



What to Know When Your Customer Files for Bankruptcy

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The COVID-19 pandemic has created financial distress across many sectors of the economy. As a result, there is a good chance that your business has, or soon will, be forced to deal with a customer bankruptcy. When your customer files for bankruptcy, all is not necessarily lost. The strategic actions you take, in consultation with an experienced attorney, before and during a bankruptcy can help improve your odds of recovery.

Commercial bankruptcies have increased this year. Through October this year, according to the American Bankruptcy Institute, approximately 28,000 commercial bankruptcies have been filed. That's an average of over 130 commercial filings every day. With government stimulus drying up, and the virus continuing, businesses need to be ready for more customer bankruptcies in the months ahead.

It's important to understand not only your rights and remedies as a creditor, but also limitations on actions you can take to pursue recovery. Here are some essential things to know, and steps to take, when your customer files for bankruptcy.

Different Types of Bankruptcy Filings

After a customer files for bankruptcy, you will be notified of what "chapter" of the Bankruptcy Code the customer's case has been filed under. When the debtor is a business, it will file under either Chapter 7 or Chapter 11 or for certain qualifying small businesses, Chapter 5; for purposes of this article, all references to Chapter 11 should include Chapter 5. Chapter 7, which is more common, is for businesses who are liquidating. A business that is attempting to reorganize will file under Chapter 11. If your customer is an individual, it may file a Chapter 7 or Chapter 13 case (which involves a repayment plan).

It's important to know what type of case is filed, because it will impact what rights and remedies you have available. Unless your claim is secured by collateral, there is little for you to do in a Chapter 7 case beyond filing a proof of claim, and in many Chapter 7 cases there is no

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recovery for unsecured creditors. In a Chapter 11 case, in which the debtor remains in possession of its assets, there are potentially more options and actions you can take.

The Automatic Stay

The filing of a bankruptcy petition automatically enjoins, without further court order, creditors from taking action to collect on debts owed or to seek possession of property belonging to the debtor. Once you learn that a customer has filed for bankruptcy, you should stop attempting to collect debts that arose prior to the bankruptcy filing, cease prepetition litigation and not initiate any new lawsuits, and otherwise avoid any collection efforts outside of the bankruptcy process. There are some exceptions to the automatic stay. And creditors can request relief from the automatic stay, such as to seek to foreclose on secured collateral. However, before taking any action that might violate the automatic stay—and subject you to sanctions—you should consult legal counsel.

Continuing to do Business with the Debtor

You can, but in many instances don't need to, continue doing business with a customer that has filed for Chapter 11 bankruptcy. There are times, such as when there is an existing contract in place obligating them to perform, that vendors and suppliers may have no choice but to continue the relationship. If you don't have a contract in place with the debtor that compels you to perform according to established terms and conditions, you can seek to supply goods and services according to terms different from your historical course of performance, such as demanding cash in advance or cash on delivery instead of extending credit. To the extent that you have goods in transit to your customer when you learn of a bankruptcy, you can stop shipment.

Goods and services provided to the debtor after the petition date are considered "administrative claims" entitled to a higher priority than prepetition unsecured claims, as long as they are, under Section 503(b)(1)(a) of the Bankruptcy Code, "actual, necessary costs and expenses of preserving the estate..." Typically, the normal operating expenses of a business fall within this definition, and therefore many vendors continue to do business with a debtor as long as their administrative claims get paid. If (and it is a big "if") the debtor has sufficient cash flow and/or debtor-in-possession financing to operate, the risk of not being paid while a debtor is in Chapter 11 tends to be low.

Reclamation Rights and 20-Day Administrative Claim

The Bankruptcy Code allows creditors to exercise rights under the Uniform Commercial Code to reclaim goods sold on credit to an insolvent customer. To do so, a vendor must send a written reclamation demand to the customer within 45 days after the customer received the goods or within 20 days of the bankruptcy filing if the filing occurred within that 45-day period.

In addition, a vendor is entitled to an administrative expense claim for goods received by the customer in the 20-day period before the bankruptcy filing, if the customer bought the goods in the ordinary course of its business.



Critical Vendor Status

In some Chapter 11 bankruptcy cases, the bankruptcy court will authorize the debtor to create a critical vendor program through which the debtor identifies “critical vendors” whose prepetition claims will be paid in full in exchange for a commitment to sell goods on credit during the bankruptcy.

If such a program is established in your customer’s bankruptcy case, being tagged as “critical” can mean the difference between being paid pennies on the dollar or having your claim paid in full. Accordingly, it’s important to consult with legal counsel to determine the best course of action to put yourself in the best position to obtain this status.

Proof of Claim

A proof of claim is an assertion by a creditor, using an official bankruptcy form, that indicates the amount of the debt owed by the debtor on the date of the bankruptcy filing. Supporting documentation is typically included as an appendix to a proof of claim form.

While in some instances, such as when a debtor has scheduled your claim amount properly and the claim is not listed as contingent, disputed or unliquidated, you don’t have to file a claim, it’s almost always advisable to do so to preserve your rights. While a proof of claim form appears to be a relatively simple and straightforward document, it’s a good idea to work with an attorney to ensure that your claim is completed correctly and filed timely.

Plan of Reorganization

A Chapter 11 bankruptcy case culminates in the confirmation of a plan of reorganization. The plan lays out, among other things, the proposed treatment of creditor claims. You should review the plan closely with legal counsel, and vote on the plan by casting your ballot or lodge an objection to the plan, as appropriate.

Preference Actions

Many creditors are dismayed to learn that their bankrupt customer can, under certain sets of facts, claw-back payments that the customer made in the months leading up to a bankruptcy filing.

Specifically, Section 547 of the Bankruptcy Code allows a debtor or bankruptcy trustee, subject to certain defenses, to recover payments made to creditors within 90 days of the filing of the petition. The look-back period for payments is increased to one year for “insiders.”

If you are served with a preference lawsuit or sent a preference demand letter, don’t panic. Don’t immediately mail a check for the full amount asserted. Do call your bankruptcy attorney for assistance. There are viable defenses to preference demands and lawsuits, and often claims can be negotiated for significantly less than the amount sought.



Remain Vigilant During, and Ideally Before, Your Customer's Bankruptcy

The best way to deal with your customer's bankruptcy is to avoid participating in it altogether. If you suspect your customer is experiencing financial distress, stop selling on credit. Attempt to obtain a security interest in collateral, or a personal guaranty from the business owner. Monitor the customer's financial situation. Remain vigilant.

If you suspect your customer is headed toward bankruptcy, or has already filed for bankruptcy, Foster Swift can help. For questions and assistance, please contact the author of this article, Scott Hogan or another member of Foster Swift's bankruptcy practice group.