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Bankruptcy Reform: What It Means For BSCs

By Mary Erpenbach

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A few years ago, Art Rose, president of Mr. Clean Maintenance Systems in Bloomington, Calif., found himself dealing with the fallout of a customer's bankruptcy. He learned a lot from the experience, but the lessons were expensive ones.

"We were servicing a small, independent grocery store and [the owner] filed for bankruptcy," Rose recalls. "He owed us about \$10,000 for services we'd already provided, and after two-plus years, we ended up getting about nine cents on the dollar."

As disheartening as it is for building service contractors to confront the bankruptcy of another party, there are ways to cut down on confusion and, sometimes, lessen financial losses. BSCs can help themselves and their companies by understanding some of the basic provisions of the laws that govern bankruptcy.

The code update

Practically speaking, bankruptcy helps a debtor to get out from under, and a creditor to get something instead of nothing. And the first thing to know about bankruptcy today, say experts, is that timing is everything. Sweeping changes to the federal Bankruptcy Code have been in effect since Oct. 17, 2005. This means companies that petitioned for bankruptcy before that date are subject to one set of regulations, while companies petitioning on or after the date are subject to another. Currently there are far more companies going through "old code" procedures than those of the new code.

"There's so much that's new in the law that it's hard to know how it's going to play out," says Stephen Elias, a California-based bankruptcy attorney and author of "The New Bankruptcy: Will It Work for You?" One result is already apparent: There was a flurry of bankruptcy filings before the code changed, and there have — and will continue to be — far fewer bankruptcies filed since.

Among the changes that could affect BSCs are new regulations that allow certain business owners to continue collection action against a company that owes them money, even after the company has filed for bankruptcy. Also, small businesses — those with less than \$2 million in debt — now must complete the bankruptcy process more quickly than before. This will give their creditors, including BSCs, less time to file a claim for unpaid bills or undelivered supplies and equipment, but will shorten the time it takes to receive payment.

Also, there are different circumstances of bankruptcy, outlined in chapters of the Bankruptcy Code. Chapter 7 and Chapter 11 are two such chapters with which BSCs should be familiar.

“In Chapter 7, a company sells everything down to the fixtures and they’re out of business,” explains Elias. Chapter 11, on the other hand, is intended to keep a company going by reorganizing its finances, coming up with a plan to pay its debts in full, and getting out of bankruptcy. The new regulations make it harder for businesses to file for Chapter 7 relief from their debts — most companies, even if they end up in Chapter 7, will try Chapter 11 first. And most successful Chapter 11 reorganizations don’t result in payment of all debts.

The third thing to know is the difference between a secured claim and an unsecured claim. BSCs generally provide a service, not a product, so the claims which a contractor makes for payment are typically unsecured ones. That is, there’s no tangible product, such as a car, that the BSC can repossess if a company can’t pay.

“It’s not possible for a service to be a secured debt because there is no collateral,” says Elias. And secured debts, along with taxes, payroll and certain other debts, are paid before unsecured debts. Does having a contract help? Not really. Bankruptcy, in effect, nullifies contracts such as those dealing with leases and services so that each can be re-examined on a case-by-case basis.

The new code appears to have changed little in terms of what happens when a BSC’s supplier files for bankruptcy. For example, if a BSC pays for, but doesn’t receive, a product such as cleaning supplies or equipment, and the supplier of that product enters bankruptcy, there isn’t much a BSC can do. Property in the possession of the supplier at the time of bankruptcy becomes the estate of the business, and the estate is what’s used to reorganize and settle debts.

What happens next

In both versions of the code, debtors are never required to ignore a debt. Under Chapter 11, for example, the trustee appointed by the court to oversee the company’s plan for reorganization typically rejects or reaffirms all service contracts. But “many debtors honor their customer contracts and relationships,” says explains William Q. Derrough, managing director and co-head of the Financial Advisory Services Group for Jefferies & Co., Inc., in New York. “They may be using the bankruptcy to deal with bigger debts like those involving bonds or litigation.”

In this way, a BSC’s positive relationship with a customer who becomes a debtor can help a BSC’s bottom line. Also, bankruptcy regulations support continuing the provider/recipient relationship when it comes to service contracts. The debt incurred by a BSC who provides service to a debtor during bankruptcy is automatically elevated from an unsecured claim to an administrative claim and is much more likely to be paid in full.

“This is one of the neat things about bankruptcy,” says Derrough. “It tries to create a system which gives trade creditors [such as a BSC] comfort to provide services to a debtor in bankruptcy by giving them this priority.” In other words, a BSC has an incentive to keep a good customer going throughout the bankruptcy process, because that portion of the debt will most likely be paid and the business relationship will be intact when the company comes out of bankruptcy.

Bankruptcy best practices

Experts' best advice involves steering clear of problems in the first place. BSCs should take care when contracting with their potential customers and look for warning signs that the company is in trouble.

"The big take-away here is: know your customer," says Derrough. "Do analysis on their credit situation and try to make a determination of their ability to continue paying their debts."

Rose agrees. His company changed its billing system after dealing with the bankrupt grocery store. "We now put all of our customers on a short leash," he says. "We bill them weekly or semi-monthly, and we ask them to pay us within five or 15 days. And we send the bill out at the beginning of the service period. That way they don't get in the position of owing us 90 days of payment."

This ounce-of-prevention strategy, say the experts, can save pounds of paperwork, headaches and dollars.

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