What Not to Believe About Chapter 11

By: Kenneth A. Rosen, Esq., Lowenstein Sandler LLP

"Don't worry about extending credit to the debtor during Chapter 11. You'll have an administrative claim."

True but not fully. Claims that arise during the bankruptcy case from goods or service received by the debtor during bankruptcy have an administrative claim. But it is the rule that a lender to the debtor will require a super priority administrative claim as a condition to making loans to the debtor (called "DIP" loans). This means that, if the bank is not paid in full from its collateral, the bank's administrative claim is senior to other administrative claims, such as those of a vendor.

Professionals retained in the case typically have a "carve out" so that their administrative claims become senior, even to those of the bank, so the super priority administrative claim given to the bank will affect professionals less. Further, professionals are paid on a monthly basis, typically 80% of their invoice amount with the balance of 20% paid every 120 days. And even when a debtor is struggling with cash flow issues, professionals seem to get paid anyway. Finally, recognize that there is never a guarantee that administrative claims are paid. There have been many cases where the debtor's estate becomes administratively insolvent. Two that come to mind are the retailers Toys R Us and Sears. It happens more often than is commonly known.

"You should now give the debtor credit because our banks have agreed to give us DIP funding."

DIP financing does not necessarily give a debtor materially more liquidity. It may be that the debtor has simply asked its lender to continue the same financing arrangements during bankruptcy that it had before bankruptcy. Advance rates may not have changed. The credit limit may not have changed. This is often referred to as "rolling over" the loan. DIP financing is more expensive than out-of-court financing. Besides a higher interest rate, there may be facility fees, maintenance fees, exit fees and default fees. Finally, even if the debtor obtained an over advance, it may be consumed to cover increased losses until the business is stabilized, increase professional fees due to the bankruptcy, or in order to give the debtor a brief opportunity to sell the business. Significant dollars do not necessarily trickle down for the purchase of goods and services.

"We're offering you critical vendor status. So, now you won't have a pre-bankruptcy claim anymore."

Yes, that is true. But a condition to critical vendor status is that you give the debtor post-petition credit (after the bankruptcy petition date) equal to the amount of the prepetition debt that was paid off. As a result, the vendor's total liability does not decline, it just becomes all administrative indebtedness. However, as stated above, there are no guarantees that administrative claims are fully paid, and critical vendor agreements usually require that a vendor provide credit terms the same as those given to the debtor in the ordinary course pre-bankruptcy. But what does "ordinary course" mean? Many debtors pay their bills in a number of days that are greater than what is stated in the invoice. Is ordinary course being interpreted by the debtor as invoice terms or as the terms that were allowed by the vendor pre-bankruptcy? It can make a big difference in terms of risk management.

A smart vendor will agree to no more than a finite amount of post-petition credit and a finite number of days for payment with the proviso that the vendor may alter terms on a rolling basis as the case unfolds. A lot can happen during the course of a Chapter 11 case. The debtor could struggle to find a purchaser of its business. It may encounter an especially hostile creditors committee. Litigation may be dragged out such that emergence from Chapter 11 becomes exceedingly difficult and/or excessively costly. And in the worst case, the debtor defaults to its lender. A smart vendor does not want to be locked into post-petition

credit terms without an “out” in the event of a material adverse change.

“The debtor can’t modify the terms of the critical vendor agreement just for you.”

This is just an excuse to not have to go back and explain to the lender or to management why the vendor’s terms for becoming critical will not work. Remember – if you have been offered critical vendor status it is because you are a *critical* vendor. In other words, the reorganization will become more difficult without the goods or services that you supply. Think about what difficulties it will cause the debtor if you say that you prefer not to sell to them on their terms. Can they easily purchase the goods or services that you provide from another vendor? Would doing so take precious time or will it delay production? If so, then the vendor should consider telling the debtor that the vendor’s counter proposal is the best that the vendor can do and that it is their burden to convince others that the vendor’s terms and conditions are worth it to the debtor because the alternative is much worse.

“The debtor budget presented to the court looks reasonable.”

It might be. But remember that it is only a cash flow budget. It is not a projection of accrued income or loss. A cash budget is easier to “manage” as is necessary to prevent a default, and the budget is usually short term. The budget contains numerous assumptions, such as the amount of post-petition credit that the debtor will be able to get. Assumptions as to sales do not always pan out. For example, many debtors will assert that they will not lose sales despite the commencement of a Chapter 11 case. But they quickly learn that, despite the debtor’s assurances, customers are wary of not having the debtor’s product at a critical time, so the customer will immediately seek to second source. Finally, a cash flow budget does not reveal the rate of inflow of new orders or the rate of decline of back orders.

“The bank is fully supportive of our reorganization.”

Really? Banks have only one interest in mind – getting themselves paid. Requiring a Chapter 11 debtor to obtain as much post-petition credit from its vendors is part of their strategy. After all, the goods sold by a vendor on credit instantly become part of the lender’s collateral upon delivery. Banks will demand that it have a security interest in any assets of the debtor that were not part of their collateral package before bankruptcy. This ensures that before other creditors see any recovery, the bank must be fully paid.

“Why don’t I want to join the creditors committee? I’m very busy already and there isn’t much to gain.”

Because you might have preference exposure. A preference is a pre-petition payment to the vendor during the 90 days preceding bankruptcy where the payment was on account of an antecedent debt. An antecedent debt is one that was past due at the time of payment. There are several exceptions to the preference statute, such as the new value defense or the ordinary course defense. The first thing that a creditor should do upon a customer commencing a bankruptcy case is to do a rough preference analysis. If there is significant exposure, then the vendor could consider creditors committee membership. The goal is to help prevent the lender from obtaining preferences as part of its collateral package and also to have preference actions waived under a plan of reorganization. It’s very painful to give back dollars that were collected pre-bankruptcy. Do not rely on other committee members – they may have less exposure when the dollars legitimately were owed to the vendor and where the collection was due to the vendor’s diligence. A creditors committee has a big voice in the Chapter 11 process and gets the attention of the bankruptcy judge. At every stage of the case, the committee should consider when it could extract such a concession, and it starts with blocking the bank from capturing preference actions. Finally, in a Chapter 11 case where the business and/or assets are sold to a third party, neither the bank, asset purchaser nor the debtor may care about helping pre-existing vendors avoid preference attack. In addition, the case professionals may need the money derived from preferences to pay administrative claims, such as their own fees.

About the Author

Kenneth A. Rosen, Esq - Lowenstein Sandler Chair Emeritus, Bankruptcy & Restructuring Department with more than 35 years of proven experience, Ken is the first call for companies seeking a strategic plan for recovery from financial distress.