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HOW TO SOFTEN THE IMPACT OF CUSTOMER BANKRUPTCY

EDITORIAL | DANIEL E. BEEDERMAN

A SPECIAL REPORT FOR BUY-(RE)SELL REPS

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Every day seems to bring a report of another financially troubled business that has filed for bankruptcy, or which is on the verge of doing so. All too often, such companies are more than just headlines in the news. Rather, **if you happen to be a "Buy-Sell" rep** — one that buys its principal's products for resale to customers, and which assumes the risk of collection for such sales — **a bankrupt company may also be a customer to whom you recently sold and delivered goods on credit.**

- What impact will such a bankruptcy have upon your business?
- What can you do and not do?
- Can you repossess previously delivered goods?
- Will you be paid and, if so, how much and when?
- More important, is there anything you can do in advance to prepare for this contingency so that another's bankruptcy will not be the cause of your own?

Obviously, to fully explore these bankruptcy-related issues would require more than the limited confines of this article. Therefore, the following is but a brief summary of some things to consider and, if appropriate, to discuss with your company's legal counsel.

There are no simple answers to these questions, for bankruptcy cases involve many variables and technical legal issues that are governed by the United States Bankruptcy Code (referred to in this article as the "Code"), which, in turn, is subject to varying judicial interpretation and enforcement by the United States Bankruptcy Courts. Also, the answers to these questions often are dependent upon whether the "Debtor" (the company that has filed for bankruptcy) has filed a Chapter 7 or Chapter 11 bankruptcy action.

Chapter 7 Proceedings

Generally, under a Chapter 7 proceeding, which is often referred to as a "straight bankruptcy" or "liquidation bankruptcy," the Debtor has ceased its business operation 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 accounts receivable (by filing lawsuits, if necessary) and will sell the Debtor's assets, such as its inventory, equipment and real estate, to the extent that such property is not pledged as security to the Debtor's bank or other "secured" or "lien" creditors. Only after all of the Debtor's assets have been liquidated (and after secured creditors have recovered their property or been paid), will any remaining funds be distributed to the Debtor's unsecured creditors. Typically, the majority of a Debtor's creditors are unsecured, meaning they do not have liens on or security interests in any of the Debtor's property. Unsecured creditors receive a proportionate share of what is left after secured creditors and creditors with statutory priority claims (such as administrative costs incurred by the Trustee) have been paid. Regrettably, that amount often is only a small fraction of what is due, if anything.

Chapter 11 Proceedings

Another type of bankruptcy that companies may file is under Chapter 11 of the Bankruptcy Code, and is referred to as a "reorganization bankruptcy." In a Chapter 11 bankruptcy proceeding, the Debtor (often referred to as the "Debtor in Possession") continues to operate its business in an effort to work out its financial difficulties, with the goal of proposing a "Plan of Reorganization" under which its creditors will receive more than they would have received through a Chapter 7 liquidation. In this scenario, many of the Debtor's various creditors may very well be asked to continue to sell products or provide services to the Debtor in Possession. Depending upon your bargaining position (such as whether your products are vital to the success of the Debtor's reorganization), you may have the ability to negotiate payment of amounts that were due and owing prior to the commencement of the bankruptcy proceeding (subject to Bankruptcy Court approval). However, you will need to be careful, because many Chapter 11 proceedings are not successful and may be "converted" to a Chapter 7 liquidation. In that event, you could find yourself deeper in the hole for sales made to the Debtor while it was trying to reorganize. The best way to avoid that possibility is to limit the amount of credit extended to the Debtor, and to be prepared to terminate the relationship if you are not being paid in a timely manner during the reorganization process.

Reclamation Rights

Immediately upon the filing of a Debtor's bankruptcy petition, there exists an "automatic stay" which limits the actions that a creditor can take against the Debtor and its property. Absent the Bankruptcy Court's approval, all pending lawsuits and other legal actions, such as those seeking to enforce a judgment order, are "stayed" – meaning put on hold. However, there are exceptions to this rule. Under Bankruptcy Code Section 546(c), a seller has the right to reclaim goods that it sold to a Debtor within 45 days prior to the commencement

If you comply with all of the legal requirements to create the PMSI, **you will have the right to recover goods** sold to a customer either before or after the commencement of a bankruptcy proceeding.

of the Debtor's bankruptcy case. In short, a buy/sell sales representative, like anyone who sells goods, has the right to repossess goods it sold and delivered to a Debtor prior to bankruptcy. To do so, a seller must make written demand for the reclamation of goods not later than 20 days after the commencement of the bankruptcy case. Moreover, each of the following conditions must be satisfied:

- The goods must have been sold to the Debtor in the ordinary course of seller's business.
- The Debtor must have been insolvent when the goods were received.
- The Debtor must have received the goods within the 45-day period prior to the commencement of the bankruptcy case.
- The goods must still be in the Debtor's possession and identifiable (if not, the seller may be entitled to "priority" treatment of its claim).

It is important to note that you need not wait for a customer's bankruptcy to seek such relief, for a similar remedy is provided to all sellers of goods under the Uniform Commercial Code (the "UCC") which, with certain variations, has been adopted in every state.

Article Two of the UCC relates to commercial transactions and governs the business relationship between a buyer and seller of goods. The UCC provides a seller of goods with a number of statutory remedies, including the right to reclaim goods sold to an insolvent customer. Under UCC Section 2-702 (while each state has its own version of the UCC, most sections are consistent with each other), a seller of goods that discovers that its customer is insolvent (but which may not yet have filed for bankruptcy) has a number of statutory remedies available to it. It may refuse to deliver goods, except for cash and the immediate payment of any outstanding balance due for goods previously delivered under contract. A seller also can stop delivery of goods in transit. In addition, if a customer received goods on credit while insolvent, the seller may reclaim those goods provided that the seller makes written demand within 10 days following the customer's receipt of such goods. However, this 10-day limitation period will not apply if the customer made a misrepresentation of its solvency within three months prior to the delivery of goods to it. Therefore, if you are concerned that a customer is having financial difficulty, you should request updated financial statements or credit applications from that customer on a regular basis. If it turns out that the information provided was false, you may be able to reclaim goods that are still in the customer's possession, even months after delivery. Of course, once the customer sells the goods in the ordinary course of its business to a good faith purchaser, all reclamation rights as to those goods cease to exist.

Another way that the UCC allows you to avoid, or at least minimize, the effect of a customer's bankruptcy is through the creation of a "security interest" or lien upon a customer's assets, or, at a minimum, on the goods sold to that customer. Typically, a security interest in all of the Debtor's assets, such as all of its inventory and accounts receivable, is taken by a bank or other entity which finances the Debtor's business operation. However, the UCC allows one who sells goods (referred to in the UCC as a "vendor") to obtain a type of security interest in the goods it sells to its customers, called a "purchase-money security interest" (a "PMSI"). Under UCC Section 9-324, a PMSI is superior to prior security interests taken in the customer's assets, which otherwise would include goods sold to the customer. While this is a highly technical legal area that requires strict compliance with the applicable UCC sections and should be discussed with your legal counsel, generally, to obtain a PMSI in goods that constitute inventory to the customer, you need to do the following:

- Obtain an agreement with the customer granting you a security interest in the goods sold. This agreement does not need to be a long or involved contract, but can be a provision included in your standard commercial documents.
- File a UCC "Financing Statement" with the Secretary of State of the state where the customer is incorporated.
- Send written notice of the PMSI to all holders of conflicting security interests (meaning you need to notify other creditors who have pre-existing liens or security interests against the Debtor and its property), advising them that you expect to acquire a PMSI in goods you are selling to your customer and describing such goods. The notice must be received within five years before the customer receives the goods. (This allows the PMSI to cover goods sold on an ongoing basis over a period of time.)

If you comply with all of the legal requirements to create the PMSI, you will have the right to recover goods sold to a customer either before or after the commencement of a bankruptcy proceeding.

Preference Claims

Perhaps the only thing worse than having a customer file for bankruptcy owing you money is having to return amounts that you received from a Debtor prior to its bankruptcy. But,

under certain circumstances, this can happen. In fact, it happens quite often in bankruptcy cases. A Bankruptcy Trustee has the right to recover "preferential transfers" made within 90 days prior to the date of the Debtor's bankruptcy. The underlying objective for this policy is to create an equality of distribution among the Debtor's unsecured creditors. However, "equality" is the furthest thing from a creditor's mind when it is sued by a Trustee (in what is called an "Adversary Proceeding") to recover amounts paid by a customer prior to bankruptcy. More likely, a creditor's immediate response is: "I have to give back what?!? I don't feel preferred." Yet, the Bankruptcy Code provides that a Trustee can sue to recover amounts a Debtor paid to a creditor within 90 days prior to filing for bankruptcy (during what is often referred to as the "preference period") if such payments were made on account of "antecedent debt" — that is, for amounts already owed a creditor. Thus, while you initially may have felt lucky to have been paid a long past due receivable just prior to a customer filing for bankruptcy, you may be required to return all or a portion of such payments months or even years later, if the payments are found to be preference payments. Fortunately, not all payments received during the 90-day preference period are properly the subject of preference claims, because the Code does provide certain defenses.

One such defense is to show that an alleged preference payment was made in the "ordinary course of business." This defense requires evidence that the payment was made and received in a manner consistent with the parties' established prior business relation, provided that those practices also were consistent with applicable industry standards. A second defense is to show that you provided "new value," in the form of additional goods sold to the Debtor after your receipt of an alleged preference payment. In that case, you may be able to assert the value of such goods as a setoff against a prior preference payment. Still another defense is provided for payments that were received contemporaneously in exchange for goods sold, such as those paid on a COD basis. It is important to keep these defenses (and there are others) in mind when confronted by a preference claim brought against your company. While these are but general descriptions of many complex legal issues and corresponding Code sections, it is critical to be aware that such defenses exist and that you have a fighting chance to defeat a preference claim, or at least a basis for negotiating a settlement.

Bankruptcy happens. Even your best customer today may have severe financial problems tomorrow. Therefore, your goal should be to lessen the impact that a customer's bankruptcy can have on your business. Whether you can obtain a PMSI ahead of a problem, or have the right to reclaim goods, the most important thing to do is to exercise sound financial and credit management for your business. Don't let your customer get too far ahead of you! If necessary, don't hesitate either to reject an order, or to terminate a relationship. Sometimes, just saying "no" may actually strengthen your company's bottom line.