There have been a number of high-profile cases of companies dealing with bankruptcy and other financial problems recently, and many businesses are now taking a closer look at their partners and suppliers to head off potential issues. However, when a supplier is in financial distress, it won’t always be obvious that there is a problem.

Fortunately, there are almost always signs signaling that you need to delve deeper to find out the financial truth. Perhaps you’ve noticed slower or late deliveries from one of your longtime parts suppliers. You’re concerned that if the supplier continues to fall behind schedule — or worse yet, fails to deliver altogether — a ripple effect will disrupt your company.

The first instinct you have is to call the supplier to express your concerns. When you do, the supplier may have excuses or blame an extenuating circumstance, assuring you that everything will be fine.

Asking the Tough Financial Questions

Find out the truth and protect yourself when a supplier seems to be in financial distress.

By Kenneth A. Rosen, Esq.
However, there's a good chance that everything will not be fine. If you suspect financial trouble, your instincts to be concerned are usually correct.

No matter what industry you're working in, if a supplier is in financial trouble, its problems quickly become yours. How can you prevent this? Fortunately, there are warning signs to look for as well as steps to uncover details that could lead to a disruption if you don’t take action.

What are common indicators of a supplier in financial distress? By doing investigative work online or speaking with employees of the supplier, you may discover that:

- The supplier’s chief financial officer resigned.
- The supplier has hired a “turnaround” firm to help it improve profitability and cash flow.
- Distribution centers, warehouses and offices have closed.

While these signs could signal a significant issue, they are not necessarily concrete evidence of distress.

Finding Out What’s Really Going On

There’s usually more to the story than meets the eye. Here are some of the things that often occur behind closed doors at a financially-troubled company:

- The company hires an investment banker to explore “strategic options” — which often means a sale of the business.
- The company delays in issuing financial statements or filings with the Securities & Exchange Commission (SEC).
- The company has negative cash flow (consuming more cash than it is generating).
- The company’s lender has called a loan and demanded payment.
- The company enters into a forbearance agreement with its lender. A forbearance occurs when that a borrower has failed to fulfill an obligation to the lender, but the lender does not do anything about it (such as declare the loan in default or foreclose).
- The company states that it is refinancing its debt.
- The company has a large interest payment due to bondholders.

So how can you find this information out? Of course, it’s easier to obtain information on public companies than private ones. For public companies, financial answers may be available from such sources as the SEC and online search engines. SEC filings will reveal such things as when a principal or interest payment is due next, if there has been a default under a bond issue and whether the bondholders have agreed to forbear from exercising remedies. For private companies, more research and legwork is required to find out the financial facts. If your organization has a legal department or corporate attorney, this will be an invaluable and time-saving resource. Here are a few things to consider:

- Asking your attorney to order a litigation search to determine if creditors of the supplier have commenced litigation in order to be paid.
- Conducting a lien and security interest search (known as a “UCC-1” search) to determine if the supplier has given its lender additional collateral.

“One thing is certain: Be wary if a supplier will not share financial information. If necessary, offer to sign a nondisclosure agreement and remind the supplier you need to know this information simply to protect your own financial situation.”

When a company grants lenders additional collateral, it is often a sign of distress.

- Looking for lien filings by taxing authorities, as this may indicate that the supplier is taking “involuntary loans” from taxing authorities.
- Asking when the supplier's current bank loan comes due. Will the supplier be able to refinance on time? Has it lost any major accounts recently? Can you get a recent balance sheet, income statement and statement of cash flows? The company may not want to share copies in print, but you can ask to visit its offices in order to view these documents yourself.

Of course, even for attorneys, it’s not always easy to get a supplier to share answers to these questions.

One thing is certain: Be wary if a supplier will not share financial information. If necessary, offer to sign a nondisclosure agreement and remind the supplier you need to know this information simply to protect your own
financial situation. If you are told that the lender or management still will not permit the disclosure of financials, your response should be simple and straightforward: “We are unable to extend credit or to place an order with you at this time if you do not provide us with sufficient information necessary to making an informed decision.”

For a company paying only interest (which happens when the borrower only makes payments toward the interest but not the principal of a loan), this is the question you need to answer: What happens once the “free ride” is over, and principal and interest come out of cash flow?

If the company has entered into an agreement to defer principal or interest payments, it could mean that it lacks sufficient cash to make payments and continue operating its business. It is a sign of trouble.

Another sign of distress is if an unofficial (sometimes called “ad hoc”) bondholders committee has been formed to negotiate with a company. A bankruptcy filing may be possible if a lender and borrower are unable to agree on the terms of a restructuring or forbearance. In most cases, the formation of an unofficial committee of creditors is often a clue that a bankruptcy, or Chapter 11, is on the horizon.

The Chapter 11 Challenge
Chapter 11 can be used to force creditors that do not like a proposed settlement to go along with the majority. But what happens in the bankruptcy case? Will general unsecured creditors (typically regular, everyday suppliers of goods and services) receive any recovery?

There is a pecking order for payment of creditors’ claims. First in line are creditors that have collateral, such as banks. Second are priority obligations, which include taxes, customer deposits and employee wage claims. General, unsecured creditors are third in line. They don’t have any priority status.

If there is not enough money to pay creditors with priority, then general unsecured creditors might be out of luck and receive no recovery at all. If the pre-bankruptcy claims of general unsecured creditors will be wiped out or receive only a token dividend in a bankruptcy case, the business of your supplier could be adversely affected in a way that ultimately hurts you as a customer of the bankrupt supplier.

Because a Chapter 11 filing can occur for different reasons, it’s important to understand what happens when a company commences a Chapter 11 case. Often, management will say that the debtor has obtained debtor-in-possession (DIP) financing. DIP financing is financing for the company that the bankruptcy court has authorized. However, not all such financing really provides a debtor with additional working capital.

The success rate in Chapter 11 is not high. As Chapter 11 has become more expensive, more lenders are unwilling to support a reorganization, instead preferring a bulk sale of the debtor’s assets or a liquidation. So, do not assume a supplier will emerge from Chapter 11 with less debt and a stronger balance sheet, despite assurances from its management.

Most distressed companies going through Chapter 11 will try to assure its customers that things will work out. Your job is to protect your organization, so don’t be afraid to ask deep questions and seek information. Here are some suggestions:
1. Please send me a copy of the bankruptcy petition.
2. Who are the members of the official creditors committee? (The creditors committee is usually made up of the largest creditors in the case and oversees the bankruptcy case on behalf of all creditors.)
3. Please send me the monthly financial reports that you file with the bankruptcy court.
4. Has anyone filed an application with the bankruptcy court to liquidate your company?
5. How much new or additional money is your lender actually giving you in Chapter 11?
6. Is the company being sold? If so, when is the deadline to sell the company or to get out of bankruptcy?
7. Do you have any assets that are not subject to mortgages or security interests?
8. How much money do you owe to banks, and how much do you owe to trade creditors?

Depending on what you find out, in cases like this it’s never too early to begin considering other options. This is especially true when Chapter 11 is on the table due to the unlikelihood of the supplier recovering from this situation. Alternate sourcing or sourcing from multiple suppliers reduces the risk of relying on a now-defunct supplier — even though you knew of its difficulties.

Keeping Your Own Bases Covered
At some point, you may become concerned about contractual obligations in place with a distressed supplier. This is where the Uniform Commercial Code (UCC) comes into play. The UCC governs certain rights of companies
that have signed a contract with each other. It allows one party to a contract (who has a reasonable basis to be concerned about the other party's ability to fulfill its obligations under the contract) to demand “adequate assurance of future performance.” In other words, it legally allows one party to request and receive information from the other in a contract to demonstrate that it will be able to perform fully and in a timely manner.

If you have a real basis to be concerned about a company’s ability to perform and don’t receive the assurances that you request, then you may be able to terminate the contract and enter into a new agreement with someone else. This is a much better option than worrying whether and when the supplier might breach its contract with you and then going into reaction mode. However, be cautious when expressing concern about a seller’s financial condition. It’s best when you can point to something like a news article rather than a rumor. Thus, check industry periodicals and newsletters.

A common place in the supply chain to experience these kinds of bankruptcies is logistics. Recently, some large trucking companies have filed bankruptcy. The concern is that, because of the bankruptcy, your goods could be stalled at a depot or in a trailer somewhere. But it’s not just trucking companies to be concerned about. For example, Hanjin Shipping (a South Korean cargo container shipping company) recently commenced a bankruptcy case. As of press time, some port operators were still refusing to unload Hanjin containers. And in some cases, ports would not allow Hanjin ships to enter, holding up a large number of containers loaded with goods.

Another shipping-related issue: Many states permit shippers to go to the recipient of goods to recover payment if the seller fails to pay the shipper. In other words, the trucking company that delivered goods to you can force you to pay shipping charges that the seller was supposed to pay. Thus, if shipping charges are payable by the supplier, before making payment to the seller, it is worth making certain that the trucker has been paid. Be proactive and make sure that you will not be responsible for shipping charges if your supplier doesn’t pay them.

When you sense that something is wrong or that your supplier is in financial trouble, it is time for you to press hard in order to protect yourself. Ask questions, demand answers, and don’t accept bluster and optimism. If you smell smoke, there’s probably a fire worth checking out. Make sure that it’s not out of control.

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