



TUCKER ELLIS & WEST LLP

ATTORNEYS AT LAW

CLIENT ALERT

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YOUR GOOD CUSTOMER JUST FILED BANKRUPTCY. NOW WHAT?

In this economic cycle, more and more businesses are seeking bankruptcy protection. Healthy companies that have thrived through this recession are likely to see a customer or vendor enter bankruptcy. In the hopes of providing a quick and useful summary of “action items” to protect your business if this happens to you, we have prepared this simple summary checklist. On the day you learn that your customer has filed, you should:

1. Stop active collection efforts. When the Debtor files for bankruptcy protection, an “automatic stay” is invoked. This means all creditors must cease trying to collect on debts owed prior to the bankruptcy filing. Even phone calls aimed at collecting old debts are not permitted. In some circumstances, you can seek relief from the automatic stay; otherwise, you must attempt to get paid exclusively through the bankruptcy process.

2. Check recent shipping activity and identify all shipments that occurred in the 45 days prior to the bankruptcy filing. Gather as much detail as possible. You may have rights to reclamation (i.e., get your goods back) or other special rights associated with goods that you recently shipped to the Debtor. You need to act quickly to fully assert and protect your rights. First, you need to make a timely written demand for reclamation (in most cases, within 20 days of the bankruptcy filing) and if warranted, follow up with an action in bankruptcy court to repossess your goods.

3. Do a detailed assessment of the status of the Debtor’s accounts. Identify any payments that you received from the Debtor within the last 90 days. The Trustee (or Debtor-In-Possession) will try to recover any payments you received from the Debtor in this period. This is called a “preference” action. The theory is that any general creditor that was lucky enough to get paid in the 90 days before the bankruptcy should be forced to return the payments and take a distribution under the bankruptcy rules. You have

defenses, the most common being that the payments were made in the ordinary course of business. This defense requires proof that the alleged preferential payments were consistent with the history of dealings between the parties. Another common defense is “subsequent advance of new value” which may allow you to keep an otherwise preferential payment if you shipped goods to the debtor between the payment and the date the bankruptcy case was filed. These defenses (and other potential defenses) require detailed analysis of invoicing, payment, and shipping activity. It is important to gather the evidence immediately while it is fresh and available (sometimes preference cases are not filed for up to two years after the filing). Look carefully at the payment patterns on your accounts with the Debtor (e.g., changes in terms, changes in payment cycle, payments to or from affiliated companies, abnormal payments, etc.) This will help you prepare your defenses. Review of your accounts will also help to identify any rights to setoff arising from accounts with the Debtor—setoff rights can be very valuable in a bankruptcy case (see below).

4. Determine dates for filing claims. Sometimes there are significant payments made to general unsecured creditors in bankruptcy cases. To participate, you have to file a timely proof of claim. There is a deadline for these claims and it is rigorously enforced. Even if you have a priority claim, which is far more likely to be paid, it has to be timely asserted or you will not be paid anything.

5. Identify any “executory” contracts or unexpired leases with the Debtor. A contract is “executory” if there are still duties to perform on both sides. Do you have a long-term contract with the Debtor (e.g., a master supply contract, requirements contract, etc.) or do you do business on a purchase order to purchase order basis? If you have an executory contract with the Debtor, the Debtor will have the option of assuming (i.e., affirming) or rejecting your contract. If the Debtor assumes your

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contract, it has to make a “cure” payment and catch up on any defaults. On the other hand, if you do business with the Debtor order-by-order, you are free to set new terms. It is important to understand your legal rights in this situation, especially if the Debtor wants to negotiate a new agreement with you.

6. Identify the possible bases for getting paid by the Debtor for pre-bankruptcy claims: In many cases, the reality of bankruptcy is that you are looking at pennies on the dollar for you pre-petition claims (claims that existed before the Debtor filed for bankruptcy protection) but there are several ways you might improve your payout.

Cure Payments: You may be entitled to cure payments if the Debtor assumes your contract. The amount and timing of cure payments is often a subject of vigorous debate but the dollars can be significant.

“Critical Vendor” Payments: In many Chapter 11 cases (where a business Debtor intends to reorganize rather than liquidate), the Debtor will make a motion to pay “critical vendors” in order to ensure its ability to continue operating. These motions are made early in the case (often on the first day) and if you are a critical vendor with a large pre-petition claim, you may want to oppose, support, or otherwise get involved with the Debtor’s motion to pay critical vendors. To be a critical vendor, your continued relationship with the Debtor must be essential to the efforts to reorganize and you must be unwilling to continue business with the Debtor unless your pre-petition claims are paid.

Administrative Priority Claim For Recent Shipments: You have an administrative priority claim for the value of any goods you shipped to the Debtor in the 20 days prior to the filing of the bankruptcy case. Sometimes the timing and procedure for how you will get paid on this claim is determined very early in the case and you may want to participate in the motion practice surrounding this issue. For example, in the Chrysler reorganization case, treatment of these claims was intertwined with critical vendor and reclamation issues that were the subject of motions filed the first day of the case.

Setoff and Recoupment: If the Debtor owes you money and you owe the Debtor money, you can setoff the debts against each other. This is a good way to get dollar-for-dollar value for money that the Debtor owed you when it filed. Setoff and recoupment are also possible defenses to preference cases. **Caution:** After the case is filed, do not exercise a right to setoff unless you first move for relief from the automatic stay.

Proof of Claim: Assuming you have exhausted all of the above and still have not been paid in full, you still have a claim and a chance of getting paid something by filing a proof of claim. You must do it timely (see above). Failure to timely file a proof of claim usually results in the claim being lost forever.

This is by no means an exhaustive list of all the things that can happen to your claim or actions you might take when your customer files. Bankruptcy is complex and sometimes the law and procedures are counterintuitive. When there is significant money on the line, you should get bankruptcy counsel involved right away. Hopefully this checklist will orient you and help make sure your actions will help your position. It should also help make your interactions with your counsel more productive and efficient.

Authors Scott Kelly and Tom Coffey are bankruptcy attorneys in the Cleveland office of Tucker Ellis & West LLP. Mr. Kelly can be reached at 216-696-3394. Mr. Coffey can be reached at 216-696-4244.

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1150 Huntington Building
925 Euclid Avenue
Cleveland, OH 44115
www.tuckerellis.com

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