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Column

Last in Line

*14 HOW TO ANALYZE A TRADE LIEN

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Whenever a business files chapter 11, a familiar “dance” begins between the debtor and its suppliers. The business debtor becomes desperate for trade credit because its suppliers often withdraw it as soon as the bankruptcy is filed. The trade lien has become increasingly common in the larger chapter 11 bankruptcy cases as a way to harmonize the needs of debtors and their suppliers to encourage suppliers to extend favorable post-petition trade credit on a secured basis. With the recent flurry of large businesses filing chapter 11 reorganizations, trade creditors and their counsel need to understand how to analyze a trade-lien program in order to assess what protection it will (and won't) provide.

The trade lien was devised approximately 14 years ago during the chapter 11 reorganization of Revco Drug Stores. Since then, it has been used in numerous chapter 11 reorganizations, including Phar Mor, Cumberland Farms, Affiliated Foods, Boston Distributors, F&M, Central Hardware, Witte Hardware, White's Fresh Foods and Kmart. In the absence of a trade lien, the post-petition supplier gets an administrative expense claim, which will get paid before pre-chapter 11 unsecured and priority claims, but after all secured creditors (both pre- and post-petition) get paid. If a chapter 11 reorganization plan is confirmed, then pursuant to 11 U.S.C. §1129(a)(9) all allowed administrative expense claims must be fully paid (unless the administrative expense claimant consents to different treatment).

In reality, however, not all chapter 11 cases result in a confirmed plan. If the chapter 11 estate is administratively insolvent, then administrative expense claims won't get fully paid, and the post-petition suppliers effectively get burned twice—once on their pre-petition claims and again on their post-petition claims. It is this—the fear of getting burned twice—that often causes post-petition suppliers to withdraw credit and demand COD or cash in advance as soon as the debtor files chapter 11. From the debtor's perspective, COD and cash in advance are costly, impractical, and inimical to the debtor's reorganization efforts because they threaten the debtor's ability to maintain appropriate inventory levels. The trade lien was devised to assuage the fears of post-petition suppliers, allowing the debtor to obtain post-petition credit on the same favorable terms it enjoyed pre-petition. The trade lien works by granting suppliers a lien (rather than just an administrative expense claim) to secure payment for all goods and services they furnish post-petition in exchange for the post-petition supplier's agreement to give the debtor credit on terms similar to (or better than) the pre-petition credit terms the debtor enjoyed from that supplier. Pursuant to 11 U.S.C. §364, establishment of a trade lien program requires bankruptcy court approval, and the debtor must prove the same elements that are required for other secured financing under 11 U.S.C. §364(c), namely that it is unable to borrow money or obtain credit on an unsecured basis or by granting an administrative expense claim and that the trade lien is necessary for an effective reorganization. If the trade lien is going to prime other liens, then the debtor must satisfy 11 U.S.C. §364(d).

Generally, post-petition suppliers want the trade lien to have the highest possible priority in the greatest volume of the debtor's assets. They would like the trade lien to have higher priority than all lenders and believe this is justified because the post-petition trade credit enhances the value of the lenders' collateral; without it, the entire reorganization is in jeopardy. The debtor's

lenders tend to view the situation differently and are often opposed to a trade lien. Indeed, frequently the first problem is to convince the debtor that it needs to institute a trade lien, and then to convince the lenders to go along. Many times, the debtor either doubts that it needs a trade lien, or is unwilling to force the issue with its lenders. This scenario can spell disaster in the retail reorganization. If the debtor doesn't push for a trade lien and post-petition credit is not forthcoming, suddenly the debtor cannot get merchandise on the shelves. Once the shelves are bare, the debtor's customers shop elsewhere and there is no business left to reorganize.

Experienced counsel for the creditors' committee needs to get involved early in the case and convince the debtor that it needs a trade lien in order to reorganize, and that it is important for the debtor to force the issue with its lenders as soon as possible in order to avoid any disruption in inventory shipments and to maximize the chances for a successful reorganization. Once the debtor begins to push for a trade lien, vigorous negotiations often ensue among the creditors' committee, lenders (both pre-petition and post-petition), debtor and other constituencies.

For those of us who represent post-petition suppliers, it is important to know what to look for when analyzing the trade lien program so that we can advise our clients about the protection it affords (or, more importantly, doesn't afford) them. Generally, it is important to analyze the following factors:

· *Scope and Priority of the Trade Lien:* To what does the trade lien attach and with what priority? Obviously, the post-petition suppliers will want to see a first lien in all assets with priority over everyone, including lenders. However, the debtor and/or its lenders will want the trade lien to be junior to bank debt and/or limited to a particular category of assets (such as inventory). A junior lien, or a lien on a particular category of assets, can greatly diminish the actual protection that the trade lien provides. For example, if the trade lien is junior to the lenders' lien, its protection is dependent upon how much equity remains in the assets and the aggregate dollar amount of the post-petition supplier claims that seek protection from that equity. If the trade lien attaches to a particular category of assets (such as inventory), its protection is limited to the value of that pool of assets. If the trade lien is both junior and restricted to a limited pool of assets, it is important for the post-petition supplier to know whether there is a "marshalling" provision in the trade lien program that requires the senior lien-holders to first seek collection from assets other than those that are subject to the trade lien. In the absence of such a marshalling provision, protection of the trade lien might be illusory at best.

· *Reinstatement of "Normal and Customary" Credit Terms.* This is a universal component of any trade lien because the goal of the trade lien is to entice suppliers to reinstate normal (or better than normal) trade terms with the debtor that are better than what the debtor's current financial condition would merit absent the trade lien. In analyzing any trade lien, counsel for the post-petition supplier needs to address (and hopefully resolve) any confusion regarding the "normal and *34 customary" credit terms that the supplier gave the customer pre-petition. For example, what terms constitute "normal and customary" if the credit terms changed pre-petition?

In addition, counsel for the post-petition supplier needs to clearly understand what will happen if that supplier participates in the trade lien program for a while and is then unwilling to give the debtor "normal and customary" terms. Will trade lien protection terminate for that supplier, and if so, will the termination apply only to future shipments, or will it apply retroactively to shipments already made by the supplier but not yet paid for by the debtor? Also, counsel for the post-petition supplier needs to carefully consider what will happen if the post-petition supplier withdraws or reduces credit because of the debtor's material breach of those credit terms—such as non-payment or repeated late payments. In the interest of fairness, a trade lien program should require the debtor to timely make all payments to its post-petition vendors, and should further provide that the protection of the trade lien does not terminate if the post-petition supplier withdraws or reduces credit in response to the debtor's non-payment for post-petition deliveries or material breach in those post-petition credit terms.

· *Duration of Trade Lien.* How long does the post-petition supplier receive protection under the trade lien? Obviously, the post-petition supplier will want the trade lien to remain in place as long as practicable, generally until the earlier of the effective date of a plan of reorganization, conversion to chapter 7, or the debtor's default under any of its financing arrangements. Some

debtors, however, use this duration issue to make certain that they are afforded favorable trade credit in exchange for the trade lien, so they draft provisions to make the trade lien last only so long as the post-petition supplier offers favorable trade terms. Thus, the issue of duration of the trade lien and continuation of customary credit terms are sometimes linked.

· *Credit Information.* Post-petition suppliers often need ongoing information regarding the debtor's financial condition. If the trade lien is junior to some or all secured bank debt or is in limited assets, the post-petition suppliers need to know the amount of bank debt, the book value of the assets and the amount of debt secured by the trade lien. This need for information is heightened if, as sometimes happens, the debtor has agreed not to incur trade debt in excess of a certain dollar amount or percentage of the book (or other) value of the inventory. Counsel for the post-petition supplier must consider the extent, frequency and level of verification of reports the debtor is to provide, and how the post-petition supplier is to get them (*e.g.*, directly from the debtor or through an intermediary such as the creditors' committee).

· *Foreclosure Rights.* Often a trade lien program will provide that an individual unpaid post-petition supplier may ask the creditors' committee to file a motion seeking permission to foreclose and that, if the committee refuses, that supplier can go to court for permission to foreclose. Such a provision is rarely (if ever) invoked. In virtually all instances, the dispute is resolved and there is no need for foreclosure.

What if there is a general default by the debtor, such as acceleration of the bank debt? Sometimes the trade lien program is drafted to eliminate all foreclosure rights relative to the trade lien until after all lenders and other creditors who are senior to the trade lien have been paid in full. This tends to adversely affect the value of the trade lien's protection. If the post-petition supplier's foreclosure rights are going to be so sharply eclipsed, it makes sense to insist that the debtor provide written verification (at appropriate intervals, such as weekly) of collateral levels and the status and level of accounts payable, so that the post-petition vendors can judge for themselves whether the trade lien will afford them sufficient protection in exchange for their extensions of post-petition credit.

In conclusion, trade liens can vary widely because they are the product of negotiations among various constituencies. Because the trade creditor is generally "last in line" when its customer files bankruptcy, most trade creditors (and their counsel) view the trade lien as a panacea—a quick and easy way to move up the priority ladder. However, each trade lien program must be carefully analyzed to make sure that it affords the post-petition supplier an appropriate amount of protection in exchange for the favorable trade credit that will be extended to the debtor. In each scenario, the post-petition supplier must carefully weigh whether its interests are best served by demanding COD or cash in advance (and risk losing the debtor's business altogether), or receiving a trade lien. Attorneys for post-petition suppliers can help their clients evaluate these complex business decisions by analyzing the critical points of the trade lien so that both the lawyer and the post-petition supplier understand the protection that the trade lien will (and won't) provide.

Footnotes

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