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5 issues to consider if your customer files bankruptcy

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As industry observers anticipate an increase in bankruptcy filings resulting from the COVID-19 pandemic, it is important for creditors to understand the risks that arise in dealing with a distressed business. Below are five issues that may arise if your customer files a Chapter 11 bankruptcy.

1. Executory contracts. If you have an executory contract with the debtor that has not been terminated as of the petition date, you will need to continue to perform your obligations under the contract. Importantly, this obligation to perform continues, even if the debtor was in default at the time the case was filed. The debtor is given time (usually by the time the plan of reorganization is approved) to determine whether to assume or reject contracts. Pending the debtor's decision on assumption or rejection, creditors are entitled to be paid for what they supply post-petition but cannot terminate the contract based on a pre-petition default. If you suspect that a distressed customer is considering filing a Chapter 11, evaluate whether there are justifications to terminate the contract prior to the bankruptcy and whether that is the best business decision in light of the circumstances.
2. Goods delivered within 20 days of the petition date. A supplier may be

entitled to an administrative expense priority for the value of any goods received by the debtor in the ordinary course of business within the 20 days preceding its bankruptcy filing. To qualify for an administrative claim, the goods must have been delivered directly to the debtor, and the administrative claim must be requested by motion in the case. The administrative claim, if allowed, must be paid upon approval of the plan of reorganization. If a supplier delivered goods to the debtor immediately prior to the bankruptcy filing, consult with legal counsel to evaluate your rights to assert an administrative expense claim.

3. Reclamation. Under both the UCC and the Bankruptcy Code, a seller has the right to stop goods in transit or to reclaim goods under certain circumstances. Before the filing of a bankruptcy, the right of reclamation is governed by Sections 2-702, 2-703 and 2-705 of Article 2 of the UCC. If the buyer files for bankruptcy before a seller's right to reclaim its goods has been established, the seller must comply with section 546(c) of the Bankruptcy Code to enforce its reclamation rights. The process to reclaim under section 546(c) is more specific than the process under the UCC and requires a written reclamation demand. Also, be aware, the bankruptcy court may enter an order establishing specific procedures for dealing with reclamation claims. As soon as you learn that a customer has filed bankruptcy (or that a filing is imminent), determine the status of recently shipped goods and evaluate whether it is appropriate to assert a right of reclamation.
4. Critical vendor. Once a debtor files Chapter 11, it is not permitted to pay any pre-petition debts, except through a confirmed plan of reorganization. However, in certain cases, the court may grant the debtor special authority to pay the pre-petition claims of vendors deemed to be of critical importance to the debtor's ongoing business. In these cases the debtor is given authority and discretion to induce the continued cooperation of key vendors through partial or full payment of their claims. Certain strings may be attached, and careful consideration must be given to all of the terms and conditions before entering into a critical vendor agreement. If you are not initially selected for critical vendor status, raise the issue with your business contacts at the debtor and evaluate what leverage you might have to become a selected "critical vendor."
5. Preference exposure. To most creditors the most infuriating aspect of bankruptcy law is the right of the debtor to take back payments made to a creditor within the last 90 days before the filing date, even where the debtor has a large delinquent balance. But the right to recover these so-called preference payments is not absolute. (For more information regarding preference claims and defenses, read one of our [recent publications](#).) If you

find yourself the target of a preference claim, be certain to properly track service of the complaint and alert your legal counsel in time to file an answer.

While a customer's Chapter 11 filing is usually not a welcome event for a supplier, make the most of a bad situation by knowing and protecting your rights.