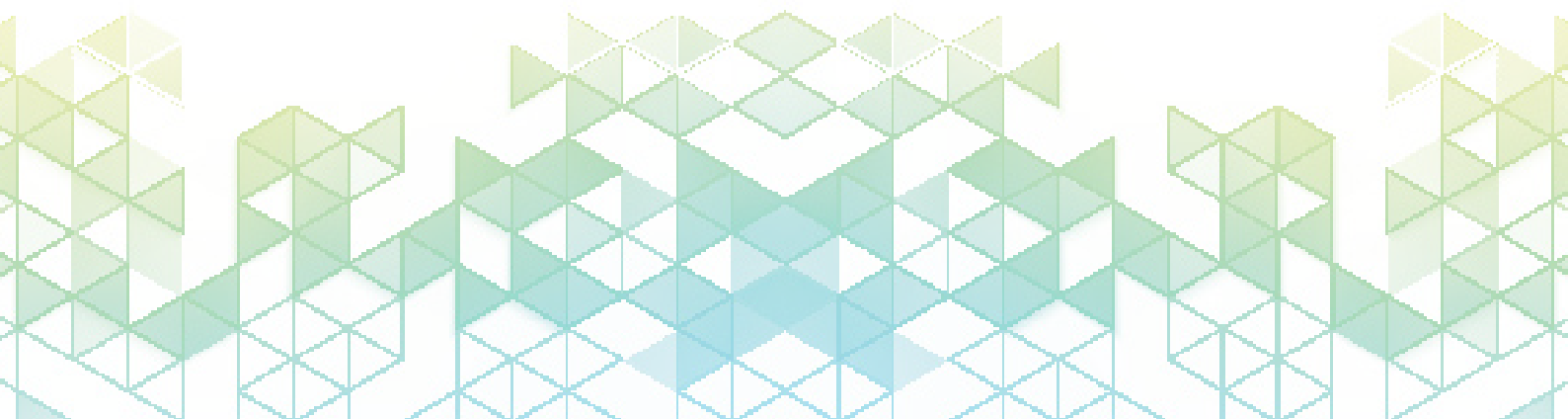




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What if a customer files for
bankruptcy?



It's something every business owner hates to hear. Your customer filed for bankruptcy. This article provides information about the bankruptcy process to help you with your recovery efforts. With any customer bankruptcy issue, we suggest consulting with our office and an attorney for expert advice, as each situation may be a little different.

Types of bankruptcies

The two most common forms of bankruptcy are Chapter 7 liquidation and Chapter 11 reorganization. With a Chapter 7 liquidation, the business ceases operations, nonexempt assets are sold and proceeds are used to pay creditors. With a Chapter 11 reorganization, the business is able to restructure its debt so that creditors are paid over time and the business is able to continue operations.

How do I get bankruptcy information?

Shortly after a company files a petition for relief under the Bankruptcy Code and commences its bankruptcy case, the bankruptcy clerk's office will mail a notice to all creditors listed in the petition. The notice will provide important information such as the location and date for the creditors meeting and deadline for filing a proof of claim. All documents filed in the case may be inspected at the bankruptcy clerk's office at the address listed in the notice or through the Public Access to Court Electronic Records at www.pacer.gov.

The bankruptcy petition will include schedules listing creditors with secured and unsecured claims. Claims may be listed contingent, unliquidated, and/or disputed. A claim is contingent if the debtor is not obligated to pay it unless a particular event occurs after filing for bankruptcy. A claim is unliquidated if the amount of the debt cannot be readily determined, such as by referring to an agreement or by a simple computation. A claim is disputed if the debtor disagrees about whether they owe all or a portion of the debt. A single claim can have one, more than one, or none of these characteristics.

If you are a creditor, you should be listed in the appropriate schedule. Generally, any creditor whose claim is not scheduled, scheduled incorrectly, or is scheduled as disputed, contingent, or unliquidated must file a proof of claim and attach evidence documenting the claim in order to be treated as a creditor for purposes of voting on the debtor's plan of reorganization and distribution under it.



On the other hand, if you agree with the claim as scheduled, and it's not listed as disputed, contingent, or unliquidated, then you do not have to file a proof of claim because the schedule constitutes evidence of the validity and amount of your claim.

When a debtor amends the schedule of liabilities to add a creditor or change the status of any claims to disputed, contingent, or unliquidated, the debtor must provide notice of the amendment to any individual or entity affected. Therefore, it's important for creditors to keep a lookout for these notifications and respond if necessary.

The bankruptcy filing imposes an automatic stay against most collection activities. This means that creditors generally may not take action to collect debts from the debtor or the debtor's property. For example, while the stay is in effect, creditors cannot sue, assert a deficiency, repossess property, or otherwise try to collect from the debtor. Creditors cannot demand repayment from the debtor by mail, phone, or otherwise. Therefore, you as a creditor must work through the bankruptcy process.

Claim prioritization

The Bankruptcy Code and case precedent establishes a general order for claims to be paid based on groupings. The higher priority group must be paid in full before any funds are paid to the lower priority group. If there are not sufficient funds to pay all claims in a group, then funds are generally dispersed pro-rata.

The following are the five main groupings:

1. Administrative claims are amounts owed for court-approved goods or services provided post-petition. For example, attorney fees and court costs fall into this group.
2. Secured claims represent debt secured by specific property in which the creditor has a security interest, such as a mortgage or a lien.
3. Priority unsecured claims are those debts that the Bankruptcy Code requires to be paid before most other unsecured claims are paid. These may include certain taxes, employee wages, contributions to employee benefit plans and deposits by individuals.
4. Nonpriority unsecured claims represent all other debt incurred and outstanding by the debtor at the time of filing.
5. Equity claims are last in priority and thus have the least probability of the receiving distributions.

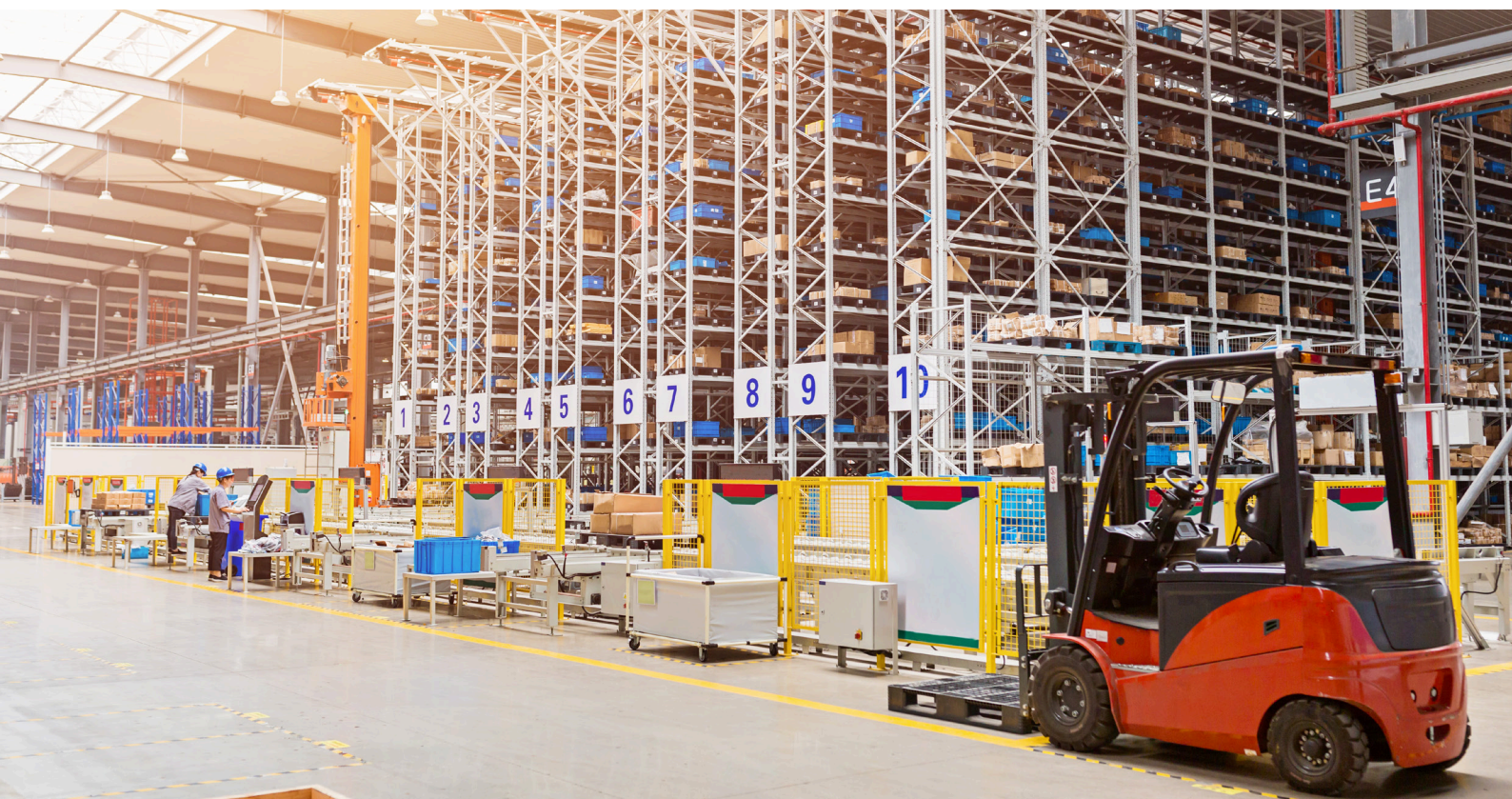


Ongoing operations

If a vendor has sold products or services to the debtor without a contract governing the relationship, that vendor can choose whether to continue serving the debtor post-petition and on what terms. If the vendor chooses to continue supplying the debtor, they may consider whether requiring prepayment or cash on delivery is appropriate.

If a vendor has a contract in place where both the vendor and the debtor have continuing obligations, the vendor may have to continue performing until the contract is assumed or rejected by the debtor or the bankruptcy court.

If a vendor is critical to the ongoing operation of the debtor, they may be classified as a “critical vendor”. Many bankruptcy courts will allow for the establishment of a critical vendor program that provides listed vendors with full or partial payment of prepetition claims in return for a commitment to continue supplying goods and services. The critical vendor list is typically established early in the bankruptcy process since those vendors are required for continuing the operations of the business.



Goods in transit or recently delivered

If a vendor has unpaid goods in transit, they can attempt to stop the shipment and arrange for the goods to be returned to their warehouse. However, once goods have been received and accepted by the debtor, they become an asset of the bankruptcy estate.

If a vendor has sold goods to the debtor in the ordinary course of business, and the debtor has received those goods while insolvent, within the 45 days prior to the petition date, then the vendor can attempt to reclaim those goods. This is accomplished by sending a Reclamation Notice no later than 45 days after the debtor received the goods; or no later than 20 days after the petition date, if the 45-day period expires after the petition date.

Another option is to pursue an Administrative Expense Claim. The bankruptcy code grants administrative priority for the value of any goods sold to the debtor in the ordinary course of the debtor's business and received by the debtor within 20 days prior to the petition date. This helps to elevate the priority of the claim and thus improves the chances of repayment.

Payments recently received from the buyer

Payments received by the creditor within the 90 day period prior to the petition date may be subject to Preference Claims in which the bankruptcy estate demands the return of the funds. A common defense to a Preference Claim is that the payment was received in the ordinary course of business between the seller and buyer. If there were any differences in the way the seller and buyer did business in the 90 day period as compared to prior periods, this defense may be compromised. However, in 2005, the ordinary course of business defense was expanded to include payments made in accordance with standard industry terms for the creditor's industry.

Another potential defense is the "new value defense." If a creditor received a payment from the debtor in the 90 day period prior to the petition date, but then extended additional credit after receiving such payment, the Preference Claim may be reduced dollar for dollar by the amount of additional credit that was extended but unpaid as of the petition date.



Unsecured creditors committee

A meeting of the creditors will be scheduled shortly after the bankruptcy is filed. The meeting provides creditors with the opportunity to ask questions about the assets and future plans for the business.

A creditors' committee is typically established and can be a valuable resource. The committee is appointed by the U.S. trustee and ordinarily consists of unsecured creditors who hold the seven largest unsecured claims against the debtor. Among other things, the committee consults with the debtor in possession on administration of the case, investigates the debtor's conduct and operation of the business, and participates in formulating a plan. A creditors' committee may, with the court's approval, hire an attorney or other professionals to assist in the performance of the committee's duties. A creditors' committee can be an important safeguard to the proper management of the business by the debtor in possession.

Record retention

Throughout the process, it's important for creditors to gather and keep documents related to their business activities with the debtor. Documentation not only helps provide evidence for claims but also helps in defending against potential liabilities such as Preference Claims.



Final Thoughts

When faced with a customer's bankruptcy, it's helpful to understand your rights, remedies, and the bankruptcy process.

The information in this video is not meant to be a substitute for the advice of competent legal counsel or a financial expert.

Every bankruptcy is unique and therefore, you may want to consult with our office and an attorney to help guide you through the process and maximize your potential for recovery. If you have any questions or would like to discuss your specific situation, please contact our office.



About Pugh CPAs

We got our start in Knoxville, Tennessee in 1969 and have grown into a regional firm with global connections. We've been in business a LONG time and that means we've worked with a diverse group of industries and clients. Of course, we do tax planning, compliance, auditing, and accounting but our passion is collaborating with our clients to ensure that your business and financial goals are met. It's critical for your business advisors to understand how your business operates within your industry—we get that! Our longevity is connected to the relationships we build with our clients and that's how we build trust. You can be confident that Pugh CPAs has the knowledge, skills and abilities to help you achieve your goals. Brilliant people with servant hearts work here.



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