

Rights of trade creditors in the US

Dan Lowenthal explains the statutes concerning the rights of trade creditors in the US



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A trade creditor who supplies goods to a company that files for bankruptcy should seek to enforce certain rights in the Chapter 11 case.

For instance, the Bankruptcy Code Section 546(c) preserves a creditor's right of reclamation under state law. The applicable state law statute concerning reclamation is Uniform Commercial Code Section 2-702. The two statutes together permit a supplier of goods to reclaim goods provided to an insolvent debtor in the ordinary course of the debtor's business when such goods are identifiable.

BC Section 546(c) permits reclamation of goods supplied within 45 days before the bankruptcy petition date or, if the 45-day period expires after the case begins, no later than 20 days after the start. The trade creditor (or its counsel) should demand reclamation right after the Chapter 11 case is filed.

But trade creditors cannot always reclaim goods they provided prepetition. The goods might be subject to a secured creditor's lien or might not be identifiable. A carton of shoes might be identifiable, but oil flowing through a pipeline with other suppliers' oil might not be.

BC Section 503(b)(9) gives suppliers a priority administrative claim for the value of goods they supply to debtors in the ordinary course of the debtors' businesses within 20 days before the filing date. Trade creditors that cannot reclaim goods under Section 546(c) can benefit by filing a claim under Section 503(b)(9).

A trade creditor might seek to stop delivering goods under the



UCC Section 2-705. The automatic stay in BC Section 362 bars creditors from trying to obtain property from the debtors' estates. Even so, some courts have allowed creditors to invoke their delivery stoppage rights. The theory is that the creditor is not seeking to obtain estate property, but rather suspending its performance while the debtor considers if it wants to assume or reject an executory contract with the creditor/supplier.

The BC also provides that the seven largest creditors by claim amount can serve on the official committee of unsecured creditors, which is formed by the US Trustee's Office soon after a bankruptcy case is filed. Although a seven-member committee is the rule, the US Trustee has appointed committees with as few as three members and others with 11 or more. The size of a committee is influenced by the number of creditors willing to serve and the size of the case.

There are pros and cons to serving on a creditors' committee. Committee members gain access

to a debtor's confidential information and receive cash flow forecasts, business plans, and more. They learn more about the debtor's reorganisation or liquidation goals than they would if they did not serve.

Yet committee members are fiduciaries for all unsecured creditors. Creditors want to maximise recoveries on their claims, but issues may arise in which an individual creditor's own interests differ from those of the other members. Bondholders or governmental agencies might pressure a committee to pursue goals on issues that differ from what trade creditors would want. As fiduciaries for all creditors, committee members must deal with those tensions.

If a debtor has secured debt, the creditors' committee investigates whether the security interests were properly perfected and other related matters concerning the validity of the secured creditor's priority claims. Committee members decide if litigation should be brought against the secured creditor.



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Debtors' Options

Retailers in bankruptcy might seek court permission to pay their critical vendors pre-bankruptcy. Debtors identify which creditors they believe are critical to their business. A Debtor's Critical Vendor Motion includes the total amount the debtor wishes to pay those creditors. The proposed order approving the motion might require vendors to keep supplying a debtor according to certain specified business terms. Creditors that agree to the proposed supply terms are eligible to receive prepetition-owed amounts for which they otherwise might be paid a fraction on the dollar as unsecured claims in the bankruptcy case.

Trade creditors must also file timely proofs of claim. Typically, a debtor files a motion to set a filing deadline. Claims should identify prepetition-owed amounts and include supporting documentation. A separate deadline is set for creditors to file administrative expense claims – claims for goods and services provided to a retailer post-petition. Administrative expense charges are the actual and necessary costs and expenses a debtor incurs to preserve its bankruptcy estate through Chapter 11. Creditors with valid administrative expense claims are paid before distributions are made to unsecured creditors on prepetition-owed amounts.

Certain trade creditors have contracts with debtors that qualify as executory contracts. This means that both the creditor and the debtor still owe performance to one another, such that failure by either to perform would constitute a material breach. A debtor can assume, reject, or assume and assign an executory contract to another party (BC §365).

A debtor that assumes or assigns a contract (or the assignee) must pay the creditor the prepetition-owed amounts and give adequate assurance that the debtor or assignee can keep performing the contract (BC § 365(b)(1)). Rejection of a contract

constitutes a material breach and allows the creditor to file an unsecured claim for damages as of the petition date (BC § 365(g)(1)). Creditors whose contracts are assumed or assigned recover more on their prepetition claims than do creditors whose contracts are rejected.

A bankruptcy estate might also have claims to assert against unsecured creditors. Debtors can seek to claw back payments that were made to trade creditors in the 90 days before the bankruptcy case was filed. The estate will have preferential transfer claims to assert under BC Section 547.

Payments are preferential if a debtor can satisfy a five-part test examining if the payment (1) was made to or for the benefit of a creditor; (2) was made on account of an antecedent debt; (3) was made while the debtor was insolvent; (4) was made within 90 days before the bankruptcy case was filed; and (5) enabled the creditor to receive more than it would in a Chapter 7 liquidation.

The fifth element applies when a trade creditor supplies goods on an unsecured basis. Payment in full for those goods would likely exceed what an unsecured creditor would receive in a Chapter 7 liquidation case. Thus, this preferred creditor would have received a greater amount in the 90 days before bankruptcy than it and other trade creditors would receive as distributions on their prepetition claims in the bankruptcy case.

The BC provides creditors with defences to preferential transfer claims. The most common defences are the ordinary course of business defence, the contemporaneous new value defence, and the subsequent new value defence. These defences prevent or reduce clawbacks of transfers because the creditors continued doing business with the debtor in the 90 days before bankruptcy in a manner that the BC says should be respected.

The ordinary course of business defence applies when a transfer was payment for an obligation incurred by the debtor

in the ordinary course of its business or financial affairs, made in the ordinary course or financial affairs of the debtor and the transferee, or made according to ordinary business terms. The creditor must show a consistent history of invoices to and payments by the debtor both during and before the 90-day prepetition period.

The contemporaneous new value defence applies when a debtor makes a transfer to a creditor, and at or about the same time, the creditor supplies the debtor with new value. The subsequent new value defence applies when a debtor makes a transfer to a creditor, and the creditor subsequently supplies to the debtor new value that remains unpaid. If a preferential transfer claim is brought against the creditor, the subsequent new value supplied would reduce the amount the creditor would owe on the claim.

Being Prepared

Trade creditors face many challenges when dealing with retailers that might or do file for bankruptcy. Pre-bankruptcy, trade creditors must monitor and manage the credit risks and consider alternative business terms.

If a retailer does file, then trade creditors must consider possible remedies related to goods they delivered before the filing; protect and pursue recovery on their prepetition claims; review filings in the case to determine if critical vendor status is an option and whether service on a creditors' committee makes sense; determine if their contracts are executory and, if feasible, pursue assumption; and, assert administrative expense claims when applicable. Finally, trade creditors must be aware that the bankruptcy estate might have claims to assert against them for amounts they received prepetition and plan accordingly. ■

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THE SEVEN LARGEST CREDITORS BY CLAIM AMOUNT CAN SERVE ON THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS



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