



Your Counterparty Filed Chapter 11 — Make Sure to Check These 10 Boxes

Commercial and Contracts

Insurance

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Cheat Sheet

- **Improve recoveries.** Although your counterparty is filing for [Chapter 11 bankruptcy](#), you might have an opportunity to receive payment in full of your claims as a critical vendor. In some cases, you may be able to negotiate repayment and ongoing relationship terms.
- **Watch the docket.** Throughout the case, being on top of docket updates will enable you to be aware of sudden changes that might lead you to change your strategy and/or adjust your expectations of the likely outcome.
- **Participate in the reorganization.** Even if you are unwilling or ineligible to serve on the unsecured creditors' committee, you might form an ad hoc committee with creditors who have similar interests to drum up negotiating power.
- **Take stock of your payment history.** If your company received payments during the 90-days prior to bankruptcy, you need to begin preparations of a defense should the debtor seek return of those payments as preferential transfers.

Far too many suppliers take a passive role when facing the Chapter 11 [bankruptcy](#) of key vendors. This is understandable: Bankruptcy can be complex, highly disruptive, and, in some cases, require meaningful time and effort on the part of in-house counsel. But with some attention and a road map, a creditor can meaningfully improve its outcome.

First, assess the type of bankruptcy and what it involves. The law is often murky and tilted in favor of the debtor; the risks of losing a debtor's business could be daunting and destructive; and your ability to affect the outcome may seem limited. This passive stance, however, may be costing suppliers severely. With greater attention and some protective measures, suppliers might improve recovery of their claims and minimize further losses should the debtor seek to avoid certain pre-petition payments made to the supplier. By following some, or all, of these 10 tips and reminders below, suppliers can begin taking a more proactive role and [improve](#) their outcomes.

1. Monitor the docket

Understand the risks of bankruptcy as soon as possible. A great deal of useful information is available in public filings on the first day of a bankruptcy case and throughout the course of the case. Do not wait until notices are delivered by mail and then wind their way internally to the person responsible at your company for the relationship. A creditor or their counsel can file requests to receive notice of all filings or, in larger cases where a third-party noticing agent has been retained, the docket (or schedule of all filings made in the case) is freely accessible through an easy internet search.

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Of particular interest is the [first-day declaration](#), often submitted by a C-suite officer of the debtor, perhaps a chief restructuring officer retained to prepare the company for bankruptcy. This declaration is often lengthy, highlighting the debtor's pertinent history, the causes of its financial distress, and its projected path to reorganization. For example, you might learn that the company intends to sell its assets or, instead, to reorganize its business with an improved capital structure. In addition to monitoring the docket, alert the appropriate members of your team that all correspondence relating to the case be promptly directed to a central location for review.

2. Advocate for critical vendor status

Debtors often seek authority to grant preferential treatment to their most important and strategic suppliers and vendors (or [critical vendors](#) in bankruptcy parlance). Based on the legal theory of [doctrine of necessity](#), debtors often argue that, absent preferred treatment, certain suppliers and vendors may cease doing business with it and impair the prospects of a reorganization. Traditionally, these critical vendors received payment in full in respect of their prepetition claims (while other unsecured creditors may be paid only pennies on the dollar).

Debtors have asked courts for greater flexibility in both the timing and amounts that they can offer in exchange for continued performance (for example, payment of 50 percent of the creditor's claim to be made 120 days after the filing date).

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negotiate treatment.

Critical vendor orders are entered early in cases. Be proactive and reach out to your debtor contacts as early as possible. When the order is entered, pay close attention for any discretionary language in it which will guide the creditor on the debtor's flexibility to deem it a critical vendor and to negotiate treatment. Creditors should advocate for inclusion in this preferred class if not offered and negotiate the best deal available — which may not be the one first offered.

3. Review your contracts

Understand your company's rights and obligations under any contracts and agreements that you may have with your debtor counterparty. If these are [executory contracts](#) — those for which material performance remains for both parties — they may be subject to assumption or rejection by the debtor at any time during the case with few exceptions.

The debtor can choose to [perform \(assume\) or terminate \(reject\)](#) executory contracts during the case in its business judgment. In conjunction with an assumption, contracts may also be assigned to a third party (despite otherwise valid anti-assignment provisions) if certain conditions are met. If assumed, the debtor must cure all monetary breaches (for example, pay all outstanding claims in full) and provide "adequate assurance of future performance" that it, or a third-party assignee, can properly perform the obligations contained in the contract (for example, prove that it has the financial wherewithal to perform). Assumption requires that the executory contract be assumed in its then-existing form, so be aware that any loose termination provisions will also survive.

Also, be aware that a debtor may threaten rejection to renegotiate certain terms. Expect any such threats to come from third-party advisors rather than relationship partners at the debtor. In any such instance, a creditor will need to make a reasoned judgment regarding the actual likelihood of a rejection (as opposed to the threat) and the consequences on its business if rejected. This review will also provide a unique opportunity to consider modifications to form agreements for use going forward. However, no supplier should wait for a counterparty's bankruptcy to conduct this review. Conduct risk reviews before entering contracts.

4. Consider participation on the creditors' committee

In most commercial cases, the US Trustee (a division of the US Department of Justice) will appoint an official committee of unsecured creditors, often consisting of five to seven of the largest unsecured creditors, to represent the interests of all unsecured creditors. The committee is authorized to retain counsel and financial advisors to represent its interests — they are paid by the debtor. The US Trustee will actively solicit creditors' participation — if a creditor is not contacted, it is unlikely a candidate for the committee.

If a creditor is not eligible for the committee due to the size of its claim, or does not wish to participate, it should consider reaching out to the committee's chosen advisors with any questions that may arise.

Members have the benefit of input into the choice of the committee's advisors, access to confidential information regarding the debtor's operations and other matters of importance, and often have a

prominent role in negotiating the terms of the plan of reorganization (which dictates the treatment to creditors, among other things).

If a creditor is not eligible for the committee due to the size of its claim, or does not wish to participate, it should consider reaching out to the committee's chosen advisors with any questions that may arise. If the interests of other unsecured creditors do not align with a creditor's interests, it might consider forming an *ad hoc* committee of creditors with similar interests. This *unofficial* committee may be a means of enhancing influence in plan structuring while also benefiting from cost sharing among several members (and if you are able to make a "substantial contribution" to the case, requesting that the debtor pay for professional fees and expenses).

5. Be aware of bar date orders and file your claim on time

Whether early or late in the case, the court will schedule the deadline for the filing of general unsecured claims (i.e., the bar date), which will appear on the docket. Notice will also go out in the US mail.

Pay careful attention to the instructions and prepare and file claims well before the deadline to avoid any mishaps. The consequences of not doing so can be drastic, and exceptions are granted only for [excusable neglect](#), which is a high standard.

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If any late filing was within the creditor's (or its attorney's) control — for example, a late filing because an attorney did not possess the proper credentials needed to file electronically — the claim, regardless of how large, will be at risk of being forever discharged. Keep careful note of similar deadlines for two other types of claims you may have: [503\(b\)\(9\)](#) claims (claims for goods received during the 20 days prior to the case and often set early in the case) and administrative claims (claims for goods and services provided during the bankruptcy and often set at the tail end of the case). Both latter categories are entitled to payment in full. Importantly, creditors should be on the lookout for any objections that may be filed.

6. Understand the debtor's liquidity

Operating during bankruptcy for a debtor reliant on secured financing often requires court approval if use of cash collateral (cash in the company's accounts) will be needed and/or to borrow additional funds, [debtor-in possession \(DIP\) financing](#).

Typically, DIP financing is provided by one or more of the debtor's pre-bankruptcy lenders that are incentivized to lend [to](#) preserve the value of the business (and naturally, their collateral), avoiding a value-destroying liquidation. Because access to liquidity is often critical, debtors seek this approval in one of many first day motions that are filed in virtually every corporate case. The motion, and the orders that follow, will describe the priority of the new liens or replacement liens that will be placed on the debtor's assets. This is important because those new lien requests might involve seeking priority over the goods and property that were provided by, or may be provided, by suppliers to the debtor.

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Sellers of goods should review these new security grants to ensure that new liens do not take unintended priority over their interests, and that any necessary [carve-outs](#) to the lien package are addressed. The motion will also provide specifics on the amount of funds newly available to the debtor (as opposed to that portion that is [rolled up](#) from a pre-bankruptcy loan and therefore not an enhancement to liquidity). The face amount of the loan facility may be a misleading picture of the debtor's finances. Additionally, lenders will typically attempt to limit or restrict the debtor's activities with new covenants and milestones that may relate to the timing of draws, terminations dates, and events of default based on sales revenue and other deadlines.

Another valuable piece of information contained in most DIP financing motions is a budget, typically in the form of a 13-week cash flow forecast. DIP financing orders will often require the debtor to operate within the budget, both receivables and payables, subject to some agreed weekly variance for certain line items. The budget will be updated on a weekly or monthly basis and includes valuable information regarding the projected cash position of your customer. The budget may also provide insight on the proceeds available to the debtor, which may in some cases differ from the face amount of the loan which may have been inflated for optics purposes.

Suppliers should carefully consider [all](#) these data points — the amount of new financing, the implications of covenants and other loan provisions, and the budget restrictions — when making decisions on whether to do business, or how much business it wants to do, with a debtor.

7. Review monthly operating reports

Debtors are required to publicly file [monthly operating reports](#) that include a current cash balance sheet and expense reporting. These reports provide insight into the debtor's receipt, administration, and transfers of its property during the case, and allow interested parties an opportunity to assess the likelihood of a successful reorganization as the case progresses. The reports will provide details on the amount of professional fees paid, the level of distributions made, and the sales of any assets, among many other things. For those suppliers that have chosen to continue to do business with a debtor, monthly operating reports may highlight a change in circumstances, not noticed by those paying less attention, that may cause them to reconsider or alter commercial terms.

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8. Explore the secondary market

While some bankruptcy cases may be completed on an expedited basis (some in as little as 24 hours), others may take years of negotiation and litigation before a plan of reorganization is confirmed, and even longer for distributions to creditors to begin.

You may find it, therefore, in your company's interest to explore opportunities to sell its claim to a

third-party purchaser for immediate cash payments. And many distressed investors may reach out to you with unsolicited offers upon seeing your name on a public creditor list. Likely you can do better than what they will offer — consult with counsel or advisors who know of other funds or investors that might have an interest in starting or building a position in the claims at issue. While a creditor may not be willing to sell at the market price, the secondary market may provide some measure of the value of the claim for internal bookkeeping purposes.

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If your company is unable to find a willing purchaser at a reasonable price, be aware that, unlike distressed debt trades (or trades of loans or notes), the purchase and sale of claims do not have a uniform set of transfer documentation. Unlike distressed debt, which tends to be in a fixed amount and not subject to challenge, the amount of your claim may fluctuate if subject to avoidance or disallowance. It will be important, therefore, to carefully address the allocation of risks associated with any potential changes in the transfer documents.

Counsel with active secondary market practices will be able to guide creditors through the process in an efficient manner and provide insight on alternatives.

9. Analyze your payment history

The risk of [clawback](#) of payments received prior to bankruptcy is often among a creditor's greatest concern when a counterparty files bankruptcy. While it is painful to receive less than full value of your company's claims, it may be far worse to return funds to the debtor that it believes were rightfully paid prior to the case.

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If a creditor provided goods or services to the debtor during the 90 days before the bankruptcy filing, the debtor (or a trustee appointed by the court) will often demand that it return all payments received during that period. Generally, any payments received during the 90 days prior to the filing, for, or on account of, an antecedent debt (payments made after goods or services are provided), and while the debtor was insolvent (which is presumed during the 90-day period), may be subject to avoidance as a [preferential transfer](#).

While plaintiffs are required to take a recipient's anticipated defenses into account when deciding whether to pursue claims, that duty is undefined and demands (and later expensive adversary proceedings) may be pursued indiscriminately.

Creditors can employ a number of defenses, most notably, that actions taken were a part of the [ordinary course](#) of doing business. Very generally, a defense to a preference demand is that the payments at issue were made consistently as part of the usual payment structure between the parties. Suppliers paid during the 90-day period should perform a brief analysis of their payment history with the debtor — both during the 90-day period and historically — to determine if they might be viewed as conducting a preference relationship, and to prepare any needed defenses.

This requires that the creditor detail the invoice dates, the payment dates, and the clearing dates for checks. There are several methods for analyzing ordinary course, including whether the subject payments were received within the historical average, median, or range of number of days between invoice and payment (or some combination thereof). If a creditor is aware of its exposure early, and able to model available defenses, it will be best suited to proactively address it and eliminate later surprises.

Importantly, within its Statement of Financial Affairs filed early in the case, the debtor will include a schedule of payments made during the 90-day period, providing creditors with an early reference point for use in any discussions with the debtor. Because of the subjective nature of ordinary course, many preference actions are settled rather than litigated, and a proactive approach may limit (or eliminate) any exposure.

10. Act with caution when addressing the debtor

If a contract was improperly terminated prepetition (importantly, including the passage of any [cure — or payment — periods](#)), the [automatic stay](#) goes into effect immediately upon the filing of the case preventing any adverse action against the debtor or its property. This statutory stay prevents suppliers from delivering demand notices, exercising otherwise valid termination rights, and instituting a [bank setoff](#) (removing funds from the debtor's account to pay your company) against prepetition accounts receivable, *among many other things*. Before taking any such action, counsel should seek relief from the stay (by filing a motion with the court) or a declaratory judgment that the stay does not apply to the contemplated actions.

Termination rights that are triggered due to the financial condition of the debtor — most commonly, the commencement of a bankruptcy case, but the concept is expansive — are enforceable. Because a knowing breach of the stay may lead to sanctions, creditors must take a very conservative approach when considering any post-petition actions against the debtor. Also, in rare cases, the automatic stay may be deemed to extend to a debtor's non-debtor subsidiaries, so it is good practice to act cautiously when a counterparty's parent has filed bankruptcy.

You're almost there

All of these strategies are essential for every general counsel to keep at their disposal for any situation involving any Chapter 11 bankruptcy of a counterparty. The particulars of managing a bankruptcy, however, require a level of expertise you may not possess in addition to the many specialties of your role. Dealing with bankruptcies, therefore, is one area in which you may recommend retaining an outside law firm.

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