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Be Prepared: What to Do When a Customer or Vendor Files for Bankruptcy Protection



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There are many issues that a business must consider when a vendor, customer or other contact files for bankruptcy protection. In anticipation of what many believe will be a tidal wave of business bankruptcies precipitated by the economic fallout from the coronavirus (COVID-19) pandemic, the following Q&A addresses a few of the many common concerns businesses may have when they first learn of a bankruptcy filing.

Fortunately, we are likely still in the calm before the storm; however, bankruptcy courts remain open (albeit with many safeguards in place in response to COVID-19) and are accepting filings. Therefore, businesses should start preparing.

Should my business pressure a customer for faster payment if it suspects the customer is about to file for bankruptcy protection?

Deviating from normal collection practices can make asserting an ordinary course of business defense more difficult if a customer files and then brings a bankruptcy preference action seeking to recover payments it made in the 90 days prior to filing. Additionally, while it is generally better to receive payment and then fight about giving all or a portion of it back to not getting paid at all, businesses should be careful when taking actions that could push a customer into bankruptcy if there are better options.

If your business is considering a new customer that may be in financial distress, getting paid in advance or taking a deposit to secure future payments will generally put your business in a much better position if the customer eventually files.

I just learned that my customer or vendor filed for bankruptcy protection. What is the first thing I should do?

Call your lawyer. Among the first things your lawyer will likely do is check if the bar date for filing claims has been set and conduct an initial review of the docket to see if there are any orders or pending motions that impact your business. Depending on the type and size of the case and the size of your claim, you may also wish to attend the meeting of creditors and serve on the official committee of unsecured creditors if one is formed. However, expect to see fewer creditor committees, as more businesses file under the new small business subchapter of chapter 11 that does not provide for them, particularly in light of the expansion of eligibility for the subchapter by the recently enacted CARES Act.

If your business has recently delivered goods to the debtor, you will also want to discuss potential reclamation claim options with your attorney.

What will happen to my contract if my customer or vendor files?

If there are material obligations owing from both your business and your customer's or vendor's business, then your customer or vendor who has filed may have the option to:

- reject the contract (amounting to breach as of the petition date),
- assume the contract (which keeps the contract alive and requires the debtor to cure monetary defaults and provide assurance that it will be able to perform), or
- assume and assign the contract to a third party (notwithstanding prohibitions against such assignment in the contract, but subject to monetary cure and assurance of performance).

If your business has no further obligations under the contract, and the other party only has an obligation to pay, then you will likely simply have a claim in the bankruptcy case.

Once in bankruptcy, your customer or vendor may want to continue doing business with you. Payments for goods and services you provide after the bankruptcy filing are generally entitled to priority over claims arising before the bankruptcy filing, which provides an incentive to keep doing business with the debtor while it is in bankruptcy. In some jurisdictions, debtors are permitted to provide the additional incentive of “critical vendor” payments to certain prepetition claims of parties that continue doing business with them.

My customer or vendor filed a motion to use cash collateral or obtain debtor in possession financing. Should I care?

Probably not, but maybe. If your customer or vendor is seeking to continue its relationship with you after it has filed, it should have cash available to do so, which your attorney can confirm by reviewing the budget attached to its motion.

My customer or vendor has filed a motion to sell its assets. Should I care?

As part of a sale of its assets, debtors often seek to assume and assign contracts that the buyer of its business may wish to continue. If your business still has an open contract with the debtor, you should see if the debtor included your contract as part of its sale and, if it did, that you agree with the cure amount that will be paid as part of the assignment.

My customer or vendor has filed a chapter 11 plan. Should I care?

Yes, but what you will need to do depends on the specific circumstances. At a minimum, your attorney will want to make sure:

- that your claim is being treated consistently with the requirements of bankruptcy law,
- that the debtor’s plan is feasible,
- if the plan proposes to deal with your contract (and you are in agreement with those terms),
- if the plan proposes any unacceptable releases (particularly of third parties against whom you may have separate claims), and
- if it contemplates a sale or other arrangement that impacts your business.

You will also want to consider voting on the plan if you have the option.