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Shumaker, Loop & Kendrick, LLP

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DISTRESSED CUSTOMER CHECKLIST

The following is a list of potential remedies that creditors should consider in dealing with financially distressed customers. The list is not, and it is not intended to be, a list of all possible remedies nor is it intended as a comprehensive review of the topics mentioned.

PRE-BANKRUPTCY ISSUES

1. Reclamation.
   The Uniform Commercial Code on sales allows a seller of goods to reclaim possession of goods delivered upon learning of the buyer's insolvency.

2. Stoppage of Goods in Transit.

   A seller of goods is also entitled to stop goods in transit upon learning of the buyer's insolvency and reclaim possession of such goods.

3. Cash Shipments.

   Upon learning of a customer's insolvency a seller of goods may, in certain circumstances, refuse shipment on terms, regardless of any contract between the parties and ship only upon a cash in advance basis.

4. Setoff and Recoupment.

   An often overlooked remedy, setoff arises from the settlement of mutual debts or accounts owed between a debtor and a creditor. Simply, if A owes B $100 and B owes A $50, then the debts can be resolved as follows: $100 - $50 = $50, so A pays B $50 and the accounts are settled. There are somewhat complicated rules regarding exercise of setoff during the 90 days prior to the bankruptcy filing, which if not followed, could result in preference exposure. Accordingly, it is prudent to consult counsel prior to exercising the setoff remedy if a near term customer filing is anticipated.

   Recoupment is similar to setoff, except that the mutual debts must arise from the same transaction. Setoff and Recoupment are treated differently in bankruptcy.

5. <u>Sales Contracts.</u>

Often sellers of goods and services do business with customers under a contract which goes beyond "spot" purchase orders and invoices. In the event of the customer's chapter 11 filing, such contracts will likely be treated as "executory contracts" under the provisions of the Bankruptcy Code. Because the rules for executory contracts are debtor-friendly, there may be an advantage to terminating such contracts prior to any bankruptcy filing.

6. <u>Preference Protection.</u>

Prior to a customer bankruptcy filing, vendors may be able to adjust payments for and shipments of goods or provision of services that can minimize potential preference exposure for payments made within 90 days of a customer's bankruptcy filing.

7. <u>Adequate Assurance of Performance.</u>

A seller of goods may suspend performance when such seller has "reasonable grounds for insecurity" about the customer's ability to perform its obligations under the contract. The seller may demand "adequate assurances of future performance" and the seller must provide those assurances, or the contract will be deemed breached by the buyer.

A seller who suspends performance without "reasonable grounds for insecurity" may breach the contract, thus, it is important that a seller verify that it has reasonable grounds for insecurity prior to suspension of performance under the contract.

BANKRUPTCY REMEDIES

1. <u>Automatic Stay</u>.

Upon a customer's bankruptcy filing, the Bankruptcy Code enjoins essentially all actions which relate to the recovery of debt owed or impact the debtor's interest in property. The injunction provided by the automatic stay of the Bankruptcy Code is broad and penalties for violation can include claim elimination and sanctions including debtor's counsel fees.

2. <u>Sales to a Debtor-in-Possession</u> (not pursuant to an executory contract).

Once a customer files bankruptcy, a seller of goods or services must decide whether to continue to do business and on what terms. Although extensions of credit in the ordinary course of business do not require court approval, extensions of credit outside the ordinary course of business require court approval. Post-petition sales to a debtor-in-possession in the ordinary course of business are granted administrative expense priority status. Absent an "administrative insolvency" where the debtor's assets are not sufficient to satisfy the claims of secured creditors, administrative priority claims are generally paid in full. To qualify for

administrative expense priority status, sales to a debtor-in-possession, not made pursuant to a prepetition executory contract, must arise from contracts that arose post-petition and the shipments must also be post-petition.

3. Executory Contract.

The bankruptcy provisions regarding executory contracts provide that a debtor has the right to assume or reject any executory contract. For unexpired real estate leases of non-residential real property under which the Debtor is the tenant in a Chapter 11 bankruptcy proceeding, the debtor has 120 days to assume or reject the real estate lease. The Bankruptcy Court will often extend this 120 day period an additional 90 days. For all other executory contracts in a Chapter 11 bankruptcy proceeding, including sales contracts, the debtor is allowed to wait until plan confirmation to assume or reject unless the Court, upon a specific motion, orders otherwise.

If a debtor rejects a contract, the breach of contract damages arising from such rejection are treated as a general pre-petition unsecured claim. If the debtor assumes an executory contract, the debtor is required to "cure" existing defaults.

The Bankruptcy Code also provides that pending the decision of a debtor to assume or reject an executory contract, the non-debtor party to the contract is required to continue to perform the contract according to its terms. Despite this general rule, there is some authority which provides that the duty to perform does not include further extensions of credit or sales of goods in all circumstances.

4. 20-Day Administrative Claim.

The Bankruptcy Code provides sellers of goods an administrative priority claim for the value of goods shipped to and received by a debtor within 20 days prior to the filing of bankruptcy. Thus, that portion of a seller's prepetition claim is in essence converted from a general unsecured claim to an administrative expense priority claim.

The Bankruptcy Code requires that a creditor seeking a 20 day administrative claim must do so by filing a motion in the court and obtaining a court order approving the 20 day administrative claim. However, many Courts, on a case by case basis, create a different procedure for asserting 503(b)(9) claims.

5. Reclamation.

The Bankruptcy Code recognizes the state law remedy of reclamation in section 2-702 of the Uniform Commercial Code. Moreover, the Bankruptcy Code allows creditors to demand "reclamation" for goods sold that were received by the debtor within 45 days prior to the bankruptcy filing. A creditor has 20 days from the date of the bankruptcy filing within which

to make a reclamation demand.

A reclamation claim is subject to a prior perfected security interest in inventory.

6. Critical Vendor.

Critical vendor is a creditor remedy based on a theory that a particular vendor is so essential to a debtor's ability to continue operating that without the uninterrupted flow of the seller's goods for services, the debtor cannot continue to operate and thus has no realistic chance at a successful operation. Such creditors can receive all or a portion of the prepetition debt owed, in exchange for an agreement to continue doing business with the debtor postpetition on normalized terms.

Only a debtor can obtain bankruptcy court approval to pay critical vendors.

7. Setoff and Recoupment.

The Bankruptcy Code recognizes the state law remedies of setoff and recoupment, as set forth above.

The Bankruptcy Code treats a creditor as a secured creditor to the extent of the value of the setoff. The creditor must obtain relief from the automatic stay before exercising the remedy of setoff, but the creditor does not need Court approval before exercising the remedy of recoupment.

8. Involuntary Petition.

The Bankruptcy Code allows three creditors with aggregate claims of at least $13,475 (for 2009) to file an involuntary bankruptcy petition against a particular debtor. The petitioning creditors must meet the requirements for filing an involuntary petition that are set forth in the Bankruptcy Code and the Debtor must be properly a Debtor under the Bankruptcy Code.

9. Proof of Claim.

A proof of claim is the document by which a creditor registers its claim with the debtor's bankruptcy estate, indicating the type of claim (secured, administrative, priority or unsecured), the amount of the claim and the basis for the claim.

Bankruptcy courts almost always set a bar date for filing proofs of claim several months after the bankruptcy petition is filed. To be considered, all claims must be filed within this bar date (except in rare circumstances).

In a Chapter 9 or Chapter 11 bankruptcy filing, if the debtor's Schedules of Assets and Liabilities lists a particular creditor's claim correctly, and does not list it as unliquidated,

contingent or disputed, and the creditor otherwise agrees with the debtor's Schedules, there is no need for the filing of a proof of claim. However, creditors will sometimes file a proof of claim even if they agree with the Debtor's schedules in case the Debtor later amends its schedules or the Debtor's bankruptcy is converted to a case under Chapter 7.

In order to assure participation in any distribution to creditors or vote on a Chapter 11 plan, creditors often file a proof of claim, rather than rely on the debtor's Schedules of Assets and Liabilities.

Creditors who file a proof of claim waive the right to demand a jury trial in, for instance, a preference action. The potential costs and vagaries of a jury trial might provide leverage to a preference defendant.

10. Preferences.

Once a customer files for the bankruptcy protection, the debtor-in-possession or a subsequently appointed trustee has two years from the date of the filing of the petition (or, if later, one year from the election or appointment of the first trustee) to file preference actions against third parties who received payments from the debtor's estate, within 90 days prior to the filing in the case of non-insiders, and within one year prior to the filing with respect to insiders.

As a general rule, payments to secured creditors are not considered preferential payments. Moreover, cash in advance payments are not considered preferential payments.

A creditor who has received preferential payments may assert certain defenses including the following: new value, relating to the subsequent sale of goods or services; that the payments were made in the ordinary course of business; and that the payment was made as a contemporaneous exchange for value.

11. Creditors' Committee.

In most chapter 11 cases, a creditors' committee is formed. A creditors' committee usually consists of some of the largest 7 creditors, who act as a representative for all unsecured creditors.

Committee members are often able to receive useful information about the debtor and its prospects for a successful reorganization. Most creditors view committee membership as a positive opportunity to obtain information, have input in the reorganization process, and where appropriate show support for the debtor's reorganization.

12. Global Insolvency

Increasingly, insolvency proceedings involve businesses, assets and liabilities in multiple countries. This has led to a reformation of many countries' insolvency laws, and also the

development of cross-border insolvency protocols to facilitate the administration of assets and liabilities in cross-border cases. Chapter 15 of the United States Bankruptcy Code contains the U.S. cross-border insolvency provisions.

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