



# **POST-BANKRUPTCY RIGHTS & REMEDIES AVAILABLE TO TRADE CREDITORS**

Matthew J. Botica  
Winston & Strawn LLP  
June 21, 2006

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# I. Claims and Interests



# I. Claims and Interests

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- Recognize the difference between pre-petition and post-petition claims.
  - In a Chapter 11, costs of operation are usually paid in full. Barring an exception, however, pre-petition claims must wait until plan confirmation before they are paid (if at all).
  - Do Not Miss a Bar Date. Timely file all Proofs of Claim for all pre-petition obligations owed by the Debtor.
  - Implications of a pre-petition claim: no interest, may be discharged for little or no consideration. See 11 U.S.C. §§ 502, 1129(a), (b).
  - Implication for administrative claim: payable in full, in cash (unless the case becomes insolvent).



# I. Claims and Interests

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## A. New Code Provision: Section 503(b)(9) Administrative Claim

- Adopted as one of the new Bankruptcy Code provisions as part of BAPCA (11 U.S.C. § 503(b)(9)).
- Provides automatic administrative claim status to creditors for value of goods received by Debtor in the ordinary course of business within the 20 days prior to the commencement of the case.
- Statute does not specify the timing of payment on the claim, but it is left to the court's discretion. In re HQ Global Holdings, Inc., 282 B.R. 169, 173 (Bankr.D.Del. 2002). Generally, the default rule is that payments are made at plan confirmation (subject to ability to pay all administrative claims in full).



# I. Claims and Interests

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- Section 503(b)(9) Administrative Claim – (continued)
  - Recent trend: Debtor sets aside a certain amount of funds to be used for the payment of section 503(b)(9) administrative claims.





# I. Claims and Interests

## C. Enhanced Federal Reclamation Right

- New bankruptcy amendments provide enhanced reclamation rights for goods delivered within 45 days prior to bankruptcy – a substantial improvement over the ten day reclamation rights recognized under the UCC and the prior Code.
- Vendor may reclaim any goods sold on credit for a 45-day period before bankruptcy, so long as written notice is provided to the buyer within 45 days of receipt of the goods or within twenty days of the bankruptcy filing. 11 U.S.C. § 546(c)(1).
- However, enhanced reclamation rights do not trump the rights of a secured creditor, hence the right to reclaim under the 45-day rule is most valuable if there are no creditors holding a security interest in the debtor's inventory.



# I. Claims and Interests

## D. Setoff and Recoupment

### 1. Setoff

- Bankruptcy Code preserves whatever rights a party has to offset pre-petition mutual claims and debts under applicable non-bankruptcy law. 11 U.S.C. § 553. Accordingly, where a right to setoff exists, the Code allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding the inequity of making A pay B when B also owes A.
- Generally, setoff will be found where four conditions exist:
  - the creditor holds a “claim” against the debtor that arose before the commencement of the case;
  - the creditor owes a “debt” to the debtor that also arose before the commencement of the case;
  - the claim and debt are “mutual”; and
  - the claim and debt are each valid and enforceable.
- See, 5 Collier on Bankruptcy § 553.01[1] (15th ed. rev. 2003).
- Before exercising a right of setoff, it is necessary to first obtain relief from the automatic stay.





# I. Claims and Interests

## 2. Recoupment

- Not defined in the Code but generally recognized by courts as determined by non-bankruptcy law.
- Recoupment allows a party to reduce an obligation otherwise payable to a bankrupt entity by the amount of a claim against the estate, as long as the obligation and claim *arose out of the same transaction*.
- Recoupment can be a more attractive option than setoff for two reasons: (1) unlike setoff, the automatic stay does not apply to recoupment, therefore, making it is unnecessary to lift the stay before exercising a right of recoupment; and (2) also unlike setoff, there is no four-part test that must be met before recoupment may be applied.





## II. Protecting Your Rights



# II. Protecting Your Rights

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## A. Squeaky Wheel Theory

- Do you have a working relationship with someone inside the bankrupt company?
- If so, getting claims issues resolved between the “business people” is an effective tool. With the cooperation of the Debtor, the claims process may be expedited.
- Benefit = knowing “where you stand” in the bankruptcy case can be a short phone call away.



# II. Protecting Your Rights

## B. Qualifying as an “Essential Supplier” f/k/a Critical Vendor

### 1. Essential Supplier Defined

- Once a company files for bankruptcy, it is generally prohibited from making payments on account of outstanding pre-petition debt, except as provided by section 507 of the Code.
- An Essential Supplier Order varies the traditional priority scheme to authorize (but not obligate) a Debtor to pay immediately, in whole or in part, certain designated “essential suppliers.”
- The rationale behind Essential Supplier Orders is that an essential supplier payment actually benefits the general creditors by preserving the Debtor's going concern value - thereby increasing the amount of the ultimate payout to all unsecured creditors.



# II. Protecting Your Rights

## 2. Recent Decision on Essential Supplier Orders

- In *In re Tropical Sportswear Int'l Corp.*, a Florida bankruptcy court approved an order authorizing payments to “essential suppliers / critical vendors” for pre-petition debts. 320 B.R. 15 (Bankr.M.D.Fla. 2005).
  - Significant because it is one of the first reported decisions to authorize pre-petition “essential supplier” payments to unsecured claimants since the Seventh Circuit in *In re Kmart Corp.* severely limited a bankruptcy court’s ability to approve such payments.
  - While in the *Kmart* decision the Seventh Circuit did not decide whether a debtor could, in appropriate circumstances, make payments of pre-petition debts under section 363(b) of the Code, the court in *Tropical Sportswear* held that a bankruptcy court may authorize payments to critical vendors under sections 105(a) and 363 of the Code under appropriate circumstances.
- While the Seventh Circuit’s decision in *Kmart* was not binding on the court in *Tropical Sportswear*, the court was guided by *Kmart* and acknowledged that payments to essential suppliers should be exercised only in certain circumstances.
- The “reach” of the essential supplier doctrine will depend upon the jurisdiction in which the bankruptcy case is filed.
- Some debtors have sought approval of essential supplier payment under Section 354 (post petition financing)



# II. Protecting Your Rights

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## C. Debtor-in-Possession (“DIP”) Financing

### 1. Procedure

- **First day order to approve DIP interim financing:**
  - What is being secured? Causes of action? Your collateral?
  - Is the pre-petition debt being “rolled-up” into the DIP? The debt must be paid on exit.
- **Final hearing on DIP financing**
  - After formation of Official Committee of Unsecured Creditors.
- **Alternative financing**
  - Sale/lease-back of underleveraged assets?





# II. Protecting Your Rights

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## 2. The Creditors' View

- **During the customer's Chapter 11 case:**
  - Object to cash collateral or DIP financing orders that appear unworkable.
    - Recognize proclivity of Bankruptcy Court to favor Debtors.
    - Constituency momentum can be difficult to overcome.
  - Perform an independent assessment of the forecast and the underlying volume assumptions. Whose production forecast are they using?
  - Monitor performance to the plan and other milestones in the case.



# II. Protecting Your Rights

## 2. The Creditors' View

- **During the customer's Chapter 11 case: *(continued)***
  - Avoid an administratively insolvent case. You will lose more than your pre-petition claim.
    - Administrative claims are still junior to secured and other DIP financing claims.
    - DIP financing should help to provide comfort to vendors that sufficient liquidity exists to warrant continued shipment. If it does not, there is something amiss
    - Committee membership will help to ensure that you get access to critical DIP compliance information and usage.
  - Look for new business opportunities as the customer restructures.





## III. The Plan Process



# III. The Plan Process

## A. Plan Negotiation

- Negotiation and implementation of a Plan of Reorganization (“POR”) is central purpose and goal of all Chapter 11 reorganization cases.
  - Recognize collateral/under-secured position of creditors.
  - Plan will substitute its obligations for any and all others of Debtor.
  - Recognize cost of prosecuting levels of priority versus paying for cooperation.
  - Recognize confirmability of POR.
  - Highest likelihood of successfully attaining required support and succeeding after effective date.
  - Bankruptcy Code imposes many requirements in order to confirm a plan.



# III. The Plan Process

## B. Key Plan Confirmation Requirements

- Significant advantage early on – only Debtors may propose and seek votes on a POR for the first 180 days of the case (called “Exclusivity”). Recent Amendments limits exclusivity and vote solicitation to 18 and 20 months, respectively, 11 U.S.C. §§1121
- Bankruptcy Code sets many hurdles for Debtors seeking plan confirmation. See 11 U.S.C. §§ 1123, 1129(a), (b). Some of the more central requirements include:
  - All administrative claims must be paid in full and in cash (unless otherwise agreed). Implications for DIP lenders.
  - Every creditor has either voted to accept the plan or would receive under the plan at least as much as the would get in a Chapter 7 liquidation case (called “Best Interests Test”).
  - Plan is not likely to be followed by another bankruptcy filing (called “Feasibility Test”).



# III. The Plan Process

## Requirements include: *(continued)*

- Every creditor class has voted to accept the plan:
  - Similar claims are usually classified together.
  - Code requires for a class of claims that: (i) two-thirds in dollar amount, and (ii) 50% + 1 of the creditors voting in that class vote to accept the plan (a quorum from those voting only).
  - If equity is allowed to vote, acceptance is from two-thirds of those voting to approve the plan.
- Plan Cramdown. If every class does not accept, the Debtors may still confirm the plan and make it binding on all creditors if they can demonstrate to the court that the plan is “fair and equitable” and that no junior class of creditors will receive a recovery until the senior, objecting class is paid in full.
- Binding Effect. Once plan is confirmed, its terms will be binding on all creditors – even those who voted against the plan. Stay Alert!





# III. The Plan Process

## C. Post-Confirmation Recovery Actions

- **Creation of Litigation Trust Fund**. Often, a litigation trust fund is created as part of the plan for the purposes of litigating and collecting on causes of action. The proceeds of this fund are often the major part of the recovery to unsecured creditors.
- **Preferences**. The most common bankruptcy recovery action is the avoidable preference (see 11 U.S.C. § 547). Generally, payments of debts received by non-insiders from the Debtor within the 90 days prior to the bankruptcy filing are subject to being recovered as a “preference,” unless a valid defense can be asserted.
  - **Exception**: cash-in-advance payments are never subject to preference attack.



# III. The Plan Process

## New Bankruptcy Code amendments are more favorable to creditors.

- **De Minimis Exception**. Where the Debtor's debts are not primarily consumer debts, if the aggregate value of the transfer is less than \$5,000, it is not susceptible to preference exposure. 11 U.S.C. 547(c)(9).
- **"New and Improved" Ordinary Course of Business Defense**. In order to prove the defense, need to show only 2 of the 3 former factors:
  1. The debt was incurred in the ordinary course of business of the Debtor and the creditor (*usually an unchallenged element*); and
  2. That either: (i) the payment was made within the ordinary course of dealing between the parties, as reflected in the payment history of the parties, **OR** (ii) the payment was made according to terms common in the industry.



# III. The Plan Process

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## Remaining Common Defenses to a Preference Action:

- Contemporaneous exchange for new value, which covers C.O.D. and over-the-counter transactions, for example. 11 U.S.C. § 547(c)(1).
- Subsequent new value, which is asserted when after a payment is received from a Debtor, the creditor ships more product to the Debtor for which the creditor was not paid. 11 U.S.C. § 547(c)(4).





# Questions?

Matthew J. Botica  
Winston & Strawn LLP  
312-558-8095  
[Mbotica@winston.com](mailto:Mbotica@winston.com)

