

FOCUS ON BUSINESS LAW

Vigilance – before and after – helps if customer goes bankrupt

By **STEVE REINBRECHT**
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Maybe the realization starts when your customer's phone is disconnected. Maybe you've watched his payments get later and later.

Or maybe you get a notification: Someone who owes your business money has filed for bankruptcy protection.

Lawyers who deal with these cases say it's a danger every business faces.

In fiscal year 2013, there were 7,170 Chapter 7 cases and 136 Chapter 11 cases filed in the U.S. Bankruptcy Court for the Eastern District of Pennsylvania, which includes Lehigh, Berks and Northampton counties.

"It's all too common, unfortunately," said Douglas J. Smillie, an attorney with Fitzpatrick Lentz & Bubba in Center Valley. "A lot of times it comes out of left field."

For example, he said, many businesses that supplied KidsPeace Corp., which offers psychological services to teenagers, didn't have an inkling the agency was in trouble when it filed for bankruptcy in May 2013.

In another case, Smillie said, a contractor received only a fraction of the hundreds of thousands of dollars he was owed when TH Properties, Lower Salford Township, Montgomery County, filed for bankruptcy in April 2009.

If your customer declares bankruptcy, your business is likely to have a "general unsecured creditor" status, which often means you'll get pennies on the dollars you are owed. Customers with "trade debt" usually line up behind banks and securitized creditors. And almost always,

Smillie said, the company in bankruptcy has few assets because its land is leased and banks have liens on equipment and inventory.

STAY ON TOP OF THINGS

The best protection is staying vigilant.

"Staying on top of things is key," Smillie said.

If you see warning flags such as late payments, partial payments or missed payments, start asking the company questions. Stonewalling should sound an alarm.

After signs of trouble, it's appropriate to ask for a financial statement and tighter credit, such as cash-on-delivery payments, said Melissa Pena, an attorney at Norris McLaughlin & Marcus' Allentown office.

THIRD-PARTY GUARANTOR

Another safeguard is to have a third party, such as the business owner, guarantee payments. This arrangement is fairly common, Pena said.

That move may put you ahead of unsecured creditors, although even then a lien by a bank on all the customer's assets may trump your claims.

Pena acknowledges that establishing such safeguards is impossible with every customer.

"It's a lofty goal," Pena said. "You can ask."

But the questions and demand might annoy some customers. Owners must balance asking for such safeguards against attracting and maintaining business relationships.

FILE PROOF OF CLAIM

Once you get notified of the bankruptcy, you

need to do a few things, Smillie and Pena said.

Fill out a "proof of claim" form (usually included in the notification you get from the court) and send it to the bankruptcy court.

This lists what you were owed on the filing date. You don't need a lawyer to do this. Typically, unsecured creditors must file a proof of claim to get any money.

You also must stop collection efforts and legal actions against the debtor. However, Pena noted, you can continue trying to collect from third-party guarantors.

PREFERENCE CLAIM

Under your "right of reclamation," you have 20 days to demand that the customer return goods you shipped it recently. However, Pena said, she's never seen goods recovered this way.

Customers will claim they can't identify which goods you've sent, and often a bank will have a lien on inventory, which now includes those items.

And don't be surprised if a year later you get sued for a preference claim, Pena said.

Your bankrupt customer has two years to make "preference claims" – demanding that you return money it paid you in the 90 days before filing for bankruptcy.

If this happens, there are several defenses, Pena said. For example, setting up a cash-on-delivery payment arrangement with customers will typically allow those payments to avoid preference demands. Also, making sure cus-

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**PROTECT YOURSELF**

Don't get hurt by others' bad fortune. How to avoid harm if a customer declares bankruptcy:

GENERAL POLICY

- Watch for partial, late and missed payments.
- Consider requiring cash-on-delivery payments, security or a third-party guarantor.
- Keep a bad-debt reserve.

AFTER NOTIFICATION

- File a "proof of claim."
- Make sure all lawsuits and collection efforts stop.
- Prepare for a potential "preference" claim.

CONSIDER

- Reclaiming recent shipments.
- Joining a committee of creditors.
- Hiring an attorney.



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tomers make payments in the same manner every time helps establish a "course of business" defense.

PAY ATTENTION

In large cases, the court creates a committee of the largest unsecured creditors to centralize administration, and it's usually a good idea to join, Pena and Smillie said. The committee can hire lawyers and advisers to assist it, and those fees are paid by the debtor's estate.

Sometimes the court arranges a meeting of creditors, which you should attend, but you won't need a lawyer.

Most of all, keep up with the proceedings, Pena said.

"The vigilant creditor is the one that gets paid," Pena said.