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You are working in your office one day when you receive the news that one of your customers has filed bankruptcy. Although you knew that this customer was having some financial difficulties, you had received assurances that these problems were short-term in nature and were being addressed.

What does the bankruptcy filing mean to you? The answer depends largely upon the nature of your business relationship with the customer, whether you have any collateral for the obligation, the type of bankruptcy, how the customer proposes to repay you, if at all, and whether you have received any recent payments from the customer. While this article cannot address all of the matters that may arise upon a bankruptcy filing, it will highlight a few important aspects of bankruptcy of which you need to be aware.

CEASE ALL COLLECTION ACTIVITIES —THE AUTOMATIC STAY

The first thing to remember is not to take any action to collect the obligation from the debtor or his property, including a simple demand for payment. When a bankruptcy is filed, a stay is immediately imposed by law prohibiting creditors from taking action to collect the debt from the debtor or his property. No action by the debtor or the Court is required to commence the stay. It is automatic and remains in effect until lifted by the Bankruptcy Court or else expires by law.

Persons who wilfully violate the bankruptcy stay can be heavily fined by the Court. The stay does not, however, protect non-bankrupt co-debtors or guarantors, except for certain situations in Chapter 13 or Chapter 12 cases. A creditor may file a motion seeking an order lifting the stay to permit certain actions to proceed in another court, typically for the purpose of taking possession of or forcing the sale of collateral, such as a state court foreclosure action. The safest course is to not do anything to try to collect the debt without first consulting an attorney.

GETTING THE SHIPMENT BACK—RECLAMATION

If you recently shipped goods on account to a customer who files bankruptcy, you may have a right to reclaim the goods you shipped, but only if you act quickly. This right of reclamation is very limited and requires written demand for return of the goods within ten days of delivery, or within 20 days of delivery if the bankruptcy is filed within ten days after delivery.

FILING A PROOF OF CLAIM

Generally, a creditor should file a claim with the Bankruptcy Court to record its rights against the debtor and ensure that it will be included in any plan of repayment. In most cases, a Proof of Claim form is attached to the Notice of Bankruptcy mailed to each creditor by the Clerk of Court.

In many straight liquidation Chapter 7 cases, claims do not have to be filed unless and until the trustee determines there are assets available for distribution to unsecured creditors. In certain limited situations, the creditor may not want to file a Proof of Claim, such as where the creditor

anticipates that it is likely to be sued by the bankruptcy trustee. The creditor in that situation should consult with a lawyer before making a final decision.

LETTERS FROM THE TRUSTEE DEMANDING REPAYMENT—PREFERENCES

Certain payments or transfers of property made to a creditor just prior to the bankruptcy filing may be set aside as a “preference” and recovered by the trustee for the benefit of the bankruptcy estate. The trustee may set aside payments or other transfers of the debtor's property made on account of an outstanding debt during the 90-day period immediately preceding the filing (or one year for transfers to “insiders”), while the debtor was insolvent, if the transfer allowed the creditor to receive a greater payment than it would otherwise receive in a Chapter 7 liquidation.

The creditor may have defenses to the preference action. If the payment was made by the debtor or received by the creditor in the ordinary course of business, and was made in accordance with ordinary business terms, the payment may not have to be returned. Also, if the payment was given as part of a substantially contemporaneous exchange of value, e.g., payment for goods shortly after delivery, the payment may be kept. Still other defenses may be available to the creditor, so you should consult with a lawyer upon receiving any demand for repayment from a trustee.

MOTIONS TO VALUE COLLATERAL

Secured creditors, that is, those creditors who have rights in collateral securing the obligations owed to them, are entitled to have their property rights protected in the bankruptcy proceeding. However, secured claims often are “valued” in bankruptcy, which reduces the amount of the secured creditor's lien to the current value of the property. In determining that value, the Court will consider the purpose of the valuation and the debtor's proposed use of the property.

For example, where the collateral is an automobile that the debtor proposes to keep, the value must be the “replacement cost” to the debtor. It is always important for the creditor to promptly respond to any motion seeking to value its collateral. Unless an objection to the valuation motion is timely filed, the motion may be granted without a hearing, and the creditor's lien rights will be reduced accordingly.

ENFORCEABILITY OF RIGHTS IN COLLATERAL

As stated above, a secured creditor is someone who has an interest in property—collateral—securing repayment of the debt. To be secured, the creditor must have properly “perfected” its security interest in the collateral. Typically, this involves the recordation of the security interest in a filing office specified by state law. If not properly perfected, the security interest will not be enforceable in the bankruptcy, and the debt will be lumped together with all other unsecured obligations.

These are only a few of the issues you may face when one of your customers files bankruptcy. What action you may need to take will depend on the particulars of your case. Valuable rights can be lost in the bankruptcy if you do not give appropriate attention to the details of the process, as well as your business practices, in anticipation of a customer actually filing bankruptcy in the future.