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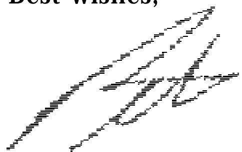
Dear Friends:

In our last feature, we answered the question, "How can I hold on to payments received from a debtor during the "preference period" prior to the debtor's filing for bankruptcy?" What if, however, the debtor has filed for bankruptcy and you have the opportunity to continue the business relationship? Must you? And if not, do you want to? This issue's feature will address some important considerations about doing post-petition business with a bankrupt debtor.

On our busy spring calendar is the Global Debt Collection Summit, sponsored by the Columbia Law List and the Strategic Research Institute on May 4-6 in Atlanta. As a featured speaker at the event, I have the honor of addressing an audience of more than 700 attorneys on the nuances of media collection, the history of liability, and the conflicting liability positions that continue to plague our industry. We will also attend the Broadcast Cable Financial Management Association convention in New Orleans, Louisiana on May 15-17, and the International Newspaper Financial Executives convention in Orlando, Florida on June 17-19.

Have a glorious spring season!

Best wishes,



Pete Szabo, President
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Executory Contracts, Critical Vendors, Administrative Expense ...

Bankruptcy Considerations You Cannot Afford to Miss!

Szabo Associates would like to thank Mark T. Power for his generous contribution to this article. A partner with the law firm of Hahn & Hessen LLP in New York City, Mr. Power represents a variety of clients in all aspects of bankruptcy/insolvency law.

Every credit manager, at one time or another, must navigate through the choppy waters of business bankruptcy. You will, at some time or another, have to answer the questions, "Must I do business with this bankrupt debtor?" "And if I don't have to, do I want to anyway?"

To answer these questions to your company's best benefit, it is necessary to have a clear understanding of three bankruptcy considerations that may come into play: executory contracts, critical vendor status, and administrative expense priority.

Executory Contracts

If you do not have an existing contract with a bankrupt debtor, there is absolutely no legal requirement for you to enter into a new one. Once the obligations of a contract have been met, you have the right to discontinue doing business with the debtor. If, however, you and the debtor have a contract in which material obligations on both sides have yet to be met, you may be required by law to continue the relationship.

The Bankruptcy Code allows a debtor in bankruptcy to decide what it wants to do with "executory contracts"—contracts with remaining performance requirements from both parties. The debtor has three choices—to "reject," to "assume," or to "assume and assign" the contract. The choice is subject to court approval. In a Chapter 7 bankruptcy, the debtor (or trustee) must assume the executory contract within 60 days of the filing date. If it is not assumed within this time frame, rejection is automatic. In a Chapter 11 case, there is no specified time limit for either assumption or rejection. Absent a bankruptcy court order, the debtor is not required to make the decision until the plan of reorganization is filed.

The debtor will usually choose to reject contracts that it deems unprofitable. Although the debtor has the right to reject an executory contract, such rejection nevertheless constitutes a breach of contract, which then allows the creditor to file a pre-petition claim for damages. Unfortunately, as we all know, pre-petition unsecured claims often bring a small percentage payout, if any payout at all. For that reason, it is often better for a creditor if the debtor assumes the contract, particularly if the pre-petition debt is substantial, unless the debtor clearly is unable to perform.

The debtor usually chooses to "assume" contracts that it deems profitable or beneficial to the bankruptcy estate. In doing so, however, the debtor must "cure all

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default," including pre-petition invoices, and provide adequate assurance of future performance. "Adequate" does not mean "absolute." Agreeing to employ reasonable business practices generally constitutes adequate assurance; however, it may include security or even cash in advance. If the creditor and debtor fail to agree, the court will decide what constitutes "adequate assurance."

The debtor may also "assume and assign" many types of executory contracts, forcing the creditor to continue doing business with someone else. Even if a contract states that it is a breach of contract to file bankruptcy or become insolvent, the Code overrides these contractual provisions and allows assignment.

Creditors may understandably feel uncomfortable when a debtor assumes and assigns their contract to another party not of the creditor's choosing. The good news, however, is that you enjoy the same benefits that you would receive had the debtor simply assumed the contract. You receive preferred status over most other creditors. Pre-petition debt must be paid in full. Reasonable attorneys' fees must also be paid if the contract so stipulates. The debtor (typically through the assumption of its obligations under the contract by the assignee) must provide adequate assurance of future performance prior to assuming and assigning. Additionally, any payment you receive from the debtor within the 90-day preference period prior to the bankruptcy filing does not have to be returned as a preference payment since the debtor must pay this debt in order to "cure all default."

As relatively simple as these three choices seem, however, they are not always so. Let us assume, for example, that you have a contract with a Chapter 11 debtor. The debtor owes your company $5,000 for pre-petition invoices. Additionally, your media property continued to run the debtor's advertising—an additional $2,000 worth—for 30 days post-petition, after which time the debtor rejected your contract.

In this case, you, the creditor, can file for a $5,000 pre-petition claim. Because the contract was ultimately rejected and not assumed, the debtor is under no obligation to "cure the default" to continue the contract. The court may possibly treat the $2,000 amount for post-petition services as a contracted administrative expense and require the debtor to pay you this amount in order to get a reorganization plan approved.

So why might a debtor continue to accrue debt with a contract it ultimately rejects? Wouldn't it be better for the debtor to quickly reject a contract prior to incurring "administrative" debt that it may be obligated to pay in full? The answer is, "not necessarily." It is usually in the debtor's interest to reject an unprofitable executory contract early in the game. By dragging out the rejection process to the bitter end, however, the debtor may avoid having to "cure" the pre-petition debt, which is required only for continuation of the contract, while benefiting from your post-petition services!

Let us assume that a creditor's executory contract is not assumed or rejected by the debtor and the debtor continues, post-petition, to order services. Based on its continued poor performance, you, the creditor, have reason to believe that the debtor will fail to pay for post-petition services. Prior to the court's approval of the reorganization plan, is there anything you can do to protect yourself? To the extent the debtor is in default of its obligation to pay for post-petition services (as opposed to pre-petition services), you are entitled to treat the contract as if the debtor is in breach and refuse to perform.

A more difficult situation arises when the debtor is current on all post-petition obligations to you, but you do not want to continue to perform because you are nervous about the debtor's future. Practically speaking, most creditors would ask the debtor for cash in advance before rendering any post-petition services. But what do you do if the debtor refuses and threatens to sue you for breach unless you continue to fulfill your obligations under the contract? In that case, you would be well advised to quickly file a motion with the bankruptcy court seeking to compel the debtor to assume or reject the contract. If the contract is rejected, it is deemed a breach by the debtor and you do not have to perform. If the debtor assumes the contract, you would then be entitled to adequate assurance of future performance (i.e., the debtor must demonstrate to the court's satisfaction that it has the ability to pay for post-petition services).

Critical Vendor Status

To facilitate operation of a debtor's business in Chapter 11, a number of "First Day Orders" are issued at the beginning of the reorganization. During the past decade, "Critical Vendor Orders" have been commonly added to the list.

Critical vendors, simply defined, are those vendors or suppliers identified by the debtor as essential to its continued existence. Usually, the debtor (or trustee) urges the bankruptcy judge to approve payment of pre-petition claims of these vendors. In return, the vendor is expected to continue to sell services, post-petition, to the debtor under the same or better terms. Critical vendor status raises otherwise low-priority pre-petition unsecured claims to higher priority administrative claims.

Because the Bankruptcy Code did not explicitly create critical vendor status, standards for this court-created concept are uncertain. Its primary legal basis has been Section 105(a) of the Bankruptcy Code, which grants bankruptcy courts broad statutory authority to enforce the Code, as well as the "doctrine of necessity," which argues that it allows for reorganization and a greater recovery to remaining creditors than they would otherwise

receive. In other words, since rehabilitating an unhealthy business is the fundamental purpose of the Bankruptcy Code, courts can endow businesses essential to the bankrupt debtor's business with first priority status to avoid a disruption in service. Critics of critical vendor programs view the requests as conflicting with the Code's underlying principle of equitable distribution to claimholders, thus disallowing the bankruptcy court's power to approve them.

One of the most visible examples of this controversy is the K-Mart bankruptcy case. In K-Mart's Chapter 11 case, the bankruptcy court granted an order allowing K-Mart to pay in full vendors that it deemed critical, awarding the status to 2330 of K-Mart's 4000 vendors. The pre-petition obligations totaled more than $300 million. The critical vendors receiving payment of their pre-petition claims were required to extend credit to K-Mart during its Chapter 11 reorganization.

Under the Chapter 11 plan proposed by K-Mart, the remaining unsecured creditors would have received about 10 percent of their claim amount, mostly in K-Mart stock pegged at approximately $13 per share.

Several pre-petition unsecured creditors that did not receive critical vendor status appealed the decision. More than 14 months after the pre-petition claim payments were made, the District Court reversed the order, subjecting the recipients to claims requiring them to return the money as avoidable payments! The District Court held that the bankruptcy court did not have the power to approve payment of pre-petition unsecured claims outside of a reorganization plan. Shortly thereafter, the U.S. Court of Appeals for the Seventh Circuit affirmed the district court order, labeling the doctrine of necessity as "outdated" and "just a fancy name for a power to depart from the Code, " and suggesting that payment of pre-petition obligations was not the way to assure payment of post-petition obligations.

The case illustrates the necessity that the debtor present evidence showing that a "critical vendor" cannot readily be replaced by another vendor, that the vendor will likely fail to provide services if it does not receive critical vendor status, and that the critical vendor program will benefit non-critical creditors by maintaining or increasing their recoveries. It may also illustrate the importance of the filing venue. The Third Circuit courts have continued to approve critical vendor programs, while the Fourth, Fifth, and Ninth circuits do not even recognize the doctrine. And as we have seen with the K-Mart case, the Seventh Circuit approaches the doctrine with considerable scrutiny. In any case, while critical vendor status remains possible, it is becoming increasingly clear that the procedural and evidentiary standards for approval are higher now than in the past.

While critical vendor status carries enviable benefits, there is still no guarantee that the debtor will be able to pay critical vendors. Financing terms for a Chapter 11 business are often highly restrictive, and the debtor may find itself unable to meet them. The case could be converted from Chapter 11 to a Chapter 7 liquidation. Or, as we have witnessed with the K-Mart case, critical vendor status can be revoked by a higher court.

"How can they refuse to give us 'critical vendor' status? I've been critical of everybody in their office at one time or another!"

Post-Petition Administrative Expense Priority

Perhaps you have neither an assumed executory contract with the bankrupt debtor nor critical vendor status, but the debtor would like to do business with you. If you do not have a contractual obligation to do business with the debtor and you do not have the advantages enjoyed by critical vendors, why might you want to sell services to a financially troubled company?

Even if you have pre-petition claims against the Chapter 11 debtor for which you may get little if any payment, it still may be in your best interests to do business with the debtor post-petition if there is a reasonably good chance of its successful reorganization.

Because the Bankruptcy Code requires that a debtor in possession pay its post-petition obligations on a timely basis, agreeing to extend credit allows you to establish a very high "administrative

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expense priority" for payment of the new credit. Administrative expense priority exists to encourage creditors to do post-petition business with debtors. The rationale behind the policy is that few creditors would take the risk otherwise, and the reorganization would subsequently fail.

In order to ensure that it will meet its post-petition obligations, the debtor may obtain authority from the court to use cash or post-petition financing to pay for your services. Debtors in possession may also offer the court other motions to accommodate post-petition vendors that have asserted pre-petition claims. An example would be a "trade benefit program" plan that promises supplemental distributions up to the amount of pre-petition claims to creditors that extend post-confirmation credit. Another accommodation might be to exempt such creditors from preference payment recovery or litigation.

These strategies do not, unfortunately, eradicate all risk to creditors. Perhaps the decision to reorganize and continue doing business was unwise, and liquidation would have been the better option. If there is no cash flow, and the business fails, post-petition creditors may not be paid. Even if the debtor obtains a new line of credit to pay post-petition creditors, the court may have granted the lender "super priority" status over administrative expenses, allowing the lender to be first in line to receive all available cash from the floundering company. Even so, the strategies can provide some measure of assurance to vendors that either fail to qualify for critical vendor status or whose jurisdictions are not likely to approve critical vendor programs.

What to Do

Considerations such as executory contracts, critical vendor status, and administrative expense priority can substantially influence what you may have to do, want to do, and should do when a customer files for bankruptcy. The primary purpose of these considerations is to maximize the Chapter 11 debtor's chances of successfully reorganizing its business by requiring or enticing creditors to continue doing business with it. Here are a few tips to help you evaluate the risks and potential benefits associated with these considerations and increase your chances of getting paid:

1. Have your legal counsel determine whether you and the bankrupt debtor have an executory contract.
2. Consider asking the debtor (and the court, if necessary) to either assume or reject the contract within a specified time.
3. Be sure to file a proof of claim early to ensure that you will not miss a deadline set by the court and to ensure that you will share in future distributions to general unsecured creditors.
4. Carefully monitor bankruptcy proceedings to ensure that your ability to receive what you should under the Code is not in jeopardy.
5. Monitor the debtor's finances, business performance, and reorganization progress. (Note: Debtors are required to file with the bankruptcy court monthly operating reports, which can provide you with current financial information concerning the debtor's post-petition performance.)
6. If you believe that your media services meet the qualifications as a "critical vendor," consider asking the debtor to request the status.
7. Wait until you see the signed court order granting critical vendor status before extending credit. Read the order carefully and understand what is expected of both parties. Some programs stipulate payment of critical vendors at a discounted rate.
8. If you have neither critical vendor status nor an assumed executory contract, consider asking for cash in advance for post-petition services. ©

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