



## Collections From Bankrupt Companies: Risk Management

**Bankruptcy trustees are aggressively seeking to reclaim payments made by insolvent firms to vendors and other unsecured creditors.**

While corporate bankruptcies have stalled in 2010 (only nine large public companies filed in the second quarter), the fallout from the explosion of filings in 2008 and 2009 is still being felt. Almost two years on, the huge number of cases from that period is creating big headaches for one group: the suppliers to those bankrupt companies. Bankruptcy estates are now attempting to claw back monies paid to these suppliers during the 90-day run-up to the insolvent companies' filing.

Cases are flooding corporate in-boxes. Three hundred and forty-five companies with nearly \$1.8 trillion in assets at the time of their filing declared Chapter 11 or Chapter 7 in 2008 and 2009, according to BankruptcyData.com. The statute of limitations for these so-called preference claims is two years after the bankruptcy, so lawsuits arising from the recent surge in bankruptcies are just beginning to be filed. The estate of Quebecor World, a bankrupt printing company, alone has filed about 1,700 preference claims.

Preference claims from other large Chapter 11s loom. General Motors, for example, had hundreds of billions of dollars in unsecured debt when it filed for bankruptcy in June 2009, owing tens of billions to such trade creditors as Starcom Mediavest Group, Delphi Corp., and Robert Bosch GmbH. While the estate has yet to file any preference claims, there's no indication that it won't pursue this avenue of recovery.

"I have not seen this level of actions being filed ever before — and I've been doing this for 30 years," says Hal Schaeffer, president of D&H Credit Services, who often acts as an expert witness on either side of bankruptcy cases.

Enabled by Section 547 of the U.S. Bankruptcy Code, preference claims are intended to prevent near-insolvent companies from favoring one creditor over others in the run-up to a filing. The suits are brought to force vendors that were paid within the 90-day window to return the payments. Presumably, the money goes back into the estate, from which all unsecured creditors may get a settlement.

Not all bankrupt companies pursue preference claims, preferring not to damage supplier relationships because the bankrupt entity is continuing as a going concern. The current cycle of claims, however, is especially costly and disconcerting for small creditors to now-bankrupt firms.

For one, compared with the 2001-2003 cycle of bankruptcies from the dot-com bubble, estates in the current wave are going after even the smallest payments made to vendors, whether it's "\$50 million, \$5 million, or even [a few thousand dollars]," says Schaeffer. The minimum claim is \$5,850, a number set by the five-year-old Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) and tied to a cost-of-living index. Schaeffer says the aggressiveness is a result of the "dry time" between 2004 and mid-2007, when trustees had very few dollars to go after because bankruptcies were scarce.

Smaller preference claims, of course, tend to fall in the laps of smaller companies. Larger companies, with armies of lawyers, can more easily intimidate trustees into taking pennies on the dollar. But if a small supplier is hit with a \$30,000 preference suit, says Schaeffer, it can spend nearly that much to hire an attorney and an expert witness and to unearth invoices and records. It can be cheaper for the supplier to simply offer the bankrupt company 50 cents on the dollar, which he calls "not a good settlement," considering that unsecured creditors typically recover only 5 cents to 7 cents on the dollar from the estate. "It won't be anywhere near what they put in," he says.

Smaller creditors also usually don't have a good defense to a preference suit, in which the burden of proof is on them. For example, in the "ordinary course" defense, the vendor has to prove that the credit terms extended to the insolvent company in the pre-bankruptcy period were consistent with the way the two normally conducted business. "The best defense is consistency," says Schaeffer. "If the numbers are inconsistent, you will lose every time." The problem is that small companies selling to large companies often bend over backward to keep the business, to the point of loosening credit terms to customers on the brink of insolvency.

Other preference-claim defenses provide small companies with some measure of protection. Under the "new value" defense (Section 547(c)(4) of the Bankruptcy Code), if the creditor shipped another order or supplied services to the debtor after it received the payments that the bankruptcy trustee is seeking to recover, the creditor can offset the preference claim by the value of the new order or services.

Finally, the BAPCPA established a new protection to suppliers that ship goods to insolvent companies in the period right before a bankruptcy filing. These "reclamation claims" (Section 503(b)(9)) award first priority, administrative status to claims by creditors that ship the insolvent company goods within 20 days of the bankruptcy filing. Administrative claims have to pay 100 cents on the dollar before other unsecured creditors see a dime.

Charging that the preferences section of the Bankruptcy Code leads to "abusive preference recovery suits," the National Association of Credit Management is petitioning Congress to change the code. It is "common practice for trustees," the NACM says, "to send out a blanket demand and complaint to every creditor who received payments within 90 days of the bankruptcy filing," and they do so with "little or no prior investigation other than to review the debtor's check register." It's rarely cost-effective for the creditor to defend against the action, the NACM contends. The NACM also says a study by the National Bankruptcy Review Commission found that more than 90% of preference recoveries are not dedicated to satisfying the needs of unsecured creditors but instead go to funding recovery activities.

Of course, the best defense to the risk of being sued in a preference action is to keep customers on a regular payment schedule. "If a customer has been paying net 45 [days] on average and they start slowing down, you have to pull back on the reins and get them back into the 45-day area," says Schaeffer. "The finance department that is more alert to customers' financial problems and treats all customers the same reduces its exposure to [bankruptcy risks]."

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