“Neither a borrower nor a lender be”

David Conaway looks at alternative sources of working capital in US and Canadian insolvencies

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BORROWERS HAVE MORE FREQUENTLY TURNED TO ANOTHER SOURCE OF BORROWING, TRADE CREDIT

It has been reported that Wal-Mart, the world’s largest retailer and third largest company on the Fortune Global 2012 list, with annual turnover of almost $450 billion, has used trade credit as a larger source of working capital than short-term bank borrowings. As capital markets, the global economy, and industries evolve and change, lenders have been generally more aware of capital requirements and more restricted in their lending commitments. Business insolvencies continue to play a significant role in today’s business environment, as businesses utilize the special provisions of bankruptcy law to buy and sell distressed assets, shed unwanted contractual obligations, restructure balance sheets, resolve legacy obligations, and achieve reductions in workforce.

As lenders continue to be judicious about making loans, insolvency proceedings worldwide have experienced lower levels of financing provided by traditional loan arrangements. Not only are lenders more cautious about making loans, but the costs of lending to borrowers has made it more difficult to obtain. As a result, borrowers have more frequently turned to another source of borrowing, trade credit. In US and Canadian insolvency issues, there are statutory provisions and other authority that allow courts to facilitate such trade credit, including payment of prepetition claims to induce credit. However, these provisions are also viewed as “remedies” for suppliers to obtain payment of prepetition debt, which can add substantial administrative costs to insolvency cases.

In the US, a Chapter 11 is designed to facilitate a business restructuring culminating in a plan of reorganization, which is fundamentally a contract between the debtor company and its creditors to satisfy creditors’ prepetition claims. Key reasons why companies have used Chapter 11 as a strategic tool include:

- the automatic stay or injunction against all actions to be paid or against estate property;
- the ability to restructure balance sheets by using the priority scheme and “cram-down” powers to pay creditors a fraction owed on general unsecured claims;
- the ability to sell assets free and clear of liens in a “Section 363” sale, and
- the ability to terminate or modify “executory” contracts such as collective bargaining agreements or other burdensome contracts.

Lenders forum

In recent years, Chapter 11 cases have also become a forum for lenders, whose loans may be “underwater”, to liquidate their collateral through a Section 363 sale. Whether a true reorganization or a “liquidating 11,” general unsecured creditors usually receive a fraction of the

debt owed, often paid over time or in the form of stock in the reorganized debtor. By contrast, in the absence of an administrative insolvency, secured claims and claims arising post petition, known as administrative claims, are paid in full, or at least receive a substantial return. The US Bankruptcy Code in essence requires that secured and administrative claims are paid in full as a condition of plan confirmation.

Vigilant vendors, however, have been able to alter the *status quo* of minimal recovery by asserting two legal theories. First, vendors have been designated as "critical vendors", meaning the debtor's ongoing business and survival are dependent on the continued supply of the vendor's goods and services. In exchange for payment of some or all of the supplier's prepetition debt, courts usually require that the supplier must continue to supply goods and provide credit terms that were historically provided. This results in *de facto* working capital financing, which lessens the need for and cost of bank borrowings. The cost of this source of working capital is the amount of prepetition debt that must be paid, usually a one-time sunk cost.

Second, in 2005, the US Congress materially altered the *status quo* in its passage of Section 503(b)(9), which allows sellers of goods to have administrative priority claims for goods shipped and received by the debtor within 20 days prior to the Chapter 11 filing. If a debtor was generally on a 60-day payment terms cycle with vendors, shipments during the 20 day period could be one-third of what would have been prepetition debt. Unlike the "critical vendor" remedy, the "20 day administrative claim" remedy has no concomitant obligation of the vendor to supply goods or extend credit. This statutory conversion of claims from prepetition general unsecured claims to post petition administrative claims has had a profound impact on Chapter 11 cases. In a "liquidating" Chapter 11, lenders historically were willing to fund a liquidation budget to accomplish a sale of the debtor's assets. Now that 503(b)(9) claims are *pari passu* with the administrative costs of liquidation, lenders have been reluctant to fund the liquidation budgets that include substantial vendor claims. In essence the critical vendor and 20 day administrative claim remedies have created a substantial exception to the general rule that general unsecured claims normally receive a fraction of their value in Chapter 11.

Critical suppliers

In 2009, Canada passed an amendment to the CCAA (Companies' Creditors Arrangement Act) to facilitate trade credit, which is similar to the US Chapter 11 "critical vendor" concept. Specifically, Section 11.4 provides that a CCAA debtor may obtain a court order declaring certain vendors as "critical suppliers" if the goods or services provided are essential for the debtor's ongoing operations. The Court can compel the supplier to deal on terms that the court considers appropriate. Further, the court must provide the supplier security, and many rank that priority over the claim of any secured creditor. Not only does this provision protect suppliers, it also changes the insolvency dynamic by allowing critical suppliers, rather than DIP lenders, to provide working capital to an insolvent debtor.

In a recent CCAA case, Catalyst Paper, the insolvency court designated 16 suppliers as critical suppliers under Section 11.4 of the CCAA, ordering them to continue supplying goods and services to the debtor with security as protection. The court determined that such relief was appropriate because Catalyst Paper kept low levels of inventory on hand, there were no other sources of supply and Catalyst's ongoing operations depended on an uninterrupted supply of goods and services. Moreover, the Canadian court in the CCAA insolvency proceeding involving Northstar Aerospace, Inc. utilized its inherent authority to order the actual payment of the prepetition debt of a Chinese supplier. The Court was concerned that a foreign supplier may not comply with an order compelling it to continue selling goods to the debtor, and actual payment of the prepetition claim was the only practical solution to ensure an uninterrupted supply of goods from the Chinese supplier.

With these laws in the US and Canada regarding suppliers' claims, the insolvency dynamic has changed materially. In the US and Canada, debtors can utilize suppliers as sources of working capital by short-term credit extensions, which may be cheaper than working capital in the form of DIP financing. Not only is the cost of credit less, but the "transaction" costs are also less. Rarely do lawyers have to be cranked up for trade credit to the same extent as for a DIP lending facility. Vendors clearly benefit in the short term because post petition payment is enhanced, and there is an opportunity to get all or a portion of prepetition debt paid. In an environment where prepetition unsecured claims rarely receive a meaningful dividend, this "remedy" is significant.

On the other hand the administrative burden of payment of prepetition debt may challenge debtors to succeed in and exit from Chapter 11 or from a CCAA proceeding. In the past, prepetition unsecured debt was for the most part put on the shelf pending a plan of reorganization. Now, debtors may have to include some portion of prepetition debt in this post petition budget. Lenders may not be willing to fund materially increased costs of insolvency proceedings in the US and Canada, unless a successful reorganization is likely. It is clear, however, that debtors in insolvency proceedings will continue to need cash, and will likely source their working capital from both lenders and suppliers.

NOT ONLY DOES THIS PROVISION PROTECT SUPPLIERS, IT ALSO CHANGES THE INSOLVENCY DYNAMIC