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Strategies for Dealing with Critical Suppliers in Distress

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As the economic impact of the COVID-19 pandemic continues to affect a greater number of businesses, suppliers' capabilities to access cash through debt and equity will likely be further constrained. For customers procuring critical-path goods, software, technology, or services, suppliers' distress puts their own business in serious jeopardy – especially when alternative solution providers are unavailable or subject to significant barriers to implementation. Suppliers and their key customers will need to find innovative solutions to continue the ongoing viability of the symbiotic relationship.

As many suppliers are close to, or facing, the real possibility of bankruptcy, both suppliers and customers will need to be open to creative thinking to sustain operations and strengthen customer relationships during these challenging times. No one-size-fits-all solution will work for each supplier relationship. Below is a non-exhaustive list of options for entities to begin to think through solutions.

Paying for Product in Advance of Delivery: While paying in advance may provide immediate cash flow issues for suppliers, it likely will not address the underlying issues causing suppliers' insolvency. Suppliers' operations may be impaired either due to stay-at-home orders, labor concerns, upstream providers, etc. Unless early payment provides a clear path toward long-term solvency and operations, early payment is a risky proposition for customers and could amount to “throwing good money after bad.”

Increased Volume or Buying Commitments: Increased purchase commitments may give sufficient confidence to suppliers, and their creditors and investors, to continue operations consistent with the “normal course” or customers' expectations. Buying commitments may justify valuable concessions for the customer, including price concessions, delivery priority, service level commitments, removal of restrictive covenants, etc.

Acquisition of Critical-Path Assets: Ownership of inventory, tooling, molds, and other manufacturing equipment and facilities, may provide an excellent contingency plan in the event the supplier must resort to bankruptcy. Such solutions could infuse capital into the supplier, or relieve the supplier of suppressing debt, without disrupting ordinary course operations. Outsourcing of the related processes will need to be clearly documented to understand each party's responsibilities. How assets are acquired should be carefully considered to avoid bankruptcy filings disrupting such contingency plans.

Intellectual Property Rights: A supplier's intellectual property rights may impair a customer's ability to implement contingency plans, including workarounds, insourcing, and engaging alternative providers. Intellectual property licenses may be structured in a way to withstand supplier bankruptcy. And, intellectual property licensing permits great flexibility for developing creative win-win solutions for customers and suppliers. Intellectual property license rights should be weighed and considered in any plan to assist distressed, key suppliers. Intellectual property rights may also be necessary to set up contingency systems.

Escrows, Triggering Events, and Contingency Systems: Technology and know-how escrows should be considered when suppliers are restricted or reluctant to deliver what may be the most essential aspects of its offerings. Even when suppliers are willing to give customers direct access to these components, suppliers may insist these components not be used or leveraged until one or more conditioned precedent (a.k.a. "triggering event") occurs. Triggering events vary and are often subject to significant negotiation. While bankruptcy filings almost always amount to be a triggering event, customers will need to structure the agreement to limit the bankruptcy trustee or debtor-in-possession from being able to stay key obligations of the supplier. Triggering events also may be used to provide suppliers some assurances of customer behavior. For instance, if the supplier agrees to assist a customer in propping up a contingency system, the customer might agree to limit cutover to such systems unless and until a triggering event occurs.

Removal of Restrictive Covenants: Nondisclosure, non-solicitation of employees or subcontractors, non-competes, anti-reverse engineering, and other limiting provisions may directly impede the execution of customers' contingency plans. Not only must customers presume that these provisions will survive a bankruptcy filing, but customers should also consider that a bankruptcy trustee or debtor-in-possession will have an obligation to enforce such provisions. As customers lean further into the relationships with critical suppliers, they should seek the removal of any covenants which will restrict the implementation of contingency plans, including the ability to insource and hire critical talent for ongoing operations.

Merger, Acquisition of Equity, and Rights of First Refusal: As the valuation of a distressed supplier deteriorates, a customer's interest and capabilities in acquiring all or some of the equity of such supplier will shift. Acquisition of all, or a controlling share, may reduce a significant portion of the risks inherent in the relationship, but will also present its own challenges. If a customer is not ready to make a significant investment in the supplier, the customer may also want to consider obtaining rights of first refusal from the supplier or its equity-holders to protect its interests and benefit from the upside of continuing to support the supplier in its business.

We encourage you to visit Holland & Hart's Coronavirus Resource Site, a consolidated informational resource offering practical guidelines and

proactive solutions to help companies protect their business interests and their workforce. The dynamic Resource Site is regularly refreshed with new topics and updates as the COVID-19 outbreak and the legal and regulatory responses continue to evolve. Sign up to receive updates and for upcoming webinars.