What to Do When a Customer Files for Bankruptcy

By Stephen B. Gerald, Esq.

If you've been working as a management accountant or finance professional in the past five years, it's a safe bet that you've encountered the bankruptcy process in some fashion. Bankruptcy isn't only intimidating to the company going through it (the debtor) but to anyone who continues to do business with an entity in bankruptcy or is otherwise involved in the bankruptcy process.

Understanding the basics of the bankruptcy process and the methods by which to maximize claims will inevitably allow management accountants and finance professionals to make smarter business decisions and be better equipped in their managerial and control functions. Having represented companies in all facets of the bankruptcy process, I've seen creditors achieve varied levels of recovery and success. Here are five proven things you can do to increase your company's odds of coming out on top.

> The bottom line is that it's smart to file a proof of claim regardless of what's listed in the schedules. Do it correctly and file it by the application deadline.

1. Respect the Automatic Stay

When an entity files for bankruptcy, it will automatically be protected by what's referred to as the "automatic stay," which gives the company a respite so that it can focus its attention on the bankruptcy case and not be distracted by creditors. The automatic stay prohibits creditors from, among other things: commencing or continuing a legal action to collect a debt; attempting to create, perfect, or enforce a lien against the company's property; enforcing a judgment against the entity; offsetting dueling debts; or performing any other act to obtain possession of, or to exercise control over, the debtor's property.

It's very important that the automatic stay be respected because a "willful" violation could result in a claim for actual damages against you, including costs and attorneys' fees—and, in certain circumstances, punitive damages. That said, it's possible in certain circumstances, and with bankruptcy court approval, to obtain relief from the automatic stay to, for instance, continue litigation, offset dueling debts, or proceed with a claim against available insurance coverage.

2. Know Whether You Need to File a Claim

All entities that have declared bankruptcy are required to file schedules of assets and liabilities. Not only do the schedules identify the amount(s) that the debtor believes is owed to each of its creditors, but they also specify whether the debtor believes that a claim is (1) secured (and if so, by what), (2) unsecured, or (3) entitled to some form of priority payment under applicable law.

The schedules also state whether the debtor deems a claim to be "contingent" (in other words, something needs to happen before the claim will be allowed), "unliquidated" (the amount owed hasn't yet been determined), or "disputed" (the debtor asserts that the amount is claimed but not owed). These characterizations are important. If a creditor is satisfied with the characterization of its claim, agrees with the amount and classification, *and* its claim has *not* been designated as contingent, unliquidated, or disputed, then, in most cases, the creditor can rely on the schedules and forgo the process of filing a proof of claim with the bankruptcy court. If, however, a creditor disagrees with the amount of its claim or the classification as set forth in the schedules, or if a claim has been designated as contingent, unliquidated, or disputed, then the creditor *must* file a proof of claim by the requisite deadline to preserve its right to recovery.

Say your company is a creditor in the bankruptcy process. If you rely on the schedules and don't file a proof of claim, you'll forfeit your ability to amend your claim should that become necessary. On the other hand, if you file a proof of claim and later realize that it's incorrect, you can amend your claim as long as it isn't asserting a "new" claim after the original filing deadline. The bottom line is that it's smart to file a proof of claim regardless of what's listed in the schedules. Do it correctly, file it by the applicable deadline, and follow all other requirements.

Note: A creditor that sold goods to an entity in bankruptcy within 45 days of the bankruptcy filing may have special "reclamation" rights for which the filing of an ordinary proof of claim may not be sufficient. Reclamation rights may allow a vendor to "reclaim" the goods it sold in certain circumstances. Recourse may be limited, however, because the rights of reclaiming vendors are subject to the rights of secured creditors, which may have a lien on substantially all of the assets of the debtor, including the ones at issue. At any rate, a reclamation demand letter should be sent in the event that relief is available. It needs to be mailed within 45 days after the debtor receives the goods or, if the 45-day period expires after the bankruptcy filing, within 20 days after the filing.

The law gets a little trickier in cases where a distressed company receives goods in the ordinary course of busi-

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ness within 20 days before the bankruptcy filing. In this instance, a claim for the cost of the goods will be entitled to administrative priority, meaning that the entity in bankruptcy *must* pay the claim in full in order to emerge from bankruptcy. Knowing when and how to file these types of claims could mean the difference between receiving payment in full or pennies on the dollar.

3. Understand the Plan Process and Other Nuances

In a Chapter 11 bankruptcy, the ultimate goal is to confirm a plan of reorganization that not only spells out the treatment of claims but also sets a course for the troubled company to either emerge as a going concern or to wind down in a controlled setting. A plan of reorganization is essentially a contract between the debtor and its creditors, which is binding after it has been approved by the bankruptcy court.

Most creditors will have an opportunity to vote in favor of or against the plan. An entity in bankruptcy is required to send its creditors a copy of the proposed plan along with a "disclosure statement" that provides creditors with sufficient information to make an informed decision on how to vote. It's extremely important for creditors to understand the disclosure statement and the plan to which they may ultimately be bound.

Plans of reorganization may also detail the fate of contracts that haven't been addressed previously in the bankruptcy case. In particular, the plan may identify whether the debtor intends to "assume" or "reject" such contracts. When an entity in bankruptcy assumes a contract, it commits to perform its obligations under the contract going forward and must make you, as a creditor, whole prior to doing so. The distressed company then proposes a dollar amount necessary to cure the deficiency, if any. If you don't agree that the proposed amount is sufficient, you must file an objection with the bankruptcy court by the applicable deadline. Once the entity in bankruptcy has assumed the contract, it has to live up to it, or, in certain circumstances, it may try to assign the contract to a third party. (That said, not all contracts may legally be assigned to third parties, particularly those that pertain to intellectual property.) If you're a creditor who doesn't want that to happen, you'll have to file an objection with the bankruptcy court. Otherwise, you'll have waived your right to object to the third-party assignment.

A debtor that seeks to reject a contract won't perform its obligations and will, for all intents and purposes, be deemed to be in breach of contract. If your contract is rejected, you'll have an opportunity to file an unsecured claim for any damages suffered as a result of that breach, but, again, this must be done by the applicable deadline.

> The Bankruptcy Code allows a debtor to recapture certain payments made within the 90-day window so that the funds can be redistributed to all creditors on a pro-rata basis.

4. Know Your Rights Ahead of Time

During Chapter 11 proceedings, it's common for the debtor to continue operating. While you understandably may be reluctant to do business with the debtor because of unpaid invoices and its otherwise precarious condition, it's important to know your rights so you can make an informed decision. While you may have provided goods or services to your customer on credit before the bankruptcy filing, you don't have to do so during the bankruptcy case. As such, you can require payment in advance or some other means to secure payment.

If you do decide to continue doing business with a debtor, your invoices during the bankruptcy case will be granted "administrative priority," and, thus, they must be paid in full before the debtor can emerge successfully from bankruptcy. These claims, however, are paid *after* those of secured creditors in a liquidation setting, so it's still important to be comfortable with the company's ability to make good on its obligations before deciding whether to do business with it.

In the event that your firm provides services or goods that are special or unique to the business of the debtor, it may seek to have you treated as a "critical vendor." In this instance, the debtor can ask the bankruptcy court for permission to pay your pre-bankruptcy claim before other creditors are paid, typically in exchange for your commitment to continue to provide goods or services. While this sounds good on the surface, think it through first. In some instances, you may be required to provide goods on credit on the same terms that you did before the bankruptcy filing or even offer the same pricing. Although bankruptcy courts vary in their willingness to allow the payment of a vendor's pre-bankruptcy claim ahead of other unsecured creditors' claims, many courts recognize that the success or failure of a Chapter 11 reorganization may hinge on the continuation of existing business relationships.

If you're a party to a contract with an entity in bankruptcy (see section No. 3), you're required to continue to perform under the terms of the contract until it's assumed or rejected, while the entity in bankruptcy isn't. That said, you can ask the bankruptcy court to require the debtor to expedite its decision to assume or reject your contract. In an effort to provide you with some degree of fairness, the required payments under your contract that accrue during the bankruptcy case (and before the contract is rejected, *if* it's rejected) are entitled to administrative priority. Again, you must be paid in full in order for the debtor to emerge successfully from bankruptcy.

5. Have a Plan if You're Sued

One of the most frustrating concepts for businesses unfamiliar with the bankruptcy process is that they may be compelled to return payments received from a debtor within the 90 days prior to the bankruptcy filing, even if they're owed money! In an effort to level the playing field, promote equality among creditors, and address creditor favoritism that may have occurred on the eve of the bankruptcy filing, the Bankruptcy Code allows a debtor to recapture certain payments made within the 90-day window so that the funds can be redistributed to all creditors on a pro-rata basis. For a payment made in that 90-day window to be recoverable, however, the entity in bankruptcy must have, among other things, paid a debt while it was insolvent or show that the payment itself caused the insolvency.

But even if the payment falls within that definition, not all such transfers are recoverable. There are defenses you may be able to assert, including that the payments were incurred and made in the ordinary course of business or that you provided "new value," such as new unpaid goods or services, after the payment was made. In determining whether payments were made in the ordinary course of business, the bankruptcy court typically compares how the payments were made by the debtor in the 90-day window to how payments were made during an earlier period. The bankruptcy court may also consider the amount of time it took the debtor to pay invoices, the number of invoices covered by a single payment, the method of payment, and whether the creditor exerted any pressure to coerce payments from the distressed company.

Clearly, entities that are going through bankruptcy proceedings can act like a cornered animal. Despite the previous relationship your company may have had with it, a troubled firm may strike back when put in a difficult situation by, among other things, attempting to reclaim certain payments to you. It's therefore important to keep in mind that preference exposure only arises with respect to payments of unsecured antecedent debts. Thus you can reduce or eliminate this exposure by requiring payment in advance or requiring security, such as a letter of credit or a bond.

By familiarizing yourself with my "top 5" things to know in a bankruptcy case, you, as a management accountant or other finance professional, can make better-informed business decisions. I hope this knowledge and familiarity with the bankruptcy process will maximize your company's return in a bankruptcy case, limit its exposure from unknowing violations of the automatic stay and preference actions, and help you decide whether to continue to do business with a distressed company. At the very least, the experience will better equip you to handle your ever-changing—and always challenging—managerial and control functions. **SF**

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