



# Bulletin

## Doing Business with a Customer in Bankruptcy

### INTRODUCTION

When a customer files bankruptcy, contractors are faced with the decision to either keep or end the relationship. This bulletin looks at the issue from the contractor's perspective, acting as a creditor who has claims against a debtor. When a smaller customer files bankruptcy, the "keep doing business" question is less critical. The bankruptcy filing may just confirm your intention to stop selling or providing services to the customer. However, when a larger customer files bankruptcy, the stakes go up—often way up. In either case, it's important to know the ground rules about doing business with a bankrupt customer.

### FIRST THINGS FIRST – BANKRUPTCY BASICS

Bankruptcy is governed by federal law. The bankruptcy statutes are designed to treat similar creditors equally. There are several kinds of bankruptcies, but this bulletin will discuss the most common types—Chapter 11, which is a business reorganization, and Chapter 7, which is a liquidation of the business.

In a Chapter 11 bankruptcy, the purpose is to give the financially struggling

business some breathing room to reorganize its finances and return to profitability. The purpose of a Chapter 7 bankruptcy is to liquidate all of the debtor's assets, turn them into cash, and to pay creditors from these proceeds.

A bankruptcy procedure is usually started by the debtor filing a petition with the bankruptcy court along with a schedule of assets and liabilities. The bankruptcy court issues an order for relief, called a "stay." The stay prohibits any further collection action by creditors that might adversely affect the assets of the bankrupt debtor. For all intents and purposes, all collection efforts must stop as soon as the stay is ordered.

If the filing is a Chapter 11 reorganization, then the business is allowed to continue to operate under supervision of the bankruptcy court and pursuant to an approved plan of reorganization. However, many Chapter 11 plans do fail and wind up converting to Chapter 7 liquidation.

To participate in any post-petition distribution of cash, each creditor must file a proof of claim within a time frame set by the court.

The final bankruptcy basic rule concerns how claims are prioritized. Usually there will not be enough money to pay all creditors or contractors in full. Creditor claims are classified and prioritized as follows:

- (a) Secured claims – such as a mortgage on a home;
- (b) Administrative claims – for the ongoing administration of the bankruptcy;
- (c) Priority unsecured – certain unpaid wages, taxes, and deposits; and
- (d) General unsecured – everything else, primarily trade debt.

### **ADMINISTRATIVE CLAIM FOR POST-BANKRUPTCY SALES**

In general, if the bankrupt customer is a Chapter 11 debtor in possession, the customer is legally permitted to pay for post-petition (post-bankruptcy filing) purchases of goods and services in the ordinary course of business. Such amounts are generally accorded administrative claim status, with priority over unsecured and certain other claims, and the debtor is authorized to pay them currently.

### **CONTINUING TO DO BUSINESS WITH THE CHAPTER 11 DEBTOR - MAKE SURE YOU HAVE AN ADMINISTRATIVE CLAIM**

The standard for administrative claims requires proof of the necessity and the value to the estate of the goods and services. While this usually is the amount set forth in a contract or purchase order, to avoid any dispute, it's best to reach a clear understanding with the debtor (or a bankruptcy trustee, where applicable) before providing post-petition goods or services. Moreover, if there's a possibility that your transaction would not be considered an "ordinary course" transaction (for example, it's an

unusually large purchase or on unusual terms), you should consider seeking bankruptcy court approval to make sure the transaction is authorized and that your rights are protected.

### **BANKRUPTCY OF A GC DURING THE JOB - THE EXECUTORY CONTRACT TWIST**

Construction contracts are considered executory contracts under bankruptcy laws. This allows the debtor (or a trustee where appointed), to make a decision to either accept or reject the contract.

- If you and the debtor are parties to a pre-petition construction contract, you cannot automatically stop performing post-petition unless the debtor has officially rejected the contract. Rejection means that the debtor has decided to stop performing and the bankruptcy court has approved that decision.
- If the construction contract is assumed, the bankrupt debtor retains the benefits it has under the contract and also the liabilities. The bankrupt debtor must cure all pre-bankruptcy defaults, and continue with contract performance. If the bankrupt debtor then subsequently defaults, the resulting damages become an administrative claim with higher priority than many other pre-petition claims.
- Until the debtor has made a decision about your contract, the debtor may be willing to make current post-petition payments under the contract. You should consider confirming this understanding with the debtor or his or her counsel in writing to protect your rights.

- If you're concerned that you won't be paid for your post-petition performance or if you don't want to continue performing for other reasons, you may need an attorney to file a motion to compel the debtor or trustee to assume or reject the contract or to seek "adequate protection" payments pending that decision. Bankruptcy courts often give a Chapter 11 debtor a long time to make this decision, even until a plan of reorganization is confirmed. However, the court may be willing to order that you be paid currently for post-petition amounts and/or clarify that you have an administrative priority claim for your post-petition performance.

### **BOND AND MECHANIC'S LIEN PROTECTION ON CONSTRUCTION PROJECTS WITH A BANKRUPT CUSTOMER**

If a bankruptcy petition is filed by a general contractor or owner during the construction project, it is critical that the mechanical contractor immediately investigate the ability to file a claim against a bond or to file a mechanic's lien. These are very complex legal issues, but are summarized here.

Generally speaking, a mechanical contractor can make a payment bond claim against a bankrupt GC's bond, even after the bankruptcy stay is granted. This is because the claim is against a third party (the bonding company) not the bankrupt debtor. However, there are rigid time limits often imposed, so act quickly.

Filing a mechanic's lien against the property after the bankruptcy petition is filed is a much more complex matter. There is an exception to the bankruptcy stay provisions for acts to perfect certain interests in property. This is strictly construed and depends primarily on

how the mechanic's lien laws are worded and construed in each state. If the state statute allows that the lien priority relates back to the commencement of the work, it may be possible to file a mechanic's lien post-petition.

Obtaining a mechanic's lien or bond claim can mean a priority position of a secured claim, ahead of all unsecured creditors. At the end of the day, this means a possible significant improvement in cash recovery. But, act quickly,

### **BUSINESS WITH A BANKRUPT CUSTOMER – OTHER CONSIDERATIONS**

If you have sold products through separate purchase orders or individual transactions without an overarching contract governing the relationship, generally you may choose to continue dealing with the debtor post-petition and on what terms (e.g., whether to require cash in advance or continue with trade credit terms). If you have unpaid amounts based on your pre-petition transactions with the debtor, that claim would be treated like other unsecured claims separate from any post-petition claim.

While these legal issues are important, it's equally important to assess the debtor's financial condition after bankruptcy. A bankruptcy filing relieves a debtor from the obligation to pay pre-petition unsecured creditor claims, and this can make a substantial difference to a debtor's cash flow. Nevertheless, the debtor must have sufficient liquidity to pay its post-petition administrative claims.

- Many debtors obtain post-petition financing from lenders, known as debtor in possession or DIP financing, and this can provide the

necessary liquidity to pay administrative claims. DIP financings are usually secured by a blanket security interest on all of the debtor's assets, which places the DIP lender ahead of even administrative claims in the event of a default.

- Debtors sometimes default under DIP financings. When that happens, the DIP lender will often foreclose on the debtor's assets and the bankruptcy case will be converted to Chapter 7 liquidation. If so, not only will the DIP lender's debt be paid first from the estate's assets, but the administrative claims generated during the Chapter 11 case will become second in line to Chapter 7 administrative claims, such as Chapter 7 trustee's fees and expenses and those of his or her counsel.
- For these reasons, it's still very important to be comfortable with a Chapter 11 debtor's financial condition and his or her ability to pay for post-petition sales before extending post-petition credit. Most debtors are required to file post-petition monthly financial reports, and these can serve as one source of financial information.

## **PREFERENTIAL TRANSFERS – HAVING TO GIVE MONEY BACK**

A Chapter 11 debtor cannot pay pre-petition claims unless they are made in accordance with a confirmed plan of reorganization, a provision generally understood by all. However, there is also a provision in the code that allows a trustee or bankrupt debtor to recover any payments made to a creditor within 90 days of the bankruptcy filing, as a preference. There may be some defense that a creditor has for ordinary

course of business payments. Also in the construction context, for progress payments, there may be a defense for a mechanical contractor who provided lien releases in exchange for the pre-petition progress payment. Like in many other examples discussed in this bulletin, consult with legal counsel quickly.

## **CONSULT WITH BANKRUPTCY COUNSEL**

Bankruptcy laws are incredibly complex, time sensitive, and many times depend on the facts of a particular situation. In addition to the legal concerns, there are also many business concerns to consider, whether dealing with a bankruptcy during a project or an ongoing customer and decisions as to future work.

One thing is common. It is best to get an attorney's advice quickly and before engaging in any significant transactions with a debtor.