Client Alert: Getting Paid in Bankruptcy – Part II, Goods and Services

BY CESIRA NEWCOMB • AUGUST 27, 2020

In this series, we look at how various payment rights are treated in bankruptcy. A summary like this could not possibly address every right that might arise in any given bankruptcy case. We have omitted several of the Bankruptcy Code's more esoteric legal protections and exceptions that arise in specific kinds of bankruptcy cases. When bankruptcy strikes, creditors should always consult a bankruptcy lawyer to understand what actions they need to take to preserve their rights and maximize their recovery.

THE BASIC CONCEPT OF A "CLAIM"

The Bankruptcy Code defines a "claim" to include any right to payment against the bankrupt entity (called the "Debtor"), regardless of whether the claim is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured. It's a broad definition.

Claims break down into four basic categories: (1) secured claims; (2) administrative expense claims; (3) priority claims; and (4) general unsecured claims.

It is no surprise that in bankruptcy there is seldom enough money to pay every creditor in full. Order of priority, therefore, is critical. Imagine the creditors forming a line: secured claims, followed by administrative expense claims, priority claims, and general unsecured claims. Equity claims – the owners' stake in the Debtor – are technically at the end of this line, but since the estate is often insolvent, they usually do not receive any payment at all.

Outside of bankruptcy, the creditor probably thinks about the money that the Debtor owes as a single debt. As we shall see, however, the Bankruptcy Code's payment hierarchy can slice and dice this debt into several tranches according to what portions of the debt qualify as administrative expense, priority, or general unsecured claims. Creditors need to think about the money they are owed according to these claims, which can differ in value significantly. A $100,000 administrative expense claim could be worth far more in real dollars than an $1 million general unsecured claim, for example, and consequently worth investing more resources pursuing.

Secured claims are secured by a lien on the Debtor's real or personal property (called "collateral"), and the creditor may, under certain conditions, levy and sell collateral in satisfaction of its claim. The perfection and priority of liens is determined by non-bankruptcy law (usually Article 9 of the Uniform Commercial Code and real property law). A secured claim is really just one of the other kinds of claims *plus* collateral. Once the collateral is liquidated and applied to the debt, any remaining debt will be treated as an administrative expense, priority, or general unsecured claim.

Creditors assert priority and general unsecured claims by filing a short and simple form with the bankruptcy court called a proof of claim. This can be done for little cost. If no one objects to the proof of claim, the claim is allowed.

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Administrative expense claims require a more extensive application filed through counsel. The bankruptcy court must approve the application before an administrative expense claim is allowed.

In a successful reorganization, administrative expense claims and priority claims are paid in full, while general unsecured claims can receive as little as nothing or as much as 100% plus accrued interest if the estate ends up being solvent. In most cases, the dividend on general unsecured claims is very small.

If the creditor owes the Debtor property (including money), it cannot receive payment until it has turned such property over to the Debtor. This allows the Debtor to net out liabilities with its creditors as part of the claim administration process.

CLAIMS FOR THE SUPPLY OF GOODS AND SERVICES TO THE DEBTOR

Suppliers (or "trade creditors") typically provide goods and services to the Debtor on credit (i.e., payment is due X days after goods are delivered). The bankruptcy filing divides the Debtor's payment obligations into pre-petition and post-petition obligations. With limited exceptions, pre-petition obligations are treated as general unsecured claims and post-petition obligations are treated as administrative expense claims. If the Debtor is operating under a court approved budget, which includes paying that creditor, then payment for post-petition goods and services will typically happen under the parties' usual business terms.

With limited exceptions, a trade creditor who owes a debt to the Debtor may set that debt off against its claim. This effectively gives the creditor a secured claim up to the amount of the debt it owes the Debtor. "Payment" of this secured claim, however, merely reduces or eliminates an in kind debt obligation.

1. Payment for the Supply of Goods

A trade creditor will have an administrative expense claim for the value of goods that the Debtor *receives* within 20 days before the bankruptcy filing. This does not apply to services. If the trade creditor provides both goods and services as part of its contractual performance, the court will probably limit the administrative expense claim to the value of the goods, and the services portion will be classified as a general unsecured claim (this is an open question, with some courts applying a "predominant purpose" test to determine whether the contract is for goods or services). This administrative expense claim only arises if the Debtor "receives" the goods. Several cases say that the creditor *does not* get an administrative expense claim, if it drop-shipped the goods directly to the Debtor's customer. Finally, there are several bankruptcy court opinions deciding that natural gas and electricity are "goods" and, therefore, the utility provider is entitled to an administrative expense claim for the value of such goods delivered within 20 days of the bankruptcy.

Other than goods received by the Debtor within 20 days of the bankruptcy, the trade creditor's claim for goods and services supplied pre-petition is treated as a general unsecured claim. Some courts in limited circumstances will permit a Debtor to invoke the "doctrine of necessity" to pay the outstanding invoices of certain trade creditors whose relationships are deemed "critical" to the Debtor's business. This relief is controversial because it effectively elevates certain creditors over others.

Trade creditors might exercise their right under the Uniform Commercial Code to "reclaim" goods delivered to an insolvent Debtor. To do so, they must make a written demand identifying the goods they wish to reclaim no later than 45 days after the Debtor receives the goods or 20 days after the bankruptcy filing if the 45-day period expires after the filing. But this remedy has limits: the trade creditor's reclamation claim is subordinate to a secured creditor's prior perfected lien on the same goods. In many cases, the presence of a first-priority lender with a "floating lien" on inventory whose outstanding debt exceeds the value of the goods will render the trade creditor's reclamation claim

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valueless.

2. Payment for the Supply of Services

Like vendors who supply goods, persons who provide services to the Debtor are entitled to an administrative expense claim for the value of their services rendered post-petition. Payment for services rendered prior to bankruptcy, however, is treated as a general unsecured claim, with limited exceptions discussed below.

If you are under contract with the Debtor (including an employment agreement), the Debtor may assume or reject that agreement prior to the conclusion of the bankruptcy case. While you will have an administrative expense claim for services rendered post-filing, any liquidated damages arising from contract rejection will be treated as a general unsecured claim. Typically, the Debtor will wait until the end of the case to decide whether to assume or reject a services contract. Because such contracts are personal, the Debtor is not able to assign a services contract without the service provider's consent. This may provide leverage to C-Suite executives and other critical employees with employment agreements if the Debtor proposes a going-concern sale of its business during the bankruptcy.

If you are employed by the Debtor, you are entitled to a priority claim for pre-petition wages, commissions, vacation, severance, and sick leave earned within 6 months of the filing date, up to a capped amount of $13,650 per employee. To the extent there are funds remaining under the cap after paying the forgoing, employees have an additional priority claim for contributions to benefit plans. Although a Debtor does not have to pay priority claims until a plan is confirmed, the Debtor will typically seek court approval to pay employee wages immediately and pay other benefits (including vacation, severance and sick leave) as they are incurred in the ordinary course of business as a necessary expense of maintaining its workforce.

If you are a "critical" employee, the Debtor might seek court approval of a "key employee retention plan (KERPs)" or "key employee incentive plan (KEIPs)." The Bankruptcy Code imposes several restrictions on KERPs to avoid excessive transfers to C-Suite executives that provide no tangible benefit to the estate. KEIPs must be structured as an exchange for value: the employee must meet performance goals such as helping the Debtor successfully reorganize or meet sales targets.

3. Special Protections for Certain Suppliers

Trade creditors who supplied fresh (and frozen) fruit and vegetables to the Debtor, might have a claim under the Perishable Agricultural Commodities Act ("PACA"). PACA is a federal law that says that a Debtor who receives proceeds from the sale of any perishable agricultural commodity holds such funds in trust for the benefit of an unpaid supplier (essentially anyone in the supply chain). PACA claims are incredibly powerful in bankruptcy because the claimant's rights to the Debtor's cash are superior even to a secured lender with a first-priority lien. Suppliers of beef and poultry can make similar trust claims under the Packers and Stockyards Act in the bankruptcy of a meat packer or live poultry dealer.

Persons who supply grain or fish to Debtors who own storage or processing facilities for those commodities have a priority claim of up to $6,725 worth of grain or fish product. The Bankruptcy Code has special procedures for the expedited determination of interests in, and abandonment or other disposition of grain assets.

Utility providers are prohibited from discontinuing service to the Debtor simply because it has filed for bankruptcy. The utility is entitled to adequate assurance of payment, however, which the Debtor must deliver in the form of a cash deposit or other liquid securities. If the Debtor fails to provide this assurance, the utility may cut off service. Older bankruptcy court opinions hold that cable and internet providers are not utilities entitled to this protection because

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they do not provide services that are necessary for a minimum standard of living. Opinions may differ in the future.

Read Part 1: Lender Claims, Part 3: Landlords, Leases, and Licenses, and Part 4: Employees.

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