

Demystifying the Bankruptcy Process – Part One

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The COVID-19 pandemic created a lot of turmoil in every industry and every company. From March to July 2020, at least 171 companies in the energy, transportation, entertainment, health & personal care, retail, travel, lodging, and leisure industries cited COVID-19 as a factor in their decision to file for bankruptcy.

The risk of dealing with a company in financial distress was at an all time high. Understanding the bankruptcy tools available to a company that is on the path to or already in a court-supervised reorganization can help you manage and reduce this risk.

Reorganizations in a Nutshell: Chapter 11 of the Bankruptcy Code governs the restructuring of businesses and individuals' assets and liabilities. It provides financially distressed companies and individuals with protections that are attractive for the debtor. Among the key benefits of the US reorganization regime are:

- The management stays in control of the company, and an outside trustee/administrator is not brought in unless there are extraordinary circumstances;
- The company can cherry-pick beneficial contracts and reject burdensome ones;
- The company can sell its business, selected business lines or individual assets free and clear of any encumbrances or interests.

Chapter 11 filers choose to opt for bankruptcy relief for various reasons: to stop debt collection action, to revise unworkable capital structure, to address overwhelming litigation, to facilitate the sale of major assets to a prospective buyer, and to reject burdensome contracts, to name a few.

Chapter 11 brings all stakeholders to one forum and facilitates the global resolution of claims and liabilities. It may have different impact on the different stakeholders and these mini-series will cover the impact of a bankruptcy proceeding on trade creditors, distressed asset buyers, landlords, and the art world. The final summary is intended to help small business owners better understand how valuable a tool Chapter 11 can be during a time of crisis.

What to keep in mind if you are a supplier of goods and services to a distressed company (or in other words, a trade creditor) with a number of open invoices:

The commencement of a Chapter 11 proceedings is an automatic prohibition on any action which has the purpose and result of collecting a debt or taking possession of property or assets of the debtor. These include:

- The commencement or continuation of legal proceedings against the debtor to recover a claim that arose prior to the petition being filed;
- The enforcement of a prepetition judgment against the debtor or against property of the bankruptcy estate;
- An act to obtain possession of, or exercise control over, property of the estate;
- An act to create, perfect or enforce any lien against property of the bankruptcy estate;
- An act to create, perfect or enforce any lien against property of the debtor, any lien to the extent that such lien secures a prepetition claim;
- An act to collect, assess or recover a prepetition claim against the debtor;
- The setoff of any debt owing to the debtor that arose before the commencement of the case against any claim against the debtor;

If there are open outstanding invoices that have accumulated over the months (hopefully not years) before your customer's bankruptcy, you typically would not receive a payment, if any, unless there is a court approval for such payment. A restructuring company in a chapter 11, referred to as a "Debtor in Possession" ("DIP") generally cannot pay pre-petition debts post-petition until a plan, governed by the Bankruptcy Code priority system and requirements, is confirmed.

Critical Vendor Programs

There are, however, exceptions to the rule. A potential avenue to receive payment on pre-petition invoices early in the restructuring process is through a critical vendor program. Pursuant to Section 363 of the Bankruptcy Code, a bankruptcy court has the power to authorize a debtor in possession to expand funds outside of the ordinary course of business and has broad flexibility in tailoring its orders as long as the debtor in possession can articulate business justification.

The court approval of a critical-vendor program usually requires a DIP to establish that: (1) the vendor is necessary for the successful reorganization, (2) the transaction must be in the sound business judgment of the debtor and (3) the favorable treatment of the critical vendor should not prejudice other unsecured creditors.

Debtors in possession consider various factors when identifying critical vendors, among which are whether each vendor (i) provides unique or specifically designed goods or services that are crucial to the continued operation and preparedness of the debtors' business, and for which no ready alternative and appropriately qualified vendors can be found with reasonable diligence; or (ii) provides essential goods and services, for which replacement with alternative vendors would be prohibitively expensive due to the time required to replace the existing vendor's institutional knowledge of the debtors' businesses, the lead-time required by any alternative vendors, required authorizations and clearances alternative vendors would need to obtain through third-parties, the alternative vendors' geographical remoteness from the debtors' operations and/or the preferential terms that have been locked in with the current vendor.

To take advantage of critical vendor programs, trade creditors in this situation should closely monitor the debtor's submissions in the first days and weeks of the proceedings.

In case you missed it, read [part two](#), [three](#), [four](#), and [five](#) here.

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