Five Things You Need To Know In Dealing With a Chapter 11 Debtor

March 11, 2016
Irve J. Goldman
Fairfield County Business Journal

With the increasing use of Chapter 11 to cure financial woes, it is important that creditors and others dealing with a debtor know their rights, risks and advantages when confronted with a distressed business that is in or about to enter Chapter 11. Here is a list of what I view as the top five things to know when that situation occurs:

1. Priority for Product Delivered Within 20 Days of the Bankruptcy Filing Date. The Bankruptcy Code provides an administrative priority claim for the value of goods sold and delivered to the debtor within the 20 days preceding its bankruptcy filing. The goods must be delivered directly to the debtor, and not drop-shipped directly to the debtor's ultimate customer. The timing of payment of this administrative priority clam, which is the highest priority claim in non-individual Chapter 11 cases (behind only secured claims), is in the discretion of the bankruptcy court, but at the latest, it must be paid in full on the approval of a plan of reorganization. So, if widgets are sold and shipped by a supplier and physically received by the debtor within 20 days of its bankruptcy filing, the seller is entitled to an administrative priority claim for the "value" of those goods, which will generally be price the debtor agreed to pay if it is in line with market prices.
2. Stoppage of Goods in Transit. Under the Uniform Commercial Code, a seller has the right to stop goods in transit if it discovers that the buyer is insolvent. Generally, the seller retains this right of stoppage, and it may be exercised, even after the buyer files for bankruptcy protection as long as the insolvent buyer has not yet physically received the goods. Courts have also held that it is not a violation of the automatic stay in bankruptcy to exercise the right of stoppage after a bankruptcy filing. The effect of exercising the right will be to require the Chapter 11 debtor to either "assume" the sale contract, which will require paying for the goods, or reject it, which will allow the seller to take the goods back into inventory and re-sell them.
3. Critical Vendor. Most bankruptcy courts will allow the debtor to establish a critical vendor program whereby the debtor selects what it views as certain "critical vendors" whose pre-bankruptcy claims will be paid in full in exchange for a commitment to sell goods on credit during the reorganization case. The rationale behind such a program is that it enables the debtor to retain these "critical vendors" during the reorganization case, thereby maximizing the chances for successfully emerging from Chapter 11. Generally, to be a "critical vendor," the creditor must supply a good or service which would be difficult for the debtor to obtain elsewhere. This type of program is usually established early in the case. If a creditor has not been selected for critical vendor status, it may be possible to lobby for it or test the "critical"

nature of what it supplies by initially refusing to continue to do business with the debtor with the objective of then being selected as a “critical vendor.”

4. Status of Contracts. With the exception of leases of commercial real estate, the debtor has until the time a plan of reorganization is approved to elect whether to assume or reject contracts or leases, unless earlier ordered by the bankruptcy court at the request of the non-debtor party to the contract. Pending assumption or rejection, the non-debtor party must continue to perform under the contract and is entitled to be paid the “reasonable value” of what it supplies. The timing of payment is within the bankruptcy court’s discretion. If a creditor becomes aware or suspects that a Chapter 11 filing is forthcoming and wants to extricate itself from the contract, it should consider taking steps to terminate it prior to the filing if there is a basis to do so. Generally, a lease or contract that is validly terminated prior to a bankruptcy filing cannot be resurrected after the bankruptcy is filed.
5. Preference Exposure. Creditors that are paid within the 90 days before a bankruptcy filing (the “preference period”) on account of a pre-existing debt may be liable to return the payment as a preference. A common defense to a claim of preference is that the payment was received in the ordinary course of business between the debtor and creditor. The defense may be compromised or lost, however, if there were differences in the manner in which the parties did business during the preference period as compared to past practices, including changes in the debtor’s method and timing of making payments, and payments that are received in response to creditor pressure. In 2005, the ordinary course of business defense was expanded to insulate payments from recovery if they are made according to what is considered ordinary course in the creditor’s industry. Payments that are received COD during the preference period are not considered preferences.

While a customer’s Chapter 11 filing is usually never a welcome event for a creditor, knowing one’s rights when it does occur is critical to minimizing loss and making the best of a bad situation.

Irve J. Goldman is an attorney practicing in the areas of bankruptcy law and commercial litigation at Pullman & Comley, LLC and can be contacted at igoldman@pullcom.com.

This article was originally published in the Fairfield County Business Journal's online version on March 10, 2016.

Professionals

Irve J. Goldman

PULLMAN & COMLEY

Five Things You Need To Know In Dealing With a Chapter 11 Debtor

Practice Areas

Bankruptcy, Creditors' Rights and Financial Restructuring