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Bankruptcy & Reorganization Law Alert

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Your Rights When Dealing With An Insolvent Customer

With the state of the economy, some of your customers may be turning into slow pays or, worse, no pays. If your customers are stretching their terms, they are forcing you into a role you never expected and never wanted: you are now their bank. Even though as an unsecured creditor you do not have a lien on any of your customer's assets, you do have rights under state law and should assert them for your own protection. In addition, although customer bankruptcy filings will cause some disruption, they also provide you with new business opportunities.

Your Rights Under State Law — COD; Halt Delivery; Reclaim Goods

If your customer is insolvent (defined below) but not yet in bankruptcy, you have the right to refuse delivery except for cash,[1] and you may stop the delivery of goods in transit.[2] In addition, if your customer received goods from you on credit while insolvent, you may reclaim the goods on demand made within 10 days of the customer's receipt of the goods. The 10-day limit does not apply (i.e. — there is no time limit) if the customer misrepresented its solvency in writing to you within three months before delivery.[3]

If you reclaim goods from your customer, that is your sole remedy. You cannot also seek damages for your cost to reclaim the goods or for the reduction in profit if the goods are later resold at a lower price. Also, you may not recover goods from a third party that purchased the goods from your customer in good faith.[4]

In order to demand cash payment, stop goods in transit or reclaim goods, your customer must be insolvent, meaning that it has ceased to pay debts in the ordinary course of business, it is unable to pay its debts as they become due or it is "insolvent" under federal bankruptcy law.[5] For a corporation, federal bankruptcy law defines insolvency as having debts that exceed the fair market value of property.[6] Rumors of insolvency are not sufficient to invoke the rights to refuse to ship except for cash and to reclaim goods that have already been shipped. This is all the more reason to demand regular financial information from your customers and to scrutinize it carefully.

Footnotes:
[1]Ohio Revised Code ("O.R.C.") §1302.76(A); [2]O.R.C. §§1302.76(A); 1302.79; [3]O.R.C. §1302.76(B); [4]O.R.C. §1302.76(C); [5]O.R.C. §1301.01(W); [6]11 U.S.C. §101(32).

Bankruptcy Overview

The filing of a bankruptcy petition creates a bankruptcy estate comprised of all the debtor's property. The debtor in possession ("DIP") or the court-appointed trustee will administer the estate on behalf of the creditors, and the Bankruptcy Code gives broad powers to the DIP/trustee to carry out its, his or her duties. Before describing those powers, it is helpful to understand some basic bankruptcy concepts and the two types of bankruptcies used by businesses.

Priorities – The Bankruptcy Code establishes "priorities," or the order of payment. In a business bankruptcy, the priorities are administrative expenses, meaning the expenses of the bankruptcy case (including court costs, professional fees, costs of running the business, taxes and environmental remediation); a specified amount of wage claims and unpaid contributions to employee benefit plans; and unsecured claims. Shareholders are last in line for payment. Secured creditors are repaid the value of the collateral securing their lien. For example, if a creditor has a $500,000 mortgage on property worth only $200,000, the creditor will be repaid $200,000; the remaining $300,000 will be paid as an unsecured claim on a percentage basis.

Chapter 11 – A Chapter 11 bankruptcy is a reorganization and is used by businesses to restructure debt and continue in business. A business can shed leased locations, cancel contracts, restructure debt to more favorable interest rates or amortization periods, and, provided the amount to be paid is more than what creditors would receive under a liquidation, pay pennies on the dollar on trade and unsecured debt. Chapter 11 cases conclude with a plan of reorganization that sets forth how the debtor intends to restructure and pay its debts. Creditors may object to the plan, and the Bankruptcy Court has the ultimate authority to approve or deny the plan. Plans that are not approved generally fail because they are deemed not "feasible," meaning that the income projections are too optimistic and the expense projections are too low. In addition, the debtor's plan must treat creditors with the same types of claims equally. It would not be permissible for a plan to propose paying one trade creditor 80 cents on the dollar and another trade creditor 10 cents on the dollar.

Chapter 7 – For a business, a Chapter 7 bankruptcy means that the debtor is closed or will be closed, and will be sold off either in whole or in parts. A trustee is appointed by the court to oversee the liquidation of the debtor's assets. Secured creditors are paid from the sale proceeds of their collateral or may receive the collateral itself in satisfaction of their claims. Unsecured creditors receive a percentage of whatever remains after administrative, priority and secured claims are paid.

Reorganization to Liquidation – Chapter 11 reorganization cases can turn into Chapter 7 liquidations. This is called a "conversion," and can happen either voluntarily, upon the debtor's request, or involuntarily, by the request of a creditor. A case will be converted to a Chapter 7 if it does not appear that reorganization is feasible or if the debtor is not otherwise fulfilling its obligations under the Bankruptcy Code, including obligations to provide periodic financial reporting, to maintain appropriate insurance, and to timely pay post-petition taxes.

Bankruptcy Obstacles

As part of giving the debtor "breathing room," the Bankruptcy Code creates obstacles for creditors, including the following:

The Automatic Stay – Upon a bankruptcy filing, there is an automatic stay that prohibits creditors from continuing litigation or collection actions against the bankrupt debtor, including setting off amounts due to the bankrupt against amounts due from the bankrupt without first obtaining Bankruptcy Court permission. If a creditor knowingly violates the automatic stay, it may be subject to damages, attorney's fees, and punitive damages.

Preferences – These are transfers and payments made by or on behalf of the debtor within 90 days before the bankruptcy filing. Preferences may be recovered from the creditor by the bankruptcy trustee and included in the bankruptcy estate for the benefit of all creditors. There are several defenses, including that the debt was incurred and the payment was made in the ordinary course of business; the sale was a substantially contemporaneous exchange (usually COD); and the creditor provided the debtor with new value, meaning money or money's worth in goods, services or new credit.

Superior Lien Creditor – A DIP/trustee has the status of a superior hypothetical lien creditor, and has the power to avoid transfers of property of the debtor. For example, if a creditor has failed to record a mortgage or file a financing statement, the DIP/trustee may set aside the unperfected interest and recover the property for the benefit of all creditors.

Post-petition Transfers – The DIP/trustee may avoid certain post-petition transfers, subject to certain exceptions, including most purchases by a bona fide purchaser without knowledge of the bankruptcy.

Fraudulent Transfers – The DIP/trustee may avoid fraudulent transfers of real and personal property, which are transfers made for less than fair market value. Thus, attempts by a debtor to transfer assets to related or friendly parties without receiving a fair price could be deemed fraudulent transfers. Despite the name, there is no need to prove fraud in such transactions.

Executory Contracts – A contract is executory if some performance other than the payment of money is due from both sides. The DIP/trustee decides whether to perform under an executory contract. In bankruptcy terms, a debtor who "assumes" a contract is agreeing to perform it; a debtor who "rejects" the contract has decided not to perform. Rejection of a contract is a breach of the contract, not termination of the contract. Until the DIP/trustee assumes or rejects the contract, the non-debtor party to the contract has to continue to perform as if no bankruptcy had been filed. The non-debtor party's only option is to ask the court to compel the debtor to decide what it is going to do. If the DIP/trustee assumes the executory contract, it has to pay ("cure") in full any payment or other defaults and show that it can perform the contract in the future. If the DIP/trustee wants to assume and assign the executory contract to a third party, commonly a buyer of its assets, the DIP/trustee has to cure any defaults and there must be a showing that the buyer can perform under the contract in the future. Personal services contracts are not generally assignable, but they are assumable.

Your Rights Under Bankruptcy Law

Notwithstanding the intricacies of bankruptcy law, a bankruptcy filing by one of your customers does not deprive you of all of rights and may provide an opportunity to do business on more favorable terms.

Stopping Goods in Transit – As described above, you may still exercise your state law rights to stop the shipment of goods in transit to bankrupt customers.

Reclaiming Goods Delivered to the Debtor – Bankruptcy Code §546(c) also permits you to seek the return of goods received by the bankrupt customer within 45 days before the bankruptcy filing. Under §546(c), you must make a written demand no later than 45 days from the date the bankrupt customer received the goods. If the 45-day period expires after the bankruptcy filing, the written demand must be made no later than 20 days after the bankruptcy petition is filed. The written demand must state that you are asserting the "right of reclamation" under 11 U.S.C. §546(c) and applicable state law, and must be sufficiently detailed to permit the bankrupt customer to identify the goods being reclaimed. You must also demonstrate that the bankrupt customer was in possession of the goods at the time of the reclamation demand, which may be accomplished by an on-site inspection or by the bankrupt customer's written acknowledgment.

Administrative Claim for Goods Sold Within 20 Days of Filing – If your §546(c) reclamation claim fails, Bankruptcy Code §503(b)(9) provides an administrative priority claim for the value of goods received by the bankrupt customer within 20 days before the bankruptcy petition was filed. In most cases, administrative claims are paid in full, unlike general unsecured claims, which receive cents on the dollar. The §503(b)(9) claim, in effect, puts vendors selling goods to a debtor within the 20 days before the bankruptcy filing on par with vendors selling goods after the bankruptcy filing. A recent bankruptcy court decision clarified that this administrative claim status extends only to goods, not to services. In re Plastech Engineered Products, Inc., et al., No. 08-42417 (Bankr. E.D. Mich. 12/10/08).

Administrative Claim for Goods Sold After Filing – Generally, administrative claims, which include the cost of goods or services needed to run business that is in bankruptcy, are paid in full. If you are not under a supply contract, you may refuse to do business with a bankrupt customer or demand COD terms or payment in advance.

Obtaining Information – You may also file a notice of appearance and request for copies with the Bankruptcy Court; attend the meeting of the bankrupt creditors (also called a §341 meeting), and hear an examination of the bankrupt and ask questions of the bankrupt yourself. Such questions can be useful when determining whether to continue doing business with the bankruptcy customer, and hearing the bankrupt's plans on how the process will proceed may help you understand the likelihood of payment of your post-petition shipments as well as your prospects of payment on any pre-petition claim.

Proof of Claim – You may assert your claim in bankruptcy by filing a proof of claim that sets forth the amount owed and the basis for the claim (goods sold, etc.) and provides supporting documentation. If the bankrupt customer does not

agree with the claim, it files what is called an "objection." If the objection cannot be resolved informally, the Bankruptcy Court decides the validity and amount of the claim.

Conclusion

If you sell to insolvent customers, you are not without power. Before a bankruptcy filing, you may demand cash for goods, stop goods that are en route to an insolvent customer and, subject to certain time limitations, reclaim goods in possession of the customer. All three of these rights survive bankruptcy, although reclamation is subject to the specific limits and requirements of 11 U.S.C. §546(c). In addition, you will enjoy an administrative priority for goods sold within 20 days before the bankruptcy filing and for goods sold after the filing.

On the negative side, if you've sold to a bankrupt entity, you will be subject to the limitations of the automatic stay; unpaid invoices for goods sold more than 20 days before the bankruptcy filing will be unsecured claims; and you may be subject to a preference claim for payments received within 90 days before bankruptcy filing.

One of the best things you can do, whether dealing with a solvent or insolvent entity in or out of bankruptcy, is to keep careful records of your sales and obtain periodic financial information from your customer. This will help you determine if your customer is solvent and will facilitate your successful assertion of state law and bankruptcy law rights. If your customer is in bankruptcy, review all notices carefully and be aware of deadlines for filing claims. Today much information is available on line, such as the Bankruptcy Court files, including periodic reports of operations. If you are dealing with a reporting company, all current SEC filings are available on line. Finally, in some large cases, there are trade associations that track cases, and often there are blogs or other credit reporting sites that can be helpful.