

CREDITOR'S RIGHTS TOOLKIT

Post-Bankruptcy Claims and Transactions: What Are the Risks and Rewards?

Many difficult questions arise when a vendor seeks to do business with a company in bankruptcy. For example: Is the vendor permitted to sell to or enter into a new contract with the bankrupt debtor? And how does the vendor get paid? May the debtor simply pay the vendor in the ordinary course of business? Must the vendor file a claim in the bankruptcy case to get paid? And what guarantees or recourse does the vendor have if the debtor does not pay?

Can a Vendor Sell to or Enter Into a New Contract **With the Debtor**?

Whether the vendor can sell to or enter into a new contract with a debtor after a bankruptcy has been filed depends on the type of case the debtor has filed.

If the debtor has filed a Chapter 7 liquidation case, the debtor's business will immediately cease operations, a Chapter 7 trustee will be appointed, and there will be no opportunity (or basis) for a vendor or other creditor to do business with the debtor or its trustee.

If, however, the debtor files a Chapter 11 bankruptcy case, the debtor will continue to operate its business as a debtor-in-possession and may without court approval engage in routine business transactions, such as purchasing goods and services from its vendors and entering into routine contracts with those vendors. For larger transactions outside the ordinary course of business (i.e., the type that typically requires board approval or perhaps approval from the debtor's CEO, CFO, or COO), court approval is required before the transaction may be completed.

May a Chapter 11 Debtor Pay a Post-Bankruptcy Vendor **Without Court Approval**?

Moreover, just as a Chapter 11 debtor is permitted to enter into ordinary course transactions and purchases with its vendors without obtaining court approval, the debtor is also permitted to pay these claims without court approval.

What If the Debtor Does Not Pay Post-Bankruptcy Claims as They Come Due?

However, while a debtor is permitted to pay ordinary course post-bankruptcy claims without court approval, it is not necessarily required to do so. If the debtor does not pay, the vendor will be required to file a motion or claim in the bankruptcy case seeking allowance (i.e., validation) and payment of these claims. Even if the claim is allowed as a valid post-bankruptcy claim, the debtor often will not be compelled to pay the claim unless and until it has confirmed a Chapter 11 plan, which can sometimes result in a significant delay in payment.

Is a Vendor Guaranteed Payment of Its Post-Bankruptcy Claims?

No! Often, after a bankruptcy case is filed, a debtor will ask a vendor to provide goods or services and will suggest that debtors are “required” to pay all post-bankruptcy claims in full. Such a statement is false at worst and misleading at best. While it is true that post-bankruptcy “administrative” claims are entitled to a high priority in a bankruptcy case and that to confirm a Chapter 11 bankruptcy plan, the debtor must show that it can pay all of its administrative claims in full, debtors often have insufficient funds to make these administrative claim payments (and is therefore “administratively insolvent”) and are forced to convert their Chapter 11 cases to a Chapter 7 liquidation cases. Chapter 11 administrative claims are junior in priority to secured claims and chapter 7 administrative claims, so if a case is converted to Chapter 7, vendors with valid administrative claims arising during the Chapter 11 case may not be paid in full (or at all). As such, vendors with administrative claims are not guaranteed payment in a Chapter 11 case.

How Can a Vendor Protect Itself With Respect to Post-Bankruptcy Claims?

The good news is that while there is some credit risk with respect to post-bankruptcy claims for goods and services, there are many things a vendor can do to protect itself.

First, a vendor may sell to a debtor on cash-in-advance or cash-on-delivery and eliminate a credit risk altogether. Second, a vendor that provides goods or services on credit may impose a strict credit limit on sales and may also require payment on fairly short credit terms. To further protect itself, the vendor should be very clear in its communications, or in a new contract, that it is not required to continue to provide goods or services if or while the debtor has exceeded a credit limit or is overdue on any payment obligation.

Note, however, that there are many other issues that arise due to a customer’s bankruptcy. For example, a vendor cannot take a lien or security interest on the debtor’s assets without first obtaining court approval (and such arrangements are extremely rare in bankruptcy for trade vendors and service providers). In addition, if a debtor does not pay, the vendor may have to file an administrative claim in the bankruptcy, prove the claim in court, and wait for payment after the claim is allowed.

Takeaway

In most cases, a vendor may sell to a debtor that has filed a Chapter 7 or 11 bankruptcy case knowing that the vendor's post-bankruptcy claims have a high priority and that the debtor can usually pay those claims without court approval. Vendors should, however, be careful to structure their relationships to limit (or eliminate) their downside credit risk.