This is Really Funny…On Our Way to The Bankruptcy Court

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A company commences a Chapter 11 bankruptcy case, obtains "debtor in possession" financing and then asks its vendors for more unsecured credit because (according to the debtor) the debtor just got lots of new financing and the vendor will have an administrative claim in the case – which is on par with professional fees and is entitled to 100% payment off the top. Therefore, giving credit during the bankruptcy is safe. I find these assertions to be very humorous because none of it is true anymore.

Sears, Barneys and Toys R Us are recent examples of administrative insolvency. In other words, debts incurred during Chapter 11 are not able to be paid in full. So, the vendor gets burned twice.

When a debtor says that it has obtained "DIP" financing, it wants you to believe that it has obtained more needed liquidity. However, many times, the debtor continues on a shoe-string and the new financing simply replaces the pre-bankruptcy financing. Not a lot of fresh cash is provided. The question is not how much DIP financing has been obtained - that will be the headline number. The better question is how much additional liquidity the debtor really is getting from the financing.

Is the secured lender increasing or decreasing the advance rates to the debtor? That is a good question to ask. Is the *aggregate* amount owed to the secured lender (the pre-bankruptcy amount outstanding as of the petition date plus the post-petition amount that will become outstanding) greater than what was owed to the lender as of the petition date? If not, then the debtor probably is treading water and has not been given a "jump start."

Preferences. A debtor has the power to recover from creditors money paid to the creditor during the 90 days preceding the date of bankruptcy if the payments were past due when made. Lenders frequently ask that they get a lien on these potential recoveries. By doing so, the vendors subsidize the secured lender's recovery. It also is a double "hit" to the vendor since the vendor gets burned for what is outstanding to it as of the petition date and then potentially has to disgorge what it was previously paid as a result of its diligence as a credit executive. The answer is simple. The vendor should not consider giving post-bankruptcy trade credit until after the Court says that the bank will not have a lien on preference recoveries.

Yes, administrative claims (claims arising during the pendency of the bankruptcy case) are entitled to 100% payment in order to confirm a plan of reorganization. But, fewer and fewer debtors or lenders care about confirming a plan of reorganization. They just want a fast sale of the assets to get the secured lenders out of the case. After that, the Chapter 11 bankruptcy case can be dismissed or else converted to Chapter 7. And, if you believe that vendors' administrative claims get treated equally to the administrative claims of professionals, then I have a bridge in Brooklyn that I would like to sell you. Somehow, vendor claims always are treated as if they are subordinate.

One thing that I like to do if my client feels that selling to the debtor post-petition is necessary for business reasons, is to file a reservation of rights whenever professionals seek compensation. Put the professionals on notice that, if your client does not get paid, you reserve the right to seek a reduction or even disgorgement of their professional fees. This approach does not make lots of friends, but it makes a debtor and its advisors think twice about who the debtor does not pay timely.

Know the milestones in the case! If the secured lender has set dates by which assets must be sold, make sure that you are ratchetting down your claim sufficiently in advance of the sale date. Not every sale yields enough to pay the secured debtor in full and leave enough over for administrative claimants to be fully paid. Once a sale [that has not resulted from spirited bidding] is done, it probably is too late to recover fully on your administrative claim.

Every debtor says that it intends to reorganize and confirm a plan of reorganization. But, when push comes to shove, it frequently does not happen absent special situations where there are remaining assets to liquidate (such as litigation) or where insider releases are sought. Lenders may not see much benefit to themselves from funding a bankruptcy case post-sale and often decline to do so. The statement that a plan of reorganization cannot be confirmed absent paying all administrative claims should not be a basis for extending new credit.

Why did the turtle cross the road? To get to the Shell station.

About the Author

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