

NAVIGATING THE BANKRUPTCY MATRIX

Management Issue

For Current Members of Process Advisory Programs

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EXECUTIVE SUMMARY

Top-performing credit and collections organizations establish tight links between credit policies and collection strategies to ensure open receivable balances are aligned with the organization's risk tolerance. Still, even with those organizations, a bankruptcy filing leaves open receivable balances that many organizations consider 100% uncollectible.

However, by monitoring customer activity and financial soundness, and acting promptly if a bankruptcy does occur, creditor companies have a greater chance of minimizing their losses than many might realize. In some cases, they can even help secure a better outcome to the entire bankruptcy proceeding. For example, by getting a representative on the creditors' committee during a customer's bankruptcy, one creditor was able to help prevent the debtor from being liquidated. C2C process owners can also create their own working groups to identify risks among customers, track claims through available websites, and file requests for notification of relevant information on filed pleadings.

BACKGROUND

Consumer and corporate bankruptcy filings in the US are at their highest daily rate since the 2005 changes to the federal bankruptcy law. According to AACER (www.aacer.com), which tracks US bankruptcy data, consumer bankruptcy filings dropped in January 2008 but company filings increased. The site reports 699 Chapter 11 petitions filed by companies in January and estimates a 34% rise in 2008 over the 6,240 major business bankruptcies of 2007 (**Fig. 1**).

The rate of corporate bankruptcies in 2008 may increase further, as Standard & Poor's has reported that nine companies defaulted on syndicated loans since January 1, compared with only two syndicated loan defaults in 2007.

AN ORGANIZATIONAL CHANGE

In some cases, a company's own organization can hamper its ability to respond quickly when a customer is heading into bankruptcy. For example, because many debtors alert their creditors of a bankruptcy filing by sending the legally required notices to the address used for sending payments, those notices, and the knowledge that a customer is filing or has filed for bankruptcy, may not make it to the right individual within the creditor organization in a timely manner.

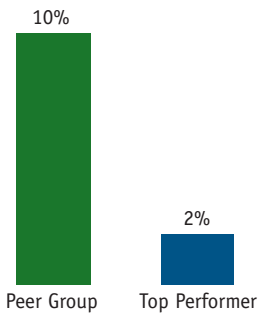
FIG. 1 Total US bankruptcy filing per business day (Jan. 2006 - Feb. 2008)



Source: Creditslips.org

Therefore, it is critically important for creditor companies to identify the most appropriate person to receive these notices – the director of credit, in-house legal counsel, CFO, controller, or some other designated individual – and to have a system or procedure in place to ensure that any bankruptcy notices are delivered promptly to that individual. Indeed, top-performing DSO (days sales outstanding) organizations have processes in place to ensure that “distressed sales” do not seriously erode their DSO. These include limiting the number of customers that go beyond their credit limit (**Fig. 2**).

FIG. 2 Percentage of customers currently over credit limit, 2008



Source: The Hackett Group, 2008

Create a working group to identify risks

A working group made up of representatives from credit, sales, accounting and shipping can help coordinate these efforts and identify customers that may be at risk for bankruptcy.

This procedure can also be useful in situations beyond bankruptcy filings. Creditors often receive notices of other situations that can imperil credit repayments, including out-of-court workouts, assignments for the benefit of creditors and receiverships. For example, companies that are undergoing reorganization or closing altogether sometimes use a receivership or an assignment for the benefit of creditors. This information must flow immediately to the right person within the creditor company.

By acting quickly, companies can position themselves to have as much influence over the bankruptcy proceedings as possible. In large cases, the court often appoints a committee made up of five to seven people from the largest creditors to represent all of the unsecured creditors involved with the help of outside counsel paid for by the debtor company. Securing a seat on this committee can give a creditor company a much larger say in how the bankruptcy is managed.

ON NOTICE – THE FIRST STEPS

How a creditor company can deal with a customer bankruptcy depends on the type of filing involved. A Chapter 11 bankruptcy generally involves some sort of reorganization or an orderly liquidation of the bankrupt company's assets. Here, the bankrupt company still has a measure of control over the process. In a Chapter 7 bankruptcy, the company is liquidated under the control of a court-appointed trustee and the bankrupt company has no control over the situation.

Once an organization receives notice of a bankruptcy filing among one of its debtors, the person in charge of the situation must make note of several important dates and deadlines, including when to file a claim and the date of the first creditors' meeting. If in-house counsel is not leading this process, it is critical for the individual who is overseeing the matter to notify his legal department of the situation and keep it apprised of developments. In general, the company's counsel will need the case location, case number, and the name of debtor counsel in order to properly track the case.

From there, the leader within the creditor company must determine how much the debtor owes the company in both cleared funds and funds that have been set off, and check the bankruptcy filing to make sure it includes the correct amount. If the amount is wrong, the leader must take appropriate steps to amend that information when filing a claim.

During the first meeting of creditors, a representative from the bankrupt company must answer questions under oath about topics ranging from the debtor's plans for dealing with or emerging from bankruptcy to the amount of its company's total assets and liabilities. This question-and-answer session will be led by an attorney from the US Trustee's Office, which is part of the Justice Department and oversees the bankruptcy process. However, creditors also have an opportunity to ask questions specific to their own situation, such as whether certain goods will be returned and when, the status of payments, and how to obtain any necessary documentation. Because the debtor's representative is under oath, this session can serve as a very short deposition.

Creditor companies can find information on their rights and the bankruptcy process as a whole online. The US Trustee's website, www.justice.gov/ust, will provide information on the trustee appointed and the staff attorney assigned to each bankruptcy case. The bankruptcy court's website, www.uscourts.gov/courtlinks, provides information about each case, including pleadings and petitions.

THE KEY ELEMENTS

Every bankruptcy case has some key elements of which creditors need to be aware. Everything from where the case is filed to the types of claims involved can have an impact on a creditor's ability to recover what it is owed.

Venue

The jurisdiction in which the case has been filed becomes the venue for the case, but the venue does not necessarily reflect where the debtor or its creditors do business. Therefore, once a creditor receives a notice of a bankruptcy filing from a customer, the company should determine whether it has counsel in that state or if it needs to hire counsel. In many cases, companies rely on their existing counsel to monitor the case and hire associate counsel in the venue state if the situation requires it.

The notice of the bankruptcy filing will include the bar date, i.e., the last date to file follow-up claims. If a creditor does not receive a notice with this information or finds out about the filing from another source, it is essential that the company find this bar date as soon as possible through a Web site or by contacting the debtor's counsel.

Proofs of claim

In order to receive payment on outstanding debts, a creditor must submit a proof of claim. In most cases, this can be done simply by filing the proof of claim form that comes with the bankruptcy notice. However, this may not be appropriate in all cases. For one thing, by filling out the proof of claim form, the creditor company is submitting itself to the bankruptcy court jurisdiction and could be subjecting itself to certain actions that can be taken against the company by the trustee in a Chapter 7 bankruptcy or the debtor in a Chapter 11 bankruptcy, such as a preference claim. Also, the creditor may possibly give up its right to a jury trial by filing a proof of claim. The creditor should consult with legal counsel to determine the appropriate steps for submitting a proof of claim.

If an organization has filed a claim against a bankrupt company, it should contact the debtor's counsel or check the bankruptcy filing document to make sure the correct amount is scheduled. A claim can be classified in many ways – unsecured, secured, priority, disputed, contingent or unliquidated – depending on the circumstances. All claims are treated differently based on their status, so it is important that creditors make sure their claim is listed with the correct status. If the debtor is disputing the claim, it is important to find out why.

When a company files for bankruptcy, its creditors are likely to be approached by third parties offering to buy their claims, usually for a few cents on the dollar. These groups have done their research and generally have an idea of what creditors will get paid. Therefore, a prudent creditor should conduct its own independent research before agreeing to sell. Otherwise, a creditor could end up selling a claim for 10 cents on the dollar when it could have received 60 or 70 cents on the dollar by waiting for it to be settled. New sections of bankruptcy law add another element to these decisions. If a claim qualifies as a so-called 503(b)(9) claim, it could gain priority in whole or in part, which could allow the claimant to be paid a higher-than-expected percentage of the claim.

Creditors' committees

The creditors' committee and its hired counsel oversee the bankruptcy case to make sure the debtor is taking steps to help unsecured creditors maximize their

recovered debts. For example, if a debtor sells some or all of its assets (or the entire company), the committee makes sure the debtors are marketing those assets to maximize their realized value. In some cases, creditors' committees have marketed these assets themselves.

Creditors do not have to be the largest entities involved in the case to get a seat on the committee, nor does membership require a great deal of time. Weekly meetings are generally conducted over the telephone and membership can yield significant benefits for the creditor companies involved. Not only do participating companies have a say in what happens to the debtor, but participation allows the creditor to get a sense of where the case is headed and even to direct what will happen in the case. Sometimes, the committee knows about developments even before the case documents are filed with the court.

Creditor access to information

Certain bankruptcy code sections allow creditors access to information about bankruptcy cases. Creditors' committees are required to send out notices by mail with updates on the case, while some larger Chapter 11 cases have dedicated websites. Debtors themselves may also have websites with information about the case.

A creditor can also keep up on developments by filing a request for special notice to receive relevant information, such as copies of filed pleadings. Although a creditor company will receive a great deal of paper about the case, this ensures that it remains fully up to date on it. Even if 90% of the information is irrelevant to a creditor, the executive in charge can make sure his company receives the 10% it really needs.

Alternatively, creditors can use Pacer (www.pacer.psc.uscourts.gov), which is a subscription-based website that provides access to specific pleadings and the docket that includes everything that goes on in the case. Creditors that are not part of the creditors' committee can monitor the case in this way.

Reclamation and section 503(b)(9) vendor claims

Reclamation and section 503(b)(9) claims require immediate action when a customer files bankruptcy. Reclamation allows recourse to creditors that sent goods to a debtor within a certain period of time before the bankruptcy filing. Creditors can use a reclamation claim either to get those goods back or to have an administrative claim that will be paid ahead of unsecured claims based on a percentage of the value of those goods. To make sure their reclamation claim is valid, creditors need to be aware of the time elapsed between the delivery of the goods and the date of the bankruptcy filing. They need to file those claims in writing and in a timely way that also follows the required procedure.

One type of reclamation is a section 503(b)(9) claim, which provides administrative status to claims on the value of goods received by the debtor within 20 days of the date of the bankruptcy filing. To qualify, these goods must have been sold to the debtor within the ordinary course of business.

These administrative claims put creditors on the same legal footing as vendors selling goods to the debtor after the bankruptcy filing and these claims must be paid in full before the debtor can confirm their plan for emerging from bankruptcy. Moreover, creditors that file administrative claims are more likely than creditors with unsecured claims to argue successfully to receive the full amount owed. This is something to keep in mind before selling a claim that might include goods sold to the debtor within 20 days of the bankruptcy filing.

Critical vendor status

Some jurisdictions allow debtors to give certain vendors critical vendor status. A critical vendor is any vendor that is essential to the continued operation of the bankrupt company. Therefore, critical vendors can receive all or a portion of their pre-petition amounts of outstanding payments so that the debtor can continue to do business with that vendor and keep its operations going. Creditor companies should find out whether the jurisdiction allows critical vendors, whether the debtor will seek to use it, and whether it make sense to apply for critical vendor status.

Dealing with preferences

Preferences are a common issue for creditors in a bankruptcy case. Using preferences, a debtor can force creditors to return payments made within 90 days of the bankruptcy filing. However, creditors face no danger of preferences if the amount at issue is less than \$5,000, according to the revised bankruptcy code. And if the amount is between \$5,000 and \$10,000, the debtor must sue the creditor wherever the creditor is located, not where the bankrupt company is located.

A creditor can defend itself against a preference claim by showing that the creditor provided *new value* after receiving the payment in question. (In other words, the payment was not for an old debt.) In many jurisdictions, creditors can claim that new value for goods and services that have been paid for, while other jurisdictions require the creditor to subtract the new value from payments received.

A creditor can also make a case against a preference by arguing that the goods were purchased in the *ordinary course* of business based on patterns of activity between the debtor and the creditor, or based on what is considered the ordinary course of business in that specific industry.

Because a preference can be filed up to two years after a bankruptcy filing, it is important for the creditor to maintain the necessary documentation in case a preference is filed. Otherwise, the creditor could find itself with a stale defense if data and correspondence is purged from electronic or paper files by the time a preference is filed. A good place to start is to determine how much money the creditor received from the debtor during that 90-day time frame and how those payments were received and then to gather and retain any relevant information about those transactions.

When arguing against a preference, creditors must be prepared to become a thorn in the side of a plaintiff that is probably pursuing hundreds of these actions. By demanding a jury trial if it hasn't filed a proof of claim, sending out discovery and raising solvency arguments, a creditor stands a better chance of forcing a quicker and better settlement.

STRATEGIC IMPLICATIONS: ARE ANY OF YOUR CUSTOMERS IN DANGER OF FILING FOR BANKRUPTCY?

Perhaps the best way to deal with this question is to identify and monitor at-risk customers before they file for bankruptcy. Companies can rely on a combination of internal tools and models developed by third-party service providers to identify early warning signs of bankruptcy. By talking to sales and marketing departments, or credit and collections and other customer-facing positions, a company can identify emerging problems within certain customer organizations. For example, purchasing activity may have suddenly and sharply dropped off or payments could be slower than usual.

If an organization is concerned that a debtor company may be facing bankruptcy in the near future, it can take certain steps to protect itself, including requiring cash on delivery or payment in advance for all shipments, purchasing money security interest, or requiring a letter of credit.

C2C process owners are encouraged to share and ask for information with members of professional credit and collections organizations who will share among themselves receivable balances by customer.

There are certain advantages to extending credit to a company that has already filed bankruptcy. The creditor company can ask for certain types of relief, such as cash collateral, as well as information about the bankrupt company's current standing, including case projections and any existing supply agreements that are still in effect. However, there are also warning signs to heed, before extending credit, including whether the bankrupt company is undertaking motions to assume or reject certain debts.

RELATED RESEARCH

[“Survey Shows That Many C2C Organizations Fail to Understand the Value of End-to-End Accountability and Process Ownership,” July 2007](#)

[“What’s Keeping Companies from Improving Their Dispute Resolution Practices?” April 2007](#)

[“Effective Contract Management Yields Greater Invoice Accuracy and Improved Cash Flow,” November 2006](#)

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Founded in 1991, The Hackett Group was acquired by Answerthink, which was renamed The Hackett Group in 2008. The Hackett Group has global offices in the United States, Europe and India and is publicly traded on the NASDAQ as HCKT.

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