

Protect Your Rights When a Customer Files Bankruptcy



By David M. Schilli

When faced with a customer's bankruptcy it is important to understand not only the rights and remedies you may have as a creditor under the bankruptcy laws, but also potential limitations on those rights and remedies. Knowing your rights and remedies will help to mitigate continuing losses to the customer and improve your likelihood of a meaningful recovery in the bankruptcy.

When a customer has filed for bankruptcy, you will be notified whether that customer has filed under Chapter 11 or Chapter 7 of the Bankruptcy Code. Your customer might become a debtor under Chapter 11 of the Bankruptcy Code to restructure its obligations to creditors. In a Chapter 11 case, subject to the supervision of the bankruptcy court, the debtor remains in possession of its assets and often continues its business operations. The bankruptcy court can appoint a trustee to operate the debtor's business, but that is rare. A debtor may also use Chapter 11 to effect an orderly sale of some or all of its assets. In contrast, if your customer files a Chapter 7 bankruptcy, the bankruptcy court appoints an independent trustee to take control of and liquidate the customer's assets and distribute the liquidation proceeds in accordance with the Bankruptcy Code. Your strategy in responding to a bankruptcy filing may depend on whether the customer has filed under Chapter 11 or Chapter 7.

While it is frustrating when a customer files for bankruptcy with an outstanding balance owed for products or services, you should be mindful of certain rights and remedies that might improve the likelihood of a meaningful recovery. Unless otherwise noted, these rights and remedies apply equally in Chapter 11 and Chapter 7.

Goods in Transit. Upon learning of a customer's bankruptcy, you should stop goods in transit, so long as the goods have not been delivered to the customer or its agent.

Adequate Assurance. If you supply goods, you may demand adequate assurance of the customer's future performance (i.e. assurance regarding its ability to pay) and suspend your performance until adequate assurance is provided. Your right to demand adequate assurance arises under the Uniform Commercial Code and is the same in bankruptcy as it was before bankruptcy. However, when you make your adequate assurance demand on the customer, the safest course is simultaneously to file a motion in the bankruptcy court seeking adequate assurance and, if not received, the right to terminate your obligation to supply the goods.

Reclamation Rights. The Bankruptcy Code recognizes - and expands - your right under the Uniform Commercial Code to reclaim goods sold on credit to an insolvent customer. You must be vigilant in invoking your reclamation rights: if you fail to act promptly, you will waive them. You must send a written reclamation demand to the customer (and we also recommend that you send the demand to the customer's counsel) 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. You should send the reclamation as soon as possible because you will not be able to reclaim goods that are no longer in the customer's possession or are not separately identifiable. Your reclamation rights may also have limited value if the delivered goods have become subject to another party's pre-existing perfected security interest in the customer's inventory. Nevertheless, we recommend that vendors always make a reclamation demand promptly because your reclamation rights will be waived if not timely asserted. Debtors often seek bankruptcy court approval of procedures to address reclamation demands early in the bankruptcy case, so you should carefully monitor the debtor's motion papers.

20-Day Administrative Claim. In addition to the reclamation remedy mentioned above, you also are 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. Your right to payment for these goods will have a higher priority than your right to payment for goods received before the 20-day period, which have the lowest payment priority. In most cases, administrative expense claims are paid in full. However, you must file proof of your administrative claim before the deadline set by the court, notice of which is sent to all creditors known to the debtor.

Critical Vendor. In a Chapter 11 case, you may be able to obtain payment for some or all goods and services provided to the customer before the bankruptcy filing if the customer considers you a "critical vendor" and obtains bankruptcy court authority to pay critical vendors. Critical vendors are those vendors so vital to the debtor's continued operations that their refusal to continue supplying the debtor might result in the cessation of those operations and the inability to reorganize. Because the debtor is seeking authority to pay pre-filing vendor claims long before the bankruptcy court considers any plan of reorganization, debtors and courts closely scrutinize critical vendor claims to limit potential abuse of this extraordinary remedy. If you are interested in being acknowledged as a critical vendor, you should refuse to supply goods or services on credit after the bankruptcy filing or, even better, refuse to do any business with the debtor unless you receive payment on your pre-bankruptcy balance. Of course, you also should consider whether the debtor can readily obtain the products or services from another supplier, which will defeat your critical vendor claim, and should evaluate the risk of losing the customer's business during and after the bankruptcy.

Executory Contract. If you have an "executory" contract with a customer other rules will apply. An executory contract is a contract under which each party still owes the other significant performance, so that one party's failure to perform will excuse the other party's performance. A supply agreement is a good example of an executory contract. If the bankruptcy court approves, a debtor can assume or reject an executory contract. To assume the contract, a debtor must cure all existing defaults and provide adequate assurance that it can perform all of its future obligations. If a debtor assumes a contract, both parties must continue to perform. Many times, a debtor will seek to assume an executory contract and then assign its rights under the contract in conjunction with its efforts to sell its assets or a particular business unit. In responding to a proposed sale, you may need to act quickly to file papers with the bankruptcy court to protect your interests. If a debtor rejects an executory contract, the rejection is treated as a breach of the contract just prior to the bankruptcy filing and (subject to some state law issues) a

termination of the contract. A vendor whose executory contract is rejected is entitled to assert a claim for pre-petition damages in the debtor's bankruptcy case. Pending assumption or rejection, the vendor must continue to perform its obligations, unless it makes an adequate assurance demand as discussed above. In a Chapter 7 case, the trustee (rather than the debtor) has the right to decide whether to assume or reject. If not assumed or rejected earlier, executory contracts in Chapter 7 cases are deemed rejected 60 days after the bankruptcy case is filed, unless the bankruptcy court extends the deadline to assume or reject. In a Chapter 11 case, the debtor ordinarily will have until confirmation of a Chapter 11 plan to assume or reject executory contracts. In either event, a vendor may seek an order from the bankruptcy court to force the debtor to decide more quickly whether to assume or reject, but will need to show extraordinary circumstances that require a quick decision.

Proof of Claim. You likely will need to file a written proof of claim in your customer's bankruptcy case to preserve your right to a distribution, and in a Chapter 7 case, you must do so. Although the form for filing a proof of claim is just a single page, it can be complicated to complete and file correctly, and bankruptcy courts will deny improperly or untimely filed claims. You also should be aware that by filing a proof of claim, you submit yourself to the jurisdiction of the bankruptcy court and probably waive certain rights, so you may want to consult with experienced counsel to weigh the benefits and detriments of filing a claim.

Until now, we have focused on remedies to consider to protect your interests should a customer file bankruptcy. We would be remiss if we failed to also caution you about two important points:

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. Upon learning a customer has filed for bankruptcy, you should stop sending invoices for debts owed as of the date of the bankruptcy filing, making collection calls for goods and services provided, and any other collection efforts (including initiating or continuing with a lawsuit). There are limited exceptions to this "automatic stay," but you should consult counsel before taking any action against the debtor or its property.

Record Retention. You also should preserve all business records and other documents relating to your relationship with the customer, including those relating to products or services supplied to the customer, products returned by the customer and payments received from the customer. These records may prove to be very important long after the bankruptcy case is filed, because the debtor or trustee has at least two years to bring litigation against creditors for pre-bankruptcy transactions with the customer and you may need these records to mount a successful defense.

When faced with a customer's bankruptcy, it is helpful to understand the general rights, remedies and limitations applicable to you as a creditor. However, the specific rights and remedies can vary greatly depending on the details of the particular case. Please contact anyone in our bankruptcy and creditor's rights group for additional advice.

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