
What Happens When Your Principal Files For Bankruptcy?

by GERALD M. NEWMAN and DANIEL E. BEEDERMAN

All too often attorneys get inquiries from sales reps who have just received notice that one of their principals has filed for bankruptcy. Invariably, their first question is whether they will get paid the back commissions owed to them. Unfortunately, there is no simple answer, for bankruptcy cases involve many variables and technical issues which are controlled by the voluminous United States Bankruptcy Code (referred to in this article as the “Code”), which is subject to judicial interpretation and enforcement by the United States Bankruptcy Courts. As such, before an attorney can answer that or any other of the

rep’s questions, counsel first will need to ascertain some initial information, including whether the principal (referred to in the Code as the “Debtor”) has filed a Chapter 7 or Chapter 11 bankruptcy action. This distinction will likely impact how much commission, if any, a rep may be able to recover.

Chapter 7 Proceedings

Generally, under a Chapter 7 proceeding, which is often referred to as a “straight bankruptcy” or “liquidation bankruptcy,” the principal has ceased its business operations and its assets will be liquidated in an orderly manner



under court supervision for the benefit of its creditors. A court-appointed trustee will collect the Debtor’s receivables (by filing lawsuits, if necessary) and sell the Debtor’s assets, such as its inventory, equipment and real estate, which are not pledged as security to the Debtor’s bank or other such “secured” or “lien” creditor. After all of the assets have been liquidated (and after the secured creditors recovered their property or have been paid), the resulting and remaining funds will be distributed to the Debtor’s unsecured creditors in order of their “priority” as set forth in the Code. Since reps typically are unsecured

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creditors who do not have secured liens on any of the Debtor's assets or any other legal protection which give them any priority rights, they usually will only receive a prorated share of what is left after the creditors have been paid. However, in a Chapter 7 proceeding that amount often-times is only a small fraction of what is due, if anything.

In all of this vision of gloom, there is one possible, but limited, glimmer of hope. In certain instances, the Code allows independent sales reps a "third priority" claim to recover up to \$4,925 of commissions earned within 90 days prior to the date on which the bankruptcy case was filed or when the Debtor ceased its business operations, whichever occurred first. Of course, payment of this or any amount is entirely dependent upon the availability of funds. Unfortunately, the Code imposes strict conditions which makes this type of relief generally unavailable to most independent sales representatives. Specifically, the Code provides third priority

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claim status only for:

"Sales commissions earned by an individual or by a corporation with only one employee, acting as an independent contractor in the sale of goods or services for the debtor in the ordinary course of the Debtor's business if, and only if, during the 12 months preceding that date, at least 75 percent of the amount that the individual or corporation earned by acting as an independent contractor in the sale of goods or services was earned from the Debtor."

In other words, this relief is only available either to an individual rep or a rep corporation with only one employee, provided the principal was responsible for at least 75% of the rep's income

in the preceding year. It appears that the Code is granting this limited priority to a rep who has the typical attributes of an employee of the Debtor.

Chapter 11 Proceedings

The second type of bankruptcy proceeding that many principals file is under Chapter 11 of the Bankruptcy Code, and is often referred to as a "reorganization bankruptcy." Under this type of procedure, the principal (referred to as the "Debtor in Possession") continues to operate its business in an effort to work out its financial difficulties, with the ultimate goal of proposing a Plan of Reorganization under which its creditors will receive more than they would under a Chapter 7 liquidation. In this scenario, a rep very well may be asked to continue to sell the principal's products for the Debtor in Possession, which is treated as a new entity. Further, depending upon the rep's bargaining position, the rep may have an opportunity to recover commissions for sales made prior to the Chapter 11 bankruptcy action. However, reps need to be careful because many Chapter 11 proceedings are not successful and ultimately may be converted to a Chapter 7 liquidation. In that event, a rep could find itself also owed commissions for services it

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rendered and for sales it procured on behalf of the principal while it was trying to reorganize.

The best way to avoid that possibility is for the rep not to extend too much credit to the principal and to be prepared to terminate its relationship if it is not being paid in a timely manner during the reorganization process. Also, whether or not the principal files a Chapter 7 or Chapter 11 bankruptcy, a rep should always file a "Proof of Claim" form with the Clerk of the Bankruptcy Court where the case is filed. This form is usually sent to the Debtor's creditors with the official notice that a bankruptcy proceeding has been filed. If a Proof of Claim form is not filed by the requisite due date, then the rep will not be entitled to recover any amount in a Chapter 7 proceeding, and only the amount listed by the Debtor as being due (which is often incorrect) in a Chapter 11 case.

Preference Payments to Reps

While most reps are justifiably concerned about recovering un-

paid commissions, they also need to be aware of the possibility that they may be required to return all or a portion of the commissions paid to them within 90 days prior to the filing of the bankruptcy action by the principal, during what is often referred to as the "preference period." Specifically, the Code provides that the trustee can demand repayment of such "preference payments" if they were made on account of "antecedent debt" — that is, for amounts already owed a creditor. Thus, while a rep may initially have felt lucky to have been paid a past due commission by a failing principal, all too often the rep will be required to return all or a portion of such payments months or even years later if the payments are deemed to be preference payments. Fortunately, not all payments made in the preference period are subject to preference claims, because the Code exempts the trustee's recovery of certain payments.

One possible defense to a preference payment is that the payment was made in the "ordinary course of business." This means a rep may have a defense to a preference claim, if the commission

received during the preference period either was paid in accordance with the terms of the rep agreement or, if not, at least in a manner consistent with how commissions were paid within the year preceding bankruptcy — even if paid habitually late. A second possible defense for a rep after it receives what otherwise might be a preference payment, is that the rep continues to provide "new value" to the principal in the form of continued services and sales of its products for which no commissions were paid prior to bankruptcy. Essentially, this gives the rep a setoff against preference payments for commissions earned from its continuing efforts for the principal.

These are general descriptions of many complex legal rules and issues. As such, the facts of each case must be thoroughly analyzed by the attorney to determine if these or other defenses may be available to a rep in any given situation. However, it is important for reps to note that such defenses do exist and that it has a fighting chance to recover commissions from a bankrupt principal and defeat a preference claim.

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