

## How to dodge financial pain when others file

**THE ECONOMIC CRISIS** of recent years has resulted in near-record bankruptcy filings. The impact upon your business when a customer or vendor files a petition for bankruptcy can be devastating.

You can alleviate the economic loss, however, by learning about the different types of bankruptcies, the effect of the automatic stay, 341 Meetings of Creditors and avoidance actions. Here's what you need to know:

### Sorting the chapters

Chapters 7, 11, 12 and 13 govern business bankruptcies. Chapter 12 is reserved exclusively for farms. Chapter 13 is a reorganizational bankruptcy, but is only available to sole proprietors and individuals. Chapters 7 and 11 are the most common in cases involving commercial business entities. Chapter 7 is known as a liquidating bankruptcy where the business has elected to cease operations. In Chapter 7 cases, the debtor files the petition and schedules and an independent trustee is appointed to liquidate the debtor's assets for the benefit of creditors.

Chapter 11 is used by corporations, limited liability companies and partnerships. The bankruptcy code requires Chapter 11 debtors to reorganize their debt and file a disclosure statement and viable plan of reorganization.

In rare instances, creditors may force a company into bankruptcy by

### [tips]

- 1 | At a 341 Meeting of Creditors, the U.S. trustee or appointed trustee questions the debtor (or its officers) under oath regarding the debtor's petition and schedules.
- 2 | Creditors have an opportunity to ask the debtor questions, but should be aware that the trustee will likely not allow any one creditor to ask too many questions.
- 3 | Just attending this meeting can provide valuable information regarding the potential direction of the case and the location of assets and collateral, if you are a secured creditor.

filing an involuntary petition. The target company is able to respond and argue that it is not insolvent or that its creditors are best served by an out of court liquidation.

Creditors contemplating filing an involuntary case should be aware that they could be held liable for the debtor's attorneys' fees and costs if the bankruptcy court determines that the debtor is not insolvent or that the filing was done in bad faith.

### Caution: automatic stays

The automatic stay goes into effect as soon as the petition is filed by the debtor. The automatic stay is absolute and prohibits anyone from taking any action against the debtor without first obtaining an order from the bankruptcy court that allows them to proceed.

Among the prohibited actions are any attempts to collect debts owing on the petition date, continuation of litigation, foreclosure against real or personal property of the debtor. Creditors who persist in efforts to collect pre-petition debts or continue with litigation or foreclosure efforts may be found to be in violation of the automatic stay, which may result in court-ordered monetary sanctions.

In addition, contracts in existence as of the petition date cannot be terminated by the creditor because of the bankruptcy filing (even if the contract specifically provides so) without relief from the automatic stay.

A creditor should contact a bankruptcy practitioner before taking any action that could violate an automatic stay because penalties can be very harsh. A creditor's recourse against the debtor may be to file a proof of claim for the pre-petition amount, or seek relief from stay.

### Time to meet

Shortly after the petition is filed, the bankruptcy court will send a

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— Margie Bodas and Deborah Swenson, Lommen Abdo

Notice of Filing to all creditors listed in the debtor’s schedules. The Notice of Filing will provide the case number, type of case, the name of debtor’s counsel and the date and time for the 341 Meeting of Creditors.

The 341 Meeting of Creditors is a proceeding in which the U.S. trustee or appointed trustee questions the debtor (or its officers) under oath regarding the debtor’s petition and schedules. Creditors have an opportunity to ask the debtor questions, but should be aware that the trustee will likely not allow any one creditor to ask too many questions.

Just attending the 341 Meeting of Creditors can provide valuable information regarding the potential direction of the case and the location of assets and collateral, if you are a secured creditor

### Who’s suing me?

Section 547 of the bankruptcy code allows the debtor or trustee to recover payments it made to unsecured creditors during the 90-day period prior to the petition date. There is a two-year statute of limitations to

commence an avoidance action.

Two common defenses are available to creditors: new value and ordinary course of business. In order to prove the new value defense, a creditor must show that it provided new value in the form of goods and/or services after receiving the payment that is subject to avoidance. Ordinary course may be established by proving that the debtor paid invoices in a similar manner and time in the pre-preference historical period as it did during the preference period or by proving, usually through an expert witness, that the payments were ordinary in the creditor’s industry.

Note that preference actions are brought against unsecured creditors. If you have a security interest that requires filing, such as a mortgage, confirm that the filing has been done immediately after the transaction granting the security interest. Do not wait to find out there was a filing problem until after the bankruptcy has been commenced. Filing problems often cause the debt to be reclassified as unsecured.

A Chapter 7 trustee rarely has any

historical information and is not responsible for proving your company’s defense. As such, companies are well-served by gathering relevant account information for the debtor soon after receiving notice of the bankruptcy and storing the account information and copies of invoices for a two-year period.

It is easy to dispose of the information if it is not needed, but almost impossible to recreate it if the need arises; this is especially the case in an age where computer systems change and data is lost. Be prepared in the event that a preference case is initiated in the future.

A good way to prevent or limit a preference claim is to assure that payments are received in accord with the terms and, if someone starts varying widely from those terms, require a contemporaneous exchange of payment for goods or service, such as a C.O.D or cash on delivery.

You can minimize the negative impact on your company in the event a customer or vendor files for bankruptcy protection by being aware of the process and taking steps to protect your company.

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