Credit Enhancements: Beyond the Personal Guaranty

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Warning Signs of Impending Default

- Deviations in the manner or timing of counterparty payment may suggest liquidity issues or a potential bankruptcy filing
- Counterparty requests lengthening of payment terms or additional trade credit
- Counterparty becomes less cooperative and avoids communications concerning outstanding amounts due
- Public reports (such as those published by Dun & Bradstreet) suggest that the counterparty is not paying its trade debts in a manner consistent with past practices
- Rumors of the counterparty's imminent demise are being conveyed by competitors or industry sources

What do you do if you do not have credit enhancements in place?

TAKE THE MONEY!!!!

- Comply strictly with any contracts in place
- Do not extend additional credit
- Evaluate past history
- Make every effort to maintain ordinary course of business terms

Credit Enhancements and Protections

Credit enhancements offer greater protection in the event a counterparty experiences financial distress and/or becomes a debtor in bankruptcy, and include:

- Irrevocable Letters of Credit
- Pre-payment of goods and services
- Guaranty Agreements and Puts
- Cross/Intercompany Guarantees
- Deposits
- Trust Agreements
- Credit Insurance
- Security Interests in Collateral (including purchase-money security interests)

Standby Letters of Credit

- A letter of credit (LOC) is, simply put, a commitment to make a payment, typically issued by a counterparty's lending institution
- The Uniform Commercial Code sets forth a number of structural requirements which must be adhered to in order to ensure that the LOC is both enforceable and irrevocable
- The most significant advantage of a LOC is that it is not considered property of a bankruptcy estate, and may therefore be drawn upon notwithstanding the imposition of the automatic stay
- Structured properly, a letter of credit will provide a high level of payment assurance by placing the funds outside the reach of the counterparty, its creditors and the bankruptcy court
- Revocable and Irrevocable LOCs – based on business judgment and creditworthiness of buyer

Standby Letters of Credit

- Buyer applies to bank for LOC in favor of seller
- Bank approves credit risk and forwards credit to correspondent bank (located near seller)
- Advising bank (bank for seller) verifies LOC
- Seller ships goods and preserves documentary evidence of same
- Advising bank confirms documentary evidence
- Forward documents to issuing bank, which examines evidence
- Issuing bank sends funds
- Only used when buyer does not pay within certain timeframe

Standby Letters of Credit

- Evidence required:
  - Commercial invoices
  - Bills of lading
  - Warranty of title
  - Letter of Indemnity
  - Can be other documentation as specified by issuing bank

Standby Letters of Credit

- Common Defects
  - LOC has expired
  - Bills of lading are out of date
  - Changes in invoice are not authorized in the credit
  - Inconsistent description of goods (volume, price, quality)
  - Invoice amount not equal to draft amount
  - Ports of loading/destination inconsistent with LOC
  - Lack of documentation or improper naming of documents
  - Improper names on documents
  - No signatures as required

Commercial Letters of Credit

- Mainly used for international transactions
- Payment directly from issuing bank
- Generally negotiable
  - Must be unconditional promise to pay
  - On demand or at definite time
- Buyer (beneficiary) has right to transfer or assign the right to draw on the LOC

Pre-Payment of Goods and Services

- A pre-payment arrangement has two key benefits:
  - No exposure in the event of a counterparty bankruptcy filing
  - Complete elimination of preference liability
- The largest hurdle to putting pre-payment arrangements in place is practical

Guaranty Agreements

- Involves a third-party guaranteeing payment of the counterparty's financial obligations under the contract in full in the event of certain future events (i.e., bankruptcy, insolvency)

- While a guaranty agreement can significantly reduce risks, it may be less desirable than a letter of credit or other forms of security
  - Is guarantor creditworthy?
  - Principal of debtor – fortunes rise and fall with debtor?
  - Litigation costs?

Guaranty Agreements

Cross-Company Guaranties

- Downstream – parent guaranties loans/debts to subsidiary
- Upstream – subsidiary guaranties loans/debts to parent
- Cross-stream – subsidiary guaranties loans/debts of another subsidiary

Potential Fraudulent Transfer Liability

- Downstream – reasonably equivalent value generally protects creditor
- Upstream/Cross-stream – likely more liability

Guaranty Agreements

- Elements of a guaranty are same as those of any commercial contract
- Generally enter at same time as credit agreement and incorporate the same
- Be careful about language describing what the guarantor is guaranteeing – a guaranty is only good for the transactions contemplated at signing (unless the guaranty is specified as being absolute)
- Change in ownership
- Revocation – guarantors can generally revoke guaranty for future transactions (include specific notice provisions)

What to Include in a Guaranty

- Guaranty of payment is irrevocable and unconditional
- Detailed representations and warranties regarding guarantor's ability to perform
- Claims of guarantor to debtor are subordinated to those of the creditor
- Waiver of subrogation rights
- Reinstatement of guaranty in event of preference recovery (Clawback)
- Waiver of guarantor's counterclaims, setoff rights, defenses, etc. against creditor, debtor or other guarantors
- Attorneys' fee and cost reimbursements
- Choice of law / jurisdiction

Puts

- "Puts" are an alternative to guaranties, that can be used in the event that a guarantor refuses to execute an unconditional guaranty
- Put agreements provide that in case of default by debtor, the debtor will sell assets to the party executing the put at a certain price
- A put defines the assets and defines the purchase price
  - Specific dollar amount
  - Specific dollar amount minus debt owed
- A put defines timing of the sale, location of sale, and other details

Deposits

A very simple concept:

- Deposit is taken to secure future extensions of trade credit
- Much like a legal retainer
  - Can reduce or increase as needed
  - Oftentimes impractical, but can at least offset loss if needed
  - "Evergreen" deposit; if deposit is offset against past due balances, impose requirement that it is replenished before further credit is extended

Trust Agreements

In some circumstances, trusts are created by operation of statute for the benefit of certain sellers of goods and services:

- Construction Trusts
- PACA/PASA

However, trusts can also be contractually created:

- Intent – must have intent to create trust
- Trustee – must designate trustee (the customer)
- Property – money
- Beneficiaries – the creditor
- Purpose – to protect proceeds of the sale of the creditor's goods

Credit Insurance

- Credit insurance is widely available from a number of different carriers
- Insurance can either be obtained on specific accounts or an entire portfolio
- Prices vary depending on a number of factors, including the creditworthiness of the customer, whether it is public or privately-held, and the amount of credit being extended
- These policies generally pay out 90% of the past-due balance in a bankruptcy or insolvency event
- Particularly useful for protection against non-payment by international customers

Security Agreements

- Governed by Article 9 of the Uniform Commercial Code
  - State not federal law governs – may vary by state
- In order for a security interest to be valid and senior to other creditors, one must establish (1) attachment; and (2) perfection
- Attachment
  - For a security interest to attach, the requirements are:
    - Value must be given (i.e., trade credit)
    - The debtor has rights in the collateral (i.e., transfer of title)
    - The debtor authenticates a security agreement

Security Interests

- Perfection
  - For a security interest to be "perfected" (i.e., to assure that no other party can assert a senior interest in the same collateral), one must:
    - File a financing statement with the appropriate public office
      - Use the correct legal name of the debtor, consulting with official state records, or driver's license or state issued ID
      - It is generally filed in the location of the debtor, or where the assets are located
    - Actually possess the collateral
    - "Control" the collateral (i.e., in the case of deposit accounts)
    - Exception: PMSIs, which perfect automatically upon attachment
- When a security interest is perfected, it has priority over all parties that subsequently attempt to take an interest in the subject collateral

Security Agreements

- Duration
  - As a general matter, financing statements are good for 5 years
  - To maintain a security interest for a longer period, a "continuation statement" must be filed within 6 months of the expiration of the UCC-1
- Amending UCC-1 financing statement
  - Mergers/name changes/moving – four months to amend
  - Can add or delete collateral

Purchase-Money Security Interests

- Security interest in goods that are collateral for an obligation arising in connection with sale of goods to debtor
    - Discussed in UCC § 9-103
  - Essentially, a PMSI is a security interest taken by a seller of goods to secure all or part of the purchase price of the goods
- Typically, sellers take a PMSI in inventory

PMSI – What is Inventory?

- Defined broadly as goods, other than farm products, that:
  - Are leased by a person as a lessor;
  - Are held by a person for sale or lease or furnished under a contract of service;
  - Are furnished by person under a contract of service; or
  - Consist of raw materials, work in process, or materials used or consumed in a business.
    - UCC § 9-102(48)

Who Needs a PMSI?

- Suppliers of goods
  - Larger items, such as machinery or equipment
  - Series of sales of goods to buyer on where buyer will hold goods as inventory for period of time

PMSI – How Does it Protect You?

- A PMSI grants a seller of goods a "superpriority" security interest over prior perfected security interest holders
  - Superior to blanket lienholders
- Follows identifiable cash proceeds of the sale of the inventory
  - Gives the PMSI holder superior rights to the cash over a conflicting security interest

How to Get and Perfect a Security Interest in Inventory

- Enforceability of a security interest governed by UCC § 9-203 and requires:

  1) Security agreement – granting Creditor security interest in future goods sold
  2) Value given : Creditor gives value by selling goods to buyer on credit
  3) Debtor has rights in collateral – ownership or legal interest in goods sold

- Perfection in inventory, governed by UCC § 9-310

  1) File UCC-1 financing statement with required state agency describing type of goods in which Creditor has a security interest

How to Gain PMSI Rights

- Additional Requirements – Section 9-324
  1) Creditor must be perfected at the time debtor receives possession of the inventory
  2) Creditor must give notice in writing to all parties having a prior perfected security interest in the specific type of collateral
     - Notice issued before Creditor files UCC-1 financing statement
     - Notice must be given within 5 years before debtor receives possession of inventory
     - Notice must state that Seller has or expects to acquire a PMSI in debtor's inventory and describe such inventory by item or type

PMSI – Potential Issues and Pitfalls

- PMSI can relate only to future goods, not prior debts
- Creditor must provide notice to prior perfected lienholders every 5 years
- PMSI security agreement cannot be combined with general non-PMSI security interest
  - Tracing issues inherent in payment

Consignment

- A consignment involves the placing of goods in the hands of another, but retaining ownership until the goods are sold by the consignee. The consignee sells the goods on behalf of the consignor, according to the consignor's instructions.
- Section 9-102(a)(20) of the Uniform Commercial Code defines "consignment" as a transaction in which a person delivers goods having a value of at least $1,000 to a merchant for sale and the merchant:
  - i. Deals in goods of that kind other than the name of the person making delivery;
  - ii. Is not an auctioneer; and
  - iii. Is not generally known by its creditors to be substantially engaged in selling the goods of others.

Consignment

- A typical consignor is relegated to the status of a general unsecured creditor, and the goods consigned become subject to the liens of the consignee's blanket lender upon delivery.
- However, a consignor can improve that status by seeking to perfect a purchase-money security interest in the consigned goods, using the same procedure that governs PMSIs under Article 9 of the Uniform Commercial Code

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Questions

or

Comments?