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Allianz Trade

Bankruptcies and Insolvencies: How to Keep Your Business Afloat

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Introduction

The waves of bankruptcies and insolvencies throughout the United States and the world is not surprising to those who monitor commerce's financial health. In many industries, the ripple effects of Covid-19 has combined with the declining economy and financial distress from the end of 2019.

The rise in insolvencies and bankruptcies worldwide (+10% increase in 2022 and +14% in 2023*) have added major pressure to supply chains—potentially disrupting and forcing businesses to urgently find (costly) alternatives, putting suppliers at financial risk with nonpayment and resulting in large and expensive legal bankruptcy procedures. The bigger the company filing for bankruptcy, the higher the risk of a domino effect that could push businesses already grasping to stay solvent further under water.

Healthy cash flow is the lifeblood of your business. Whenever you extend credit to a client, you take a risk that the client will not pay, and your cash flow will be interrupted. With the Covid-19 crisis and the ongoing rise in bankruptcies, your key customers that struggle financially or declare bankruptcy could expose your business to loss.

Because your business extends trade credit, you should understand the process of bankruptcy and the unique challenges presented if one of your clients start proceedings. This eBook provides and overview of the different types of bankruptcies, forecasted data for what's to come, and how to stay afloat in challenging times and protect your cash flow and business.

*https://www.allianz-trade.com/en_US/insights/global-insolvency-report-2022-2.html

SECTIONS

The Different Types of Bankruptcies and Insolvency

Insolvency vs. Bankruptcy

Insolvency and bankruptcy are, at times, intertwined. Insolvency is typically the first step toward bankruptcy trouble for a business. Invoices pile up, assets deplete, and it becomes more difficult to pay invoices. However, just because the business is insolvent doesn't mean it can't make a sharp turn back toward solvency and promptly meet financial obligations.

There are ways to turn insolvency around—including loans, negotiating payment terms, and even restructuring the business. A business doesn't always need to declare bankruptcy when it becomes insolvent.

However, if a business cannot overcome insolvency, bankruptcy may be the best alternative to struggling and incurring additional debt.

Insolvency:

This is the state of financial distress when a business is unable to promptly meet its financial obligations.

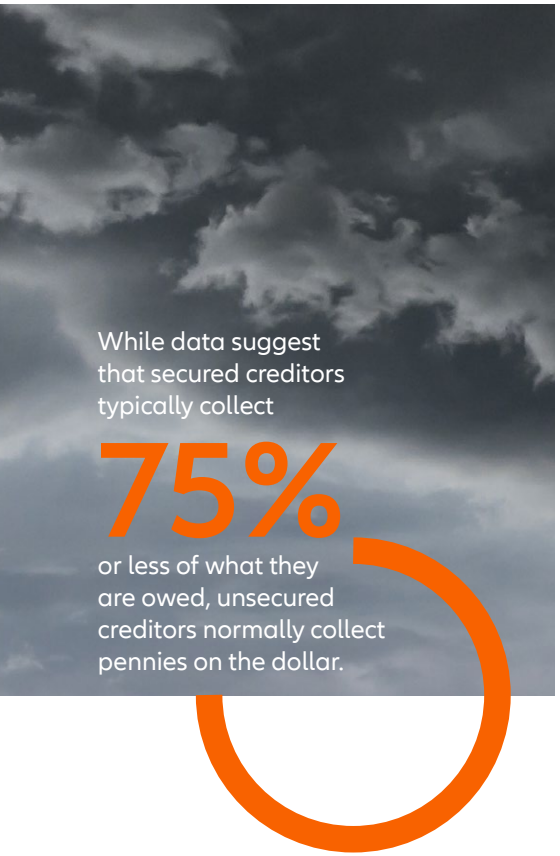
VS.

Bankruptcy:

This is the formal process through a court order that allows a business to reorganize and pause payments on debts while reorganizing or before going out of business.

There are several different types of business bankruptcy →

The Different Types of Bankruptcies and Insolvency



Administration: A company can try to preserve its business venture by choosing administration rather than liquidation bankruptcy. During administration, an appointed administrator decides how to turn the business around to pay its debts and avoid bankruptcy. The administrator may determine to sell the company or explore funding options that can keep the company operating.

Chapter 7 Bankruptcy: Under Chapter 7 bankruptcy, a business determines that its debts are so overwhelming that there is no option other than to close the business. A court-appointed trustee becomes responsible for selling company assets, the proceeds of which are used to pay off the company's debt.

Chapter 11 Bankruptcy: Under Chapter 11 bankruptcy, a company can reorganize and create a plan to repay creditors over time. Creditors get an opportunity to vote on that plan. The company can continue to operate, but a bankruptcy court must approve financial decisions (like paying off creditors). You may be owed money by a company in administration or a company that has gone bankrupt. In both types of bankruptcies, claims are paid in a specific order. Secured claims, like those made by mortgage holders, are paid before unsecured claims, like those made by businesses that provided products or services. If you get any money at all, it will likely be much less than the actual debt owed to you.

Chapter 5 Bankruptcy: Subchapter 5 of Chapter 11 bankruptcy allows businesses with debt below $2.75 million to reorganize under Chapter 11 without getting consent from those creditors about the proposed plan to make repayment. Repayment may happen over a three- to five-year term. A trustee is automatically appointed to mediate between the debtor and its creditors. However, the debtor remains in control of the assets and operation of the business.

Small Business Reorganization Act (SBRA), also known as Subchapter V

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Subchapter V is for smaller debtors. It is much faster than the typical Chapter 11, and the reorganization plan does not have to be approved by creditors, who would now have no say about what they should be repaid.

Dan North
Chief Economist, Allianz Trade

Waves of Global Insolvencies

After two years of declines, we expect global business insolvencies to rebound.

Covid-19 and the Ukraine crisis has set waves of insolvencies in motion

Before the global health crisis struck, Allianz Trade predicted global business insolvencies would rise based upon the moderate pace of economic growth and the lagging effects of trade disputes, political uncertainties, social tensions, and a prolonged discrepancy between the manufacturing and services sectors.

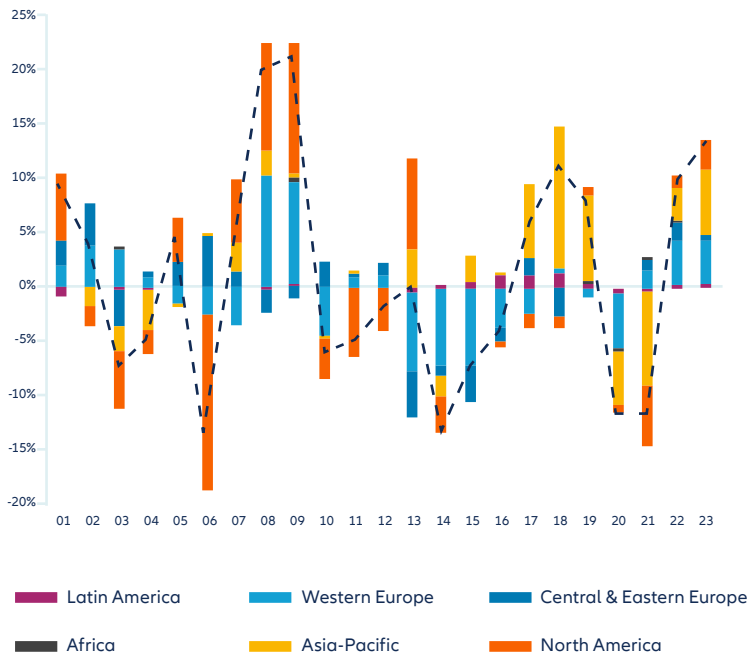
Then, the Covid-19 pandemic happened, and its sudden impact of historic proportions has caused lasting effects on the global economy—causing uncertainty and rises in bankruptcies and insolvencies. Then, the Ukraine crisis happened, which has contributed to a surge in inflation sending more shockwaves through the supply chain.

> We now have a high level of zombie firms—firms that can't pay back their debts, only the interest. They can't grow, they can't pay dividends—they are merely operating to cover interest payments. These firms are skating on the edge of collapse and will contribute to an increase in bankruptcies.
>
> **Dan North**
> Chief Economist, Allianz Trade

Waves of Global Insolvencies

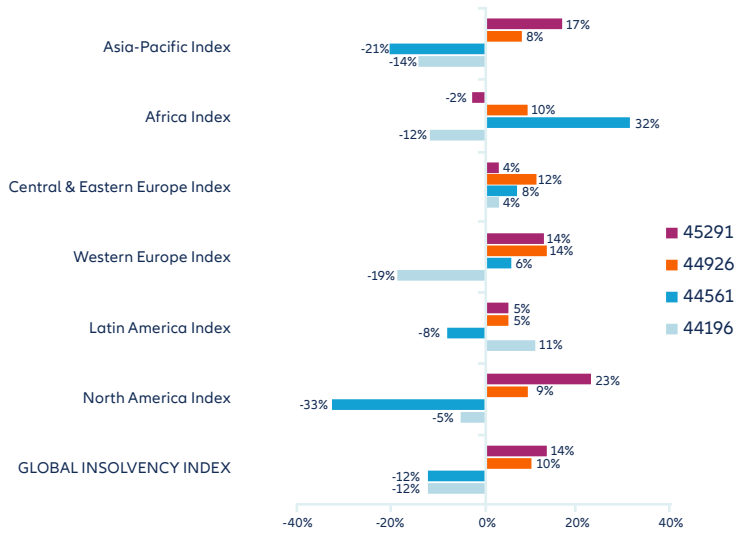
Insolvency indices by region, contributed to yearly change in global insolvency index

Source: Allianz Research



Global and regional insolvency indices, yearly change in %

Source: Allianz Research



What to do if a Company goes Bankrupt and Owes you Money

> Learning that a client has declared bankruptcy is difficult news. But there are steps to take that can help you feel more in control of the situation.

What type of creditor are you?

First, understand your status as a creditor. If a business goes bankrupt and owes you money, your debt is listed with all other obligations according to a specific order for repayment. Typically, bankruptcy debt is determined to be preferential, secured or unsecured, in that priority order.

- **Preferential or preferred creditors** can include employees of the company who are owed wages as well as tax authorities.
- **Secured creditors** have liens on the debtor's property (such as a financial institution that has loaned money for the company to purchase a building or vehicles).
- **Unsecured creditors** are those that provided the company goods or services, such as suppliers and contractors.

When a business files a Chapter 11 bankruptcy case, a U.S. trustee will appoint a creditors' committee. The trustee will appoint three to seven creditors to the committee to represent the interests of the business's creditors. It is not uncommon for a trustee to form both a secured creditors' committee and an unsecured creditors' committee. The creditors' committees' goals are to represent the interests of all the secured or unsecured creditors' interests in the bankruptcy proceedings. The committee is responsible for reviewing the debtor's business operation and helping to formulate a place to reorganize the business to liquidate it.

What to do if a Company goes Bankrupt and Owes you Money

Filing a claim

Second, know how to file a claim to be paid what you are owed. If a company goes bankrupt and owes you money, you will receive a notice from the bankruptcy court detailing the action. That notice will include instructions for filing a proof of claim. A proof of claim is a written statement and supporting documentation that outlines why the client declaring bankruptcy owes you money. The proof of claim document and directions for how to complete it will be included in the bankruptcy notice. Filing is time-sensitive, so you should give this document full attention and file on or before the deadline. Submit the proof of the document with the bankruptcy court where the bankruptcy was filed.

Also, when a bankruptcy case is filed, you must stop all collection efforts, such as sending past-due notices or calling about past-due invoices.

To receive notice of the bankruptcy and a proof of claim form, the business that is declaring bankruptcy must list you as a creditor. If that does not happen and you learn of the customer's bankruptcy another way, contact the customer and ask for the bankruptcy case number and the court in which the bankruptcy was filed. Call the clerk of the appropriate court and confirm that a filing has taken place. Ask them about any relevant dates regarding your filing a proof of claim and request a copy of both the bankruptcy notice to creditors and a proof of claim form. Review the bankruptcy notice to see if you are or are not listed. Then, file a proof of claim.

> "...when a bankruptcy case is filed, you must stop all collection efforts, such as sending past-due notices or calling about past-due invoices.

What to do if a Company goes Bankrupt and Owes you Money

Take steps to avert loss

Filing a proof of claim only means you are listing your past-due amounts for consideration of payment by the bankruptcy trustee. There is no guarantee those debts will be paid. However, when you insure your accounts receivable with trade credit insurance, you can count on being paid if the customer is covered under the terms of your particular policy, even if that customer is unable to pay due to bankruptcy.

In a recent survey of its broker partner members, the International Credit Brokers Alliance learned that trade credit insurance remains a robust way for businesses to reduce risk, particularly in the wake of the global pandemic. Experienced trade credit insurance specialists who responded to the survey indicated that trade credit insurance has delivered peace of mind to those with coverage who experienced default risk without warning due to bankruptcies and market volatility caused by Covid-19.

In addition to securing trade credit insurance, you can also avert loss from a potential bankruptcy claim filed by a client by including a retention of title clause in your contract of sale. This clause allows you to retain the rights of ownership of the goods you deliver to the client until full payment is received.

A contract of sale that includes this clause and which is signed by you and your client can give you a claim to those goods if the client becomes insolvent. This way, you can avoid becoming an unsecured creditor in a bankruptcy filing.

It is important to note that some goods, like perishable goods, are not covered by a retention of title clause. Also, if your customer enters administration, you will not be able to enforce a retention of title clause.

> “...trade credit insurance has delivered peace of mind to those with coverage who experienced default risk without warning due to bankruptcies and market volatility caused by Covid-19.

Doing Business with a Company in Chapter 11

The waves of business insolvencies and ongoing Covid-19 uncertainties enhances the threat that some of your current clients could declare bankruptcy.

Conducting business post-filing

Once a company files for Chapter 11 bankruptcy, it may continue to operate in the ordinary course of business. That means it can still purchase essential goods or services necessary for the business to run. These purchases (made after Chapter 11 has been filed) typically get administrative claim status. The company must pay for them even though debts accumulated before the Chapter 11 filing are held until a restructuring plan or liquidation plan is confirmed and the bankruptcy court approves payment.

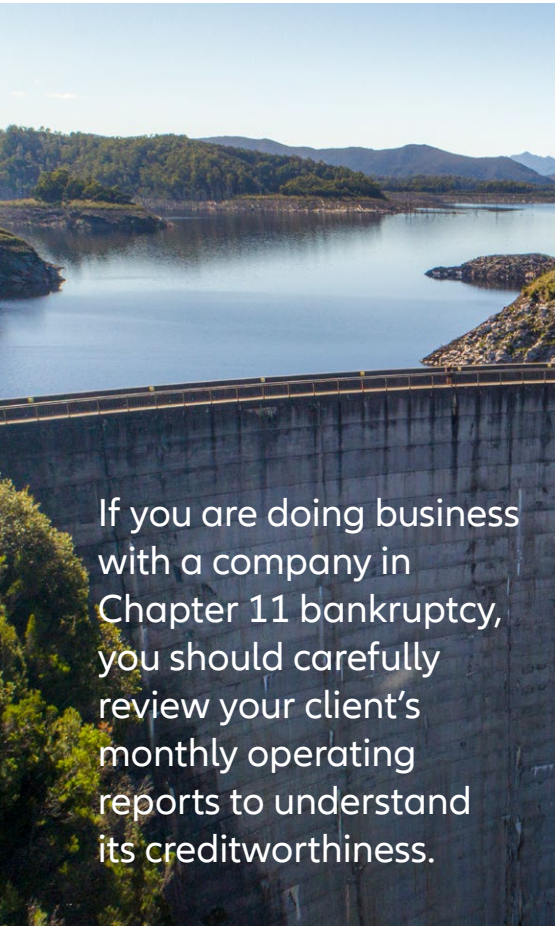
Before you conduct business transactions with a company in Chapter 11, you should first be sure a transaction will receive administrative claim status. Seek approval for the transaction from the bankruptcy court or the trustee. If you choose to do new business with a client in Chapter 11, you should consider protection, such as:

- Shortening trade credit terms
- Requiring cash on delivery
- Requiring a deposit or letter of credit before delivery

Under Chapter 11 bankruptcy, a company can reorganize and create a plan to repay creditors over time. The company can continue to operate, but a bankruptcy court must approve financial decisions (like paying off creditors). This can impact your cash flow. The bankrupt company's past-due invoices may eventually be paid, may eventually be paid but not in full, or may never be paid at all.

In a Chapter 11 bankruptcy, the company that has filed Chapter 11 is allowed to continue to operate under the supervision of the bankruptcy court and an approved plan of reorganization. Unless you have a contract with the client that states otherwise, you can still choose to do business with a company in Chapter 11 bankruptcy.

Doing Business with a Company in Chapter 11



Understanding cash collateral orders

As a company that has filed Chapter 11 bankruptcy continues to do business, it will likely bring in money from accounts receivable and/or sale of inventory or property. That income is placed in a cash collateral account. This cash cannot be used without a court order.

If you choose to do business with a company in Chapter 11 bankruptcy, verify that the company has the authority to spend cash collateral. Often, cash collateral is subject to a creditors' lien. So, if you conduct a business transaction with a company after it has filed Chapter 11, and the company pays you from cash collateral it was unauthorized to spend, that transaction can be challenged in court and you may be ordered to pay back all of the money you received for that transaction.

Asset sales

Chapter 11 is an opportunity for a business to pause in paying creditors while coordinating a plan to reorganize and become profitable. Doing so can maximize value for creditors. However, it may be determined that assets of the business or the business itself must be sold. Once this occurs, the company or the creditor's committee will organize how the proceeds will pay creditors. There is no guarantee that all creditors will be paid or paid in full. If the company is sold, the new owner is not responsible for the previously owned debt.

Assessing creditworthiness

A company that files Chapter 11 bankruptcy can continue to do business and its previous debts are paused for payment. This allows the business to reorganize. During this period, the company's cash flow will change regularly. Companies in Chapter 11 must provide monthly reports and summaries to the bankruptcy court of its business operations, including statements of receipts and disbursements, balance sheets, cash flow statements, schedules of accounts receivable, tangible assets (like inventory), and post-petition debts.

If you are doing business with a company in Chapter 11 bankruptcy, you should carefully review your client's monthly operating reports to understand its creditworthiness. Understanding the creditworthiness of any customer is important in guarding your own business's cash flow.

How to Recover when a Client Doesn't Pay

Now that you know more about doing business with a company in Chapter 11, what else do you need to do to pick up the pieces?

Let's say the worst happens: Your customer doesn't pay and you find yourself suffering from nonpayment. Whether it's your first experience with significant past-due invoices, your most- recent experience with a customer that is always late in paying, or the most significant amount of unpaid invoices you have ever had from a single client, it can certainly feel overwhelming. Whether the customer is bankrupt, insolvent, or simply late paying their bills, knowing where to start in any scenario is essential for protecting your cash flow.

1. Contact the customer
2. Explain the past-due situation
3. Call a collection agency
4. Pay attention to your staff

How to Recover when a Client Doesn't Pay

How to avoid nonpayment from the start

A customer nonpayment event is typically the first time many businesses start to look into their loss-mitigation options. Going forward, it helps to understand a little more about how the nonpayment occurred in the first place:

- Did you have systems in place to prevent loss or limit your exposure?
- Did you get contracts signed?
- Did you outline your deliverables and payment terms?

1. **Contact the customer:** You must first learn if your client has declared bankruptcy before you can take any additional actions. Call your client contact to find out. If they have declared bankruptcy, follow the steps in the previous section. If they have not declared bankruptcy, continue with these next steps.

2. **Explain the past-due situation:** Sometimes, a phone call or resending the invoice is enough to secure payment. If this doesn't work, courteously explain the consequences of nonpayment—whether it's discontinuing their service or reporting their delinquency to a credit-rating organization if the payment is not received in the agreed timeframe.

3. **Call a collection agency:** If contacting the customer does not resolve the past-due invoice, you may consider calling a collection agency. This way, you task another company with collecting the payment, and you free up your staff's time for other work. This may be the best solution for small payments, and you often won't have to put up any money — the collection agency takes a part of the recovered sum. With trade credit insurance, you receive proactive debt collection as part of your policy. It helps maintain your customer relationships, offers unparalleled market insights and expertise, and offers expert legal and litigation services.

   For larger delinquent payments, filing a lawsuit may be warranted. Talk to your attorney about how to proceed in your state. You may not need representation for the proceedings, but it is a good idea to get legal advice before filing a suit.

4. **Pay attention to your staff:** Make sure to pay attention to your staff. In severe nonpayment events, your cash flow may be interrupted, and employee morale may be impacted, especially if you have to introduce job cuts and other cost-saving measures to remain competitive. In these cases, it benefits you to foster open and honest two-way communication between employees and management about the situation. Explain what is being done to resolve the situation and how it will be avoided moving forward.

   Maintain trust by ensuring that payroll is satisfied and that employees have clear expectations about when they will receive their checks. If you have to get a bridge loan or pursue financing to ensure these payments, do so. If your employees stop trusting you, you could end up facing even bigger issues, like non-attendance and loss of reputation.

A trade credit insurance policy goes beyond protection from future debt. It also helps you recover from outstanding debt. When you start your partnership with Allianz Trade, we collect any of your existing debt at a discounted rate.

How to Recover when a Client Doesn't Pay

You can make nonpayment less likely to happen by answering these questions and being proactive. You can also begin to mitigate your accounts receivable risk by following the best practices described to the right:

1. **Start with the basics:** Make sure that invoices are sent out regularly by adhering to a repeatable process. Also, take steps to address nonpayment the minute that a receivable becomes overdue. Sending past-due notices helps highlight the issue, and the practice provides a valuable paper trail so that you are prepared if you need to escalate the matter later.

2. **Standardize business practices:** After you've been burned by nonpayment, start the rebuilding process by establishing a predictable standard for your core accounts receivable business practices. To collect a receivable, you must generate documentation supporting your claim. Every time you work with your customer, create a contract that specifies the work or products you provide as well as the payment schedule to which your customer has agreed. Write out the timeline and spell out the consequences of late payments.

3. **Implement new policies:** If nonpayment has been a real issue for your company, you may also want to institute new policies to protect yourself. Many companies use down payments, cash-up-front terms, retainers, or milestone payments to minimize their losses. Another option could be to keep an alternative form of payment on file such as a credit card and include in your agreement a remedy to charge the account in the case of a missed invoice. Establishing a clear, signed agreement is key for an option like this.

   While these options insulate you from some or all of the receivables risk, keep in mind that they may also impact your competitive edge; if your competitors offer open terms and you require cash terms, you may lose business. In a recent Allianz Trade survey, 80% of CFOs and their direct reports said they experienced a business loss due to stricter payment terms. On average, $1.1 million in revenue was left on the table that year as a result of a conservative risk posture.

4. **Credit monitoring:** Your credit team's primary responsibility is to check and monitor your prospective and existing customers' creditworthiness. Creditworthiness is fluid, so this is not a once-and-done task. Rather, you should implement a defined monitoring system for changes in financial health, particularly warning signs of distress.

   This process should be informed by the relative risk of customers, with more frequent checks for newer, smaller, and less-stable companies. Prudent credit management is a tough and never-ending job. You may want to consider augmenting your internal staff by partnering with capable credit monitoring experts to ensure efficiency and thoroughness.

5. **Protect your receivables:** Also, consider trade credit insurance, also known as accounts receivable insurance. Like other types of insurance that protect your assets from unexpected loss, trade credit insurance protects against a loss in your largest and most vulnerable asset: your accounts receivable.

How to Recover when a Client Doesn't Pay

How does Allianz Trade spot the warning signs?

For over 125 years, Allianz Trade has offered growing companies the best information about their trading partners. We're not leaving anything to chance.

- 85 million + companies are monitored in our proprietary risk database.
- 1,700 sector-specific credit analysts' in 62 countries + 30 full-time data scientists.
- An extensive array of proprietary and third-party data sources.
- Direct contact with monitored buyers to request & analyze financial statements.
- Real-time past-due and claims reporting from 55,000+ worldwide customers.
- Machine learning and artificial intelligence to augment our expert analysts.

A customer bankruptcy is not the best experience to go through. But once it happened, the claim process with Allianz Trade went as smoothly as possible—just as we expected it would.

Jack Freund
Owner of NAP Industries

Cautionary Tale 1:
An unpleasant bankruptcy of a critical customer

NAP Industries, a leader in flexible packaging, and Allianz Trade have been partners for 30 years. In early 2019 when one of NAP's largest customers suddenly declared bankruptcy, the news was a surprise.

"We didn't know the full extent of [the customer's] problems," said owner Jack Freund. Because this customer considered NAP to be a critical supplier, they had always paid on time.

To help NAP Industries resolve the situation, the Allianz Trade team brought their depth of expertise to bear on Freund's behalf. They guided Freund through the complicated bankruptcy case and helped him deal with the bankruptcy court's demands. Once the customer's attorney acknowledged the debt they originally listed as disputed, Allianz Trade could pay NAP's claim within 24 hours.

How to Recover when a Client Doesn't Pay

Cautionary Tale 2:
Weathering retail's cyclical and risky nature

New Elevation, a subsidiary of Turnberry Solutions (an IT service management company), partners with Allianz Trade to onboard new—and potentially financially risky—customers.

Chapter 11 bankruptcy is not uncommon in retail. Before trouble struck with one its largest customers, New Elevation was able to work with Allianz Trade to cover a significant—about half—of the bankrupt customers business.

Then payments started coming in late, often one of the first signs of financial trouble. Late payments are risky for those in the retail industry, as companies operate on low margins and can't afford to not be paid for services.

Allianz Trade helped mitigate the risks associated with slow payment, providing "as much peace of mind as you can have," according to New Elevation President, Joe Garcia. New Elevation's trade credit insurance coverage reduced the company's risk enough for it to continue doing business with the troubled client, despite late payments.

"Trade credit insurance allows you to capture that revenue without having any fear," says Garcia. "Having this policy allowed us to continue providing services instead of backing away and letting competition have the opportunity."

> Having this policy allowed us to continue providing services instead of backing away and letting competition have the opportunity.
>
> **Joe Garcia**
> President of New Elevation

Protect your Business

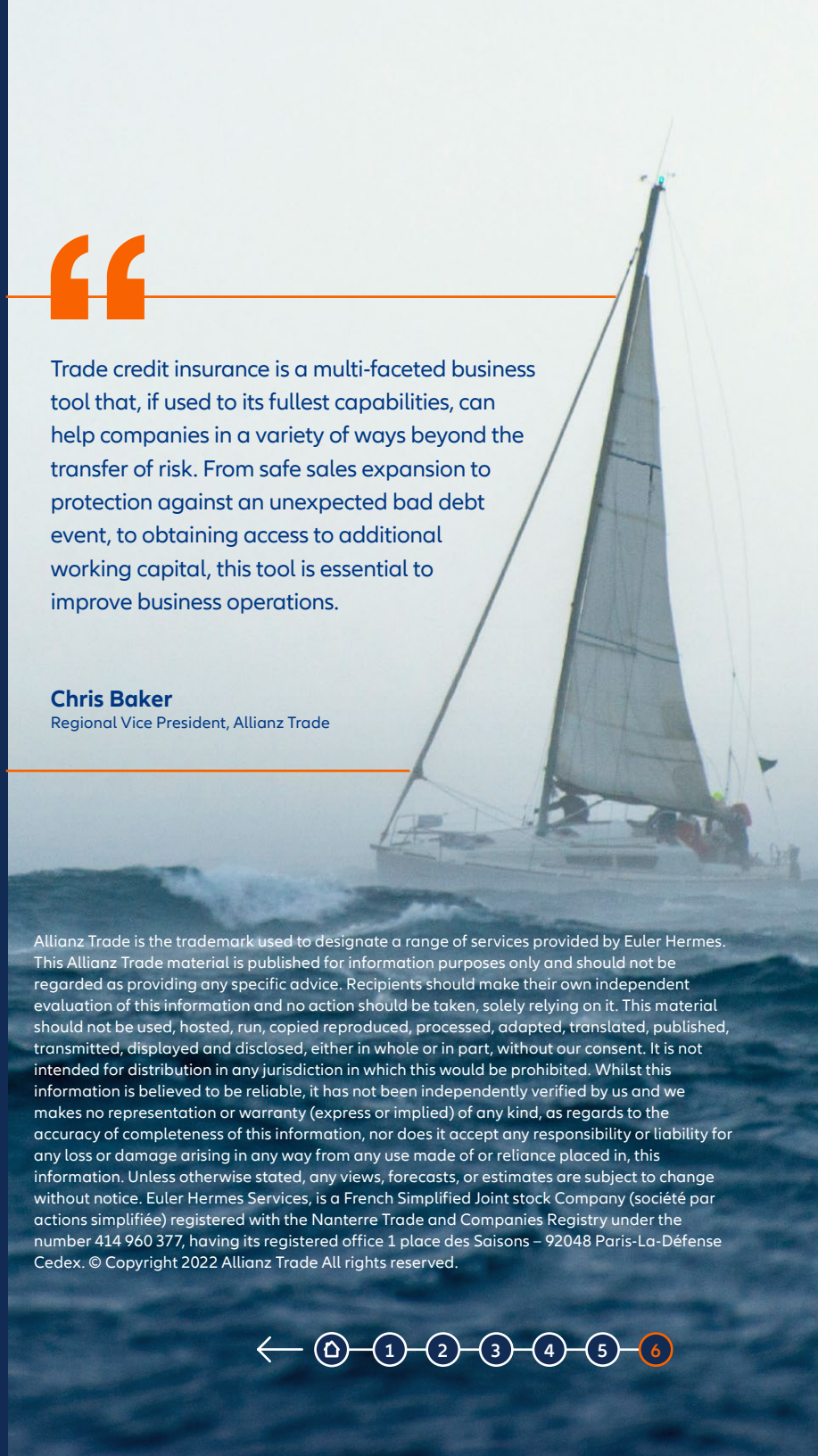
Navigating Bankruptcies with Trade Credit Insurance

When your customer becomes insolvent or declares bankruptcy, a partnership with Allianz Trade can help keep your cash flow healthy and protected.

Trade credit insurance protects your accounts receivable against loss and guarantees compensation even in the event of covered nonpayment. It also comes with the added benefit of the support needed to make data-informed decisions about extending credit to customers in Chapter 11 bankruptcy.

Even companies who have never been burned by a significant loss from a bankrupt or insolvent client may find they are limiting their growth potential by being overly conservative with their credit risk policies. This tendency is magnified for companies that have been stung by nonpayment. The investment in a trade credit insurance policy can often pay for itself multiple times over—even if a claim is never filed—simply by fueling safe but aggressive sales in the future.

The Covid-19 global health crisis (along with the Ukraine crisis) has shown that no one can predict the future and no one is immune from bankruptcy. The insolvency and bankruptcy waves and surges will continue to disrupt the economy for some time to come. Trade credit insurance from Allianz Trade can help protect your business from unpaid invoices and major losses.



> Trade credit insurance is a multi-faceted business tool that, if used to its fullest capabilities, can help companies in a variety of ways beyond the transfer of risk. From safe sales expansion to protection against an unexpected bad debt event, to obtaining access to additional working capital, this tool is essential to improve business operations.

Chris Baker
Regional Vice President, Allianz Trade