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Considerations for Dealing with Entities That may File for Bankruptcy (Part 1)

April 17, 2020 - COVID-19 has disrupted businesses and supply chains in nearly every industry. A wave of new bankruptcy filings is expected to follow in the wake of this crisis. During these precarious times, pre-bankruptcy planning is not just for businesses that are themselves facing financial issues. All businesses should be preparing now to protect themselves against the future insolvency of financially distressed customers, suppliers, and other counterparties.

From a creditor's perspective, bankruptcy can in many ways seem like the anti-law. Doing right by your customers and working with them through periods of financial uncertainty might seem like a moral and prudent business decision, but it may increase exposure in the event that a customer fails and a bankruptcy trustee, liquidating agent, or creditors' committee scrutinizes those transactions with an aim toward recouping money to distribute to other creditors.

The United States Bankruptcy Code permits a debtor to recover payments that it made to creditors within 90 days of the bankruptcy filing. These payments are called preferences. The underlying theory is that a debtor should not be able to "prefer" some of its creditors over others whose claims are entitled to equal priority by paying those creditors that it likes on the eve of bankruptcy and leaving other creditors holding unsecured claims that will not receive full payment. Creditors faced with preference actions typically raise one or both of the following defenses. First, a creditor that received payments in the ordinary course of business—i.e., payments that are in line with the parties' past business practices or are within the outer bounds of industry norms—may rebut the presumption that the payment was preferential. Second, a creditor that gives "new value" to the debtor by providing goods or services on credit is entitled to a dollar-for-dollar offset against any preferential payments that it received.

Making accommodations for a financially distressed customer by, for example, stretching out payment terms may have adverse implications if that customer files bankruptcy in the near future because later-than-usual payments received shortly before a bankruptcy filing may be deemed outside the ordinary course of business. Similarly, while continuing to extend credit to financially distressed customers may reduce preference risk, if not done carefully it may increase a business's overall exposure in a bankruptcy.

None of us can predict the financial harm that the COVID-19 crisis ultimately will inflict. But businesses are able to implement preventative measures to mitigate those risks. Establishing appropriate controls for managing open receivables and timely reporting qualifying claims to credit insurance carriers are important steps that should be taken now to best position your business in the event that it becomes a creditor in a customer's or vendor's bankruptcy proceeding down the road.

Our bankruptcy team members are available to offer advice and answer any questions you may have.

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