When a Customer Files Bankruptcy: Write-Off is Not Your Only Remedy

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MANAGEMENT MATTERS

Bankruptcy filings have not noticeably declined despite the economic recovery of the Reagan years. Businesses continue to receive notices that their customers have filed bankruptcy. Many of them are writing off significant losses each year as a result. Despite the frequent use of bankruptcy by debtors, many business owners and managers have little or no idea of the post-bankruptcy remedies available to them.

Once bankruptcy is filed, you are subject to the automatic stay. You no longer have a right to prosecute any lawsuits anticipated or pending against the debtor. You no longer have the right to repossess collateral in the possession of the debtor without prior court order. You no longer have the right to offset accounts, without prior court order. All actions against the debtor must stop.

The remedies available to you differ in a Chapter 7 liquidation from those in Chapter 11 reorganization. A Chapter 7 contemplates turnover of all the debtor's non-exempt assets to an independent trustee to liquidate. The only recovery the creditors will receive will be derived from the value of the assets administered by the trustee. The debtor will be forever discharged from any obligation to repay his debts incurred prior to bankruptcy. Under Chapter 11, the debtor is proposing to continue to operate his business under the protective arm of the court. He will usually act as his own trustee as debtor-in-possession. He will hold and control his assets, continue to do business, and ultimately file a plan of reorganization. In most cases, he will propose to pay only part of his debts and will be discharged from the balance.

File a Claim

If a Chapter 7 is filed, creditors should file proofs of claim with the bankruptcy clerk. These are simple, one-page forms that can be obtained from your attorney or the clerk. In most cases, you can fill out the forms yourself. Be sure to attach any written evidence of debt you have, such as invoices and promissory notes. If you have any knowledge of fraudulent conveyances by the debtor prior to bankruptcy, payments of large sums to family members or preferred creditors, unusual gifts or transfers of property prior to bankruptcy, or other misdealings by the debtor, notify the appointed trustee. The trustee has only the information contained in the debtor's schedules, and without creditors' assistance, he will rarely discover hidden assets.

Object to Discharge

Creditors should also determine whether they were induced to extend credit to the debtor by any fraudulent or false representation. You have the right to object to discharge of the debtor if you can prove he is hiding assets from the estate, has been guilty of fraudulent conveyances within one year before filing, has committed fraud in obtaining money or property, or is failing to comply with orders of the court. If you think you have grounds for such objection, discuss them with your attorney, as you must act before the discharge is granted.

Reclaim Goods

If you have shipped prod

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uct to the debtor just prior to bankruptcy, you have the right to reclaim goods within 10 days after their receipt. This right applies when the goods were sold on credit while the debtor was insolvent. If you find this is the case, immediately inform your attorney, who will file an action in the bankruptcy court to obtain court approval of your retaking the property.

Obtain Relief

If you have a lien on the debtor's property, and you believe the value of the property is less than the amount you are owed, you may file an application for relief from the automatic stay and abandonment. Relief from stay will allow you to take action to recover the property. Abandonment is nothing more than a disclaimer of interest by the trustee. The trustee must conclude that there is no value to be recovered for unsecured creditors. If the debtor's schedules indicate there is no value in excess of your lien, the trustee will usually consent to abandonment. If the schedules indicate that there is equity, you should have the property appraised to prove the debtor was incorrect. Once the property is abandoned, you can exercise any remedy you would normally have under the law just as if no bankruptcy were pending.

Chapter 11

If a Chapter 11 is filed, you should consider some additional actions. You should always file a proof of claim. If you do not, the debt as listed by the debtor in his schedules will control. If he substantially devalued your claim in the schedules, his figure will govern if you have not filed a claim. In addition, if the case is ultimately converted to Chapter 7 liquidation, you must have a claim on file in order to share in the final settlement.

Joint Creditors' Committee

If you are an unsecured creditor and have a large claim against the debtor, you should consider joining the creditors' committee. The members of the creditors' committee act on behalf of all unsecured creditors and review the financial records of the debtor, negotiate with the debtor as to the contents of the proposed plan of arrangement, and recommend to creditors whether to accept or reject the plan. The debtor will attempt to negotiate as cheap a deal with creditors as he can. If you want your money, you should be prepared to fight for it.

Attend First Meeting

The unsecured creditors should have someone in attendance at the first meeting of creditors to interrogate the debtor. There is a great deal of information to be gathered at that meeting. It is normal for debtors to overvalue their property in the bankruptcy schedules in order to demonstrate that they have substantial equity and a reasonable likelihood of surviving if they can get their debts extended. Careful cross-examination as to the source and validity of the figures used in the schedules can help later in disputes over the value of secured claims and the ability of the debtor to finance a plan. It is

also important to determine what caused the debtor to become bankrupt, and to determine what efforts the debtor is making to remedy those causes. It is important to determine the present financial structure of the company and the debtor's break-even point for operations. If the debtor is continuing to operate at less than break-even level during the Chapter 11, people supplying credit to him during the Chapter 11 are at risk, and the debtor is not generating cash with which to fund a plan. The court will not be inclined to allow a debtor to operate indefinitely under such conditions. The creditors have no way to monitor the debtor's performance unless they begin with some understanding of his financial position.

Requesting a Review

If the creditors believe that the debtor has committed fraudulent acts, is untrustworthy, or is dissipating the assets of the estate, the creditors have the right to seek appointment of an examiner to review the acts and financial condition of the debtor, and to seek appointment of an independent trustee to operate the debtor's business during Chapter 11.

Seek Adequate Protection

In Chapter 11, the debtor is entitled to use property that has been pledged to secured parties unless the secured parties object. If they object, they are entitled to adequate protection of their collateral. If that does not occur, the secured parties have the right to seek relief from stay and abandonment of their property from the estate. If you are a secured creditor, and your property is in the hands of the debtor, you should contact your attorney to negotiate an agreement that you will have a continuing lien on the same assets and any proceeds, products, and replacements thereof. If you do not do so, and the debtor sells your collateral and reinvests the money in the business, your lien will disappear. Adequate protection can also mean providing a form of insurance or surety to protect the value of the collateral or depositing money instead of physical assets as collateral.

The debtor has no right under the Bankruptcy code to use "cash collateral" without prior approval of the bankruptcy court. Cash collateral is cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents. The debtor can use it only if each entity with an interest in that cash collateral consents to such use, or the court has held a hearing and thereafter permits such use. If your security is cash collateral, you should contact the debtor immediately upon the filing of bankruptcy and advise him that you do not consent to such use unless he grants you adequate protection. Any agreement reached should be reduced to writing and approved by the bankruptcy court. Although the Bankruptcy Code specifically prohibits the use of cash collateral, most debtors will dip into money on hand to finance operations. Secured creditors must move quickly to minimize their risks.

Obtain Information

Creditors can have a substantial voice in the operation of the Chapter 11 if they take an active role. The creditors' committee can demand to be informed of every material decision made by the debtor-in-possession that affects its operations. It can demand more frequent and detailed financial accountings and meetings with the officers of the debtor to review the progress of the company. If the creditors are concerned about mismanagement, they can ask the court to limit the debtor's ability to operate his business, limit the amount of executive compensation to be paid, limit capital expenditures, or change the debtor's management.

Review Disclosure Statement

Many financial disclosure statements actually provide little financial information. If the debtor does not give sufficient financial information prior to filing a plan, creditors may object. In most instances, if your objections are reasonable, the court will order the debtor to amend his disclosure.

File Creditors' Plan

The debtor has the exclusive right to file the plan of arrangement within the first four months of bankruptcy. Once the exclusive period has run, whether or not the debtor has filed his plan, creditors have the right to develop and propose their own plan of arrangement. The creditors' plan may simply propose to liquidate all of the assets and pay the claims as allowed by the court. In some cases, that plan may be more reasonable than the debtor's plan to retain his assets and stay in business. Creditors should consider filing their own plan.

Vote No

Even if the creditors do not file their own plan, they need not accept the debtor's. If the creditors are convinced that the plan offers too little, they should consider contacting other creditors and soliciting their rejections of the proposed plan. The court has the right to approve the plan if the court determines that the creditors are receiving as much under the plan as they would receive if the debtor were liquidate under Chapter 7. In most cases, the court does not force acceptance of the plan, however, and the creditors' rejection of the debtor's plan will force him to offer a better deal.

When your account debtors file bankruptcy, you have the right and power to do more than simply write off your debt and take a bad debt deduction on your tax return. You have a number of options that may reduce your losses. Discuss these options with your attorney. Ignoring the case is not the answer.

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