a preference if there is a subsequent external administration. We generally recommend that you not be overly concerned whether a payment may be a preferential transfer. While it is true that a payment from a distressed party may be a preferential transfer, that transfer can be clawed back only *if* the company making the payment enters external administration within a specified time period, *if* the statutory elements of a preference under the Corporations Act (Cth) 2001 (**Act**) are met, *if* the external administration seeks to avoid the transfer as a preference and *if* there are no available defences under the Act. There are a number of very significant *"if's"* in that scenario. The bottom line is that if you are owed money, then you should do your best to collect.

Collecting is easier said than done in practice. The fact is that you may have a longstanding relationship with your customer that precludes you from demanding payment on time every time. Moreover, the COVID-19 pandemic has most businesses looking for concessions now, so you may feel obliged to be flexible. Whatever the scenario, it is better to have the payment in hand prior to an external administration. You should understand that the longer you put off receiving payment, the more likely it is that you may never receive payment, especially if your customer files for protection under the Act. It is a business risk that should be carefully managed.

Know and understand your rights. You undoubtedly have written terms that govern most of your counterparty relationships. If you believe your business counterparty is in distress, it is a good time to dust off those agreements and review and understand exactly what rights you have. Your written terms will have remedies that you should consider whether and when to exercise. There may also be applicable notice and cure periods that need to be followed in order to exercise remedies, including termination. Importantly, properly terminating an agreement before an external administration commences is a potential game changer.

Also, State laws or other legislation related to the Act, as well as purchase orders or contracts, may provide reclamation rights in your favor. Understanding precisely what you can do when your counterparty is in breach is critical to effectively managing through the distress of your counterparty.

This is not to say that every remedy should be exercised. Rather, you should consult your R&I counsel to understand your rights and understand the ramifications of exercising those rights (or not). Again, you likely will want to consider balancing collection pressure with maintaining the commercial relationship you have with your customer. Recognise, however, that an intervening external administration changes the dynamic regardless of your longstanding customer relationship.

Understand your shipping/delivery terms and when title to goods pass. An intervening external administration during the shipment of goods on credit can often create problems for the company supplying the goods. The intervening administration may raise questions about whether the goods are or are not property of the estate, including whether they are subject to a senior lender's liens and security interests including potential interests or rights afforded under the Personal Properties Securities Act *(Cth)* 2009 (**PPSA**). Collection on delivery (**COD**) or pre-payment may be necessary under circumstances where your customer is suffering distress. You may also be entitled to adequate assurance of performance under various laws.

Consider whether a forbearance agreement or a modification of existing rights makes sense. Distress often results in a breach or default in your agreement. This may provide an opportunity to negotiate a forbearance agreement or modification that improves your position. Oftentimes, good faith negotiations concerning a forbearance or modification may result in obtaining collateral for previously-unsecured debt. Obtaining collateral in this fashion may be a preferential transfer or otherwise voidable under the Act, but it is always better to have that security (see above). Moreover, you may have an opportunity to cure defects including in loan documents (e.g., unauthorized purchase money security interests, unperfected security interests, incorrect legal name for borrower, incorrect guarantor information, incomplete executions and other anomalies relevant to the Act, the PPSA and their related legislation).

You also may be able to negotiate financial incentives or other favorable terms as part of the forbearance agreement or other modification. The party seeking a forbearance may also agree to more lucrative terms in consideration for the relief you are providing – perhaps you can obtain a personal guaranty from principals or more stable affiliates. You may also have your legal fees paid as part of the negotiated deal.

In short, and in consultation with your R&I counsel, there may be a number of benefits to negotiating a forbearance agreement or other modifications to your contractual arrangements.

After External Administration

The landscape changes once a company enters any form of external administration under the Act. Once that occurs, you should consult your R&I counsel immediately because:

- Litigation, foreclosure, and other actions against the company or its property should probably cease immediately subject to the nature of the moratorium on foot
- You cannot unilaterally terminate an executory contract
- You may be able to stop goods in transit
- You should consider freezing payments owing to the debtor to determine whether you have recoupment or offset rights
- You should consult the external administrators to determine if you will be treated as a critical vendor and whether they wish to adopt the company's contractual arrangements
- You should assess your payment history to determine whether and to what extent you have a claim in the external administration
- You should timely file a proof of debt for any and all amounts owed and prepare and submit documentary substantiation of same
- You should assess preference exposure to understand whether there is any clawback risk
- Before continuing to do business with the debtor, you should understand whether it has authority to use cash from its lender(s) to pay for your goods and services or whether the external administrators may be liable for incurring new debts
- You should consider whether the external administrators have sought or obtained relief from liability or other protections from the court
- You should pursue your rights of participation in the external administration and consider whether you ought to exercise your rights under the Insolvency Practice Rules (**IPR**) or the Insolvency Practice Schedule (**IPS**) to the Act

Conclusion

Taking a proactive approach with distressed customers and counterparties is always the best tactic. A few hours crafting a thoughtful strategy with R&I counsel early in the process can save you large sums as your counterparties' distress deepens and they perhaps enter into external administration. The external administration regimes under the Act are often tied to very short statutory imposed timeframes within which significant decisions are made by external administrations. Once a company enters external administration, decisions are often made at a rapid pace and are sometimes complicated by intervening court decisions. Accordingly, it is always best to be prepared for such scenarios by understanding your legal and commercial position and the levers and rights available to you. Our team at SPB can assist you by navigating and advising you on all of the above issues and the complex regimes applicable under the Act, the IPR, the IPS and the PPSA.

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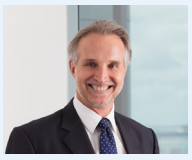

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