

Prepare for Increased Commercial Bankruptcies

Jamilex Gotay, editorial associate

Bankruptcies are on the rise again, a trend tracing back to December of last year. Most notably for trade credit professionals, year-over-year commercial filings were up 24%. Chapter 11 cases (including Subchapter V) surged 79% compared to March 2022. Of the total commercial Chapter 11 filings, the 140 Subchapter V filings in March represented a 12% increase from the 125 filings in March 2022, per [Epig Bankruptcy](#). In order to maximize recovery for their company and minimize any additional risk exposure, trade creditors should consider the following tools:

#1 Sound Credit Procedures

Creating and following sound, written credit procedures is essential in mitigating losses. This entails keeping the credit application in the customer file, along with all documentation used to assess the creditworthiness of the customer. The credit application should also be signed by a party authorized to obligate the customer.

#2 Use a Formal Bankruptcy Checklist

When notified a customer has filed for bankruptcy, use a formal checklist to assure all information about the bankruptcy is captured, necessary documents are retained and steps are taken to comply with the automatic stay that is granted the debtor at the time of filing. You also want to check whether or not you have any open contracts with that customer that might be subject to assumption or rejection.

#3 Recover Undelivered Shipments

A creditor can intercept a shipment prior to the debtor taking physical control. Although this can be a verbal order, it is a good practice to also send the demand in writing to the carrier. The creditor will then be responsible for additional freight or transit charges.

#4 Recently Delivered Shipments

File an administrative expense claim for goods delivered to the debtor within 20 days of the date of filing. The value of shipments meeting these criteria can be carved out from the general unsecured claim and filed as an administrative claim. This section does not cover services performed, only goods delivered.

#5 Should You Continue Selling to a Customer that Is Operating Under Bankruptcy Protection?

When considering making additional sales to the customer, set up a Debtor in Possession (DIP) account separate from the prior account. DIP is a commercial decision as well as a potential legal obligation. Before doing so, it is important to do your due diligence as if they're a new customer. This will help you decide how much value there is for this customer and if it's worth the risk. If you are continuing to sell, the new transactions are now for the new legal entity, the Debtor in Possession. Just as with opening any new account, it is necessary to confirm the actual legal entity.

#6 Assumption of Contract

If there are elements of the contract that both the debtor and creditor have not performed, the courts may rule the contract to be an “executory contract.” The debtor must seek a court order allowing for assumption of an executory contract. This obligates both the creditor and the debtor to fulfill the remaining duties of contract, including payments and payment terms. If the courts approve the assumption of the contract, the debtor will be required to cure any default, including payment of invoices incurred prior to the bankruptcy filing (pre-petition debts).

#7 Critical Vendor Status

As a critical vendor, the creditor must continue to supply the debtor the goods at the same terms offered prior to the bankruptcy filing. In return, the debtor is obligated to pay all invoices, pre-petition and post-petition, at the original terms. In the event the debtor does not pay for new shipments, that portion of the creditor’s claim is considered an administrative claim and receives a higher treatment than general unsecured claims.

#8 Filing a Proof of Claim

Although, it may not be necessary to file a Proof of Claim, it is a good practice to do so. By filing a proof of claim, even if the amounts on the debtor’s schedules match your records, it puts the courts on notice of the exact amount of your claim in the event the debtor amends their schedules.

#9 Absolute Priority Rule

The bankruptcy code segregates all creditor claims into separate classes, by order in which they will be paid, called the Absolute Priority Rule. Administrative claims are paid first, followed by the wages and employee claims, taxes, secured debt, unsecured debt, then equity. Claims of vendors and trade creditors are often last in line as general unsecured creditors. Each class must be settled in full before payments can be made to a lower class of debt.

#10 Selling a Claim

Creditors may be able to sell their claim to funding and investment firms acting as a Trade Claim Buyer for immediate payment. “The sellers of bankruptcy claims can be either: (i) creditors that have extended unsecured credit to the debtor company (most commonly trade suppliers of materials or services); or (ii) secured creditors (most commonly financial institutions) that have obtained collateral to secure an advance of credit to the debtor,” reads an article from FindLaw. Once the bankruptcy is paid out, the money will go to the claim buyer instead of the creditor.

#11 Preferences

Make sure to review all recent financial records of the debtor within the 90 days prior to the bankruptcy filing for any indication the debtor asserted they were solvent. Analyze the customer payment behavior for any potential exposure to a preference claim. If the details of the alleged transfers are not included with the initial demand, ask for a list with details of the invoices intended to be paid with the transfer and dates. Confirm the details against the books and records of your company.