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NO NEED FOR DISTRESS
PRACTICAL TIPS FOR MITIGATING THE RISK OF SUPPLIER INSOLVENCY IN COMMERCIAL CONTRACTS

April 2020

TERMINATION NOT ENOUGH?

Current market uncertainties related to the Covid-19 pandemic will lead to the financial distress or insolvency of a number of companies, some of which may feature in your supply chain. It is therefore likely you will be impacted by insolvency, if not directly, then indirectly through your key commercial contracts with third party suppliers.

Given the heightened risk of supplier insolvency in the current economic environment (and recalling the customer impact caused by the collapse of certain major suppliers in the recent past), the approach to addressing the risk of supplier insolvency in your key commercial contracts may warrant further thought. For example:

- While trade customers can often be major creditors of large suppliers, they rarely have the same protections that a financial creditor would insist upon. This puts them at the back of the queue in a supplier insolvency situation.
- The contractual remedies that customers do have usually kick in at the point of supplier insolvency, by which time there is very little that a customer can do to protect itself. At the point of insolvency the supplier will have limited assets, meaning a customer's ability to recover financial loss is, from a practical perspective, similarly limited. Separately, insolvency practitioners often have wide-reaching powers which can make it difficult for a customer to enforce contractual terms against the supplier once they are insolvent.
- Even if they can be enforced, contractual remedies for insolvency are frequently very stark, usually termination of the contract. This achieves the opposite outcome to the one which a customer would likely prefer – i.e. the continued delivery of the goods or services. It also forces the customer into what is likely to be a complicated transition from the insolvent entity to a new supplier. Importantly, in some jurisdictions, 'ipso facto' clauses (i.e. clauses that give a party the right to terminate a contract upon the counterparty's entry into insolvency proceedings) are not recognised. While this is not currently the case in the UK, it is expected that such a prohibition will be introduced as part of the proposed changes to UK insolvency law in response to Covid-19.

When entering into your future strategic commercial arrangements with key suppliers (or as part of renegotiating existing ones), in addition to termination you should be thinking about a more extensive arsenal of practical remedies, as well as bringing the trigger point for the exercise of those remedies forward in time.

EARLY WARNING OF FINANCIAL DISTRESS

Insolvency events are often defined in contracts by reference to insolvency proceedings actually having commenced (e.g. the appointment of an administrator, winding up, voluntary arrangement, or scheme of arrangement with creditors) and, sometimes, to any threat or proposal in respect of those events.

While, superficially, this makes sense where the remedy available is contract termination, in practice you will want to have much earlier visibility that your supplier may be suffering some form of financial distress. This gives you time to address any issues with your supplier directly, as well some ability to start contingency planning should the worst happen.

Set out (in the box below) are some examples of financial distress 'trigger points', all of which are indicators that the financial health of your supplier is not as robust as it could be. The extent to which you include any or all of these trigger points in your contracts will depend on your particular circumstances (including the type of contract, the identity and activities of the supplier and the wider economic environment) – however they all act as a form of insolvency 'early warning' system.

Financial distress trigger points

- the supplier's sub-contractor complaining of not being paid
- the supplier disclosing a material uncertainty in its going concern statement
- an auditor providing a qualified audit opinion in respect of the supplier's accounts
- the supplier issuing a profit warning
- the supplier's credit rating being downgraded below a certain level
- the supplier breaching certain financial covenants (which, ideally, should be aligned with those in the supplier's principal financing arrangements to allow you to act at the same time as the lenders, and coupled with associated reporting and audit provisions that ensure you remain apprised of the supplier's status)

PRACTICAL REMEDIES/MITIGATING ACTIONS

In addition to termination rights, the following are a range of remedies and mitigations that will allow for a more practical and effective approach to coping with the insolvency of a supplier:

Access to information – often the issue is that counterparties are kept in the dark by companies in financial distress until it is too late. Following the occurrence of a financial distress trigger (or when you otherwise reasonably request), the supplier should be obliged to provide information regarding the financial condition of the business (for example, copies of the accounts within a specific period or copies of compliance certificates shared with the lenders under the supplier's principal financing arrangements). The contract could also contain a right for you to require the supplier's CFO to attend meetings with your representatives, to explain in person the challenges faced by the business and the proposed mitigations. These measures can allow you to gauge the true financial health of the supplier and plan accordingly.

Access to sub-contractors – you can reserve a right under the contract to pay the supplier's sub-contractors directly if it becomes clear that the supplier is withholding payments to those sub-contractors. While the key consideration will be ensuring the continuing provision of goods or services by the sub-contractor, you should consider withholding or setting-off amounts due to the supplier (if, for example, payment has already been made to the supplier as well) and possibly amending payment terms (see below) to minimise the risk of you being out of pocket. This can help maintain service performance under the contract while reducing dependence on the supplier. In a similar vein, step-in rights are a more substantive customer remedy, giving you the ability to directly control/influence the supplier's underlying supply chain and ensure service delivery is preserved.

Credit support – the contract can include obligations on the supplier to post some form of credit support, such as parent company guarantees. This could be triggered when certain financial thresholds are breached or at the outset of the contract where you might have concerns about your ability to recover from your supplier (e.g. if they are based abroad or are an SPV). It is important to perform due diligence on the creditworthiness of the parent company before accepting it as the guarantor – it may be that a guarantee from another operating company within the supplier's group might be more appropriate (i.e. they have more assets and/or are better placed to guarantee the performance of the services or provision of the goods). A more robust credit support option would be some form of bonding (e.g. where you make significant upfront payments to the supplier, an advance payment bond might be more relevant than a parent company guarantee).

Amend payment terms – extend existing payment terms and/or make them payable in arrear rather than in advance in order to ensure that goods or services are received or delivered before cash is handed over to the supplier. This helps prevent you becoming an unintended source of credit to the supplier.

Have a contingency plan – ensure that the occurrence of a financial distress trigger requires an update to the draft exit plans in relation to services provided under your contract, to help facilitate an efficient migration to an alternative supplier. More generally, having an obligation on your supplier to regularly refresh and update the draft exit plan (whether or not there are signs of financial distress) is also important as frequent reviews will minimise the updates that need to be done in an insolvency situation. It is also worth looking at your supply chain and thinking about who might be able to take over the role if a key supplier becomes insolvent (e.g. in a multi-sourcing situation, one of the other providers could be well-placed to assume the provision of the relevant services).

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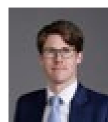

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