

Paper Source Bankruptcy Offers Lessons for Vendors Playing Their Cards

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On March 2, 2021, stationery and gift retailer Paper Source filed for chapter 11 bankruptcy, stating in court filings that effects of the COVID-19 pandemic damaged its finances and operations. Paper Source stated that in bankruptcy, it sought to sell its assets, reevaluate and renegotiate leases, and continue operations, while minimizing adverse impact on trade partners and other stakeholders.

Shortly thereafter, however, card makers identifying themselves as vendors to Paper Source hit social media and the press decrying debts Paper Source racked up just before its bankruptcy for which they did not receive payment. According to some card makers, Paper Source placed orders up to four times larger than usual in January and February 2021. This left vendors who had already shipped goods to Paper Source on generous payment terms with relatively large (in the context of the vendors' businesses) unsecured, prepetition claims when Paper Source entered bankruptcy.

Some Paper Source vendors have received limited relief. In its bankruptcy case, Paper Source immediately sought and obtained an order authorizing it to pay up to an aggregate of \$2 million on prepetition claims of vendors critical to its business operations, referred to as "critical vendors," in full or in part, provided vendors agree to supply goods on continued customary or other favorable trade terms. Prepetition claims are the claims for amounts Paper Source owed as of the date it filed for bankruptcy. The same court order authorizes Paper Source to pay such critical vendors in the ordinary course of business if it cannot strike a deal on trade terms and Paper Source believes failure to pay will result in irreparable harm to its business. Paper Source states it determined which of its vendors are critical for the purposes of the critical vendor relief pursuant to a number of considerations, like the volume of goods supplied, existence of alternative vendors, and vendors' trade terms.

The "critical vendor" motion Paper Source filed to obtain this relief indicates the retailer typically pays for goods ordered via purchase order within 30 to 60 days after receiving products. It also indicates that the \$2 million sought will cover less than 20% of its outstanding trade payables as of the date it filed for bankruptcy. Thus, not all vendors are deemed critical, and even critical vendors cannot count on a full and immediate recovery on their prepetition claims under the critical vendor relief. According to [media reports](#),

some critical vendors are seeing as little as 10% recoveries of their prepetition claims pursuant to the critical vendor relief.

The experience Paper Source vendors report highlights the surprise, frustration, and uncertainty that may confront vendors when a customer files for chapter 11 bankruptcy. The impact can be particularly profound for vendors who are small businesses or essentially captive to the customer, as appears to be the case for some of Paper Source's vendors.

The early effects of Paper Source's bankruptcy on its vendors and its limited critical vendor relief have garnered public reactions and attention. But there are other procedures in chapter 11 bankruptcy that can affect (and aid) vendors and the payment of their claims against debtors.

Administrative Expense Claims. In some cases, vendors may be entitled to assert administrative expense claims—which are paid ahead of any payment to unsecured creditors—for at least part of their claims against a debtor. For example, section 503(b)(9) of the Bankruptcy Code provides for an administrative expense claim for the value of goods provided to the debtor within 20 days of the date the bankruptcy case was filed, provided that such goods were sold to the debtor in the ordinary course of the debtor's business. Notably, it is unclear if a situation where the debtor ordered significantly more product than usual prior to the bankruptcy filing—as asserted regarding Paper Source—would be considered to be “in the ordinary course” of a debtor's business. Additionally, a vendor may be entitled to assert an administrative expense claim under section 503(b)(1) of the Bankruptcy Code for goods provided to the debtor after the commencement of the bankruptcy case, if the debtor has not paid for those goods in the ordinary course of business.

Administrative expense claims are preferable to general unsecured claims because they have priority in payment. But vendors should note that even if they have an allowed administrative expense claim, it does not mean they will necessarily be paid immediately. Administrative expense claims may not be paid until the case is resolved, which can take months or years.

Reclamation of Goods. In some instances, a vendor may prefer to recover goods provided to the debtor rather than wait for payment through the bankruptcy process. Section 546(c) of the Bankruptcy Code provides a mechanism for vendors to enforce rights to reclaim goods provided to the debtor within 45 days of the bankruptcy filing. If a vendor wishes to pursue this option it must act quickly by providing a written demand for reclamation to the debtor no later than (a) 45 days after the receipt of goods by the debtor, or (b) not later than 20 days of commencement of the bankruptcy case, if the 45-day period expires after commencement of the case. The vendor must establish, among other things, that it has a common law right of reclamation, meaning that the goods that are the subject of the demand are in the debtor's possession and are identifiable. Notably, however, a bankruptcy court may determine that a secured creditor's “blanket lien” supersedes reclamation rights.

Cure Claims. In certain cases, a vendor may have an executory contract with a debtor, which may be assumed or rejected by the debtor in its bankruptcy case. If the debtor wishes to continue its contractual relationship with the vendor and assume the contract, it will be required to cure any past due amounts owing under the contract prior to assumption. The amount required to cure defaults is a “cure claim.” For many vendors—like those in Paper Source—that operate solely on purchase orders, there is no executory contract subject to assumption, and therefore there is no requirement that the debtors cure their outstanding obligations.

Claims on Prepetition Claim. If a vendor's claim does not qualify for or is not satisfied by critical vendor relief, any of the above options, or otherwise, the vendor can file a proof of claim on account of its prepetition claim. Recoveries on vendor claims, which are typically general unsecured claims, and other claims are governed by a chapter 11 plan. In cases where an official committee of unsecured creditors is formed, the committee will often negotiate recoveries on behalf of all unsecured creditors. Such creditors' committees are typically comprised of a variety of unsecured creditors. For example, the committee in Paper Source's case is comprised of two product vendors, two landlords, and one service vendor.

The existence, availability, and extent of relief available to vendors in a particular bankruptcy case, including the payment options set forth above, will vary from case to case. Many factors affect potential recoveries by vendors in a bankruptcy case, including the identity of the debtor, its circumstances, the purpose of the bankruptcy filing, events that transpire during the bankruptcy case, and the ultimate result of the bankruptcy case. Therefore, vendors should seek the advice of bankruptcy counsel to ensure they protect their rights and optimize their recoveries.

As more retailers file for chapter 11 bankruptcy protection as a result of the COVID-19 pandemic, more vendors will be faced with situations like those in Paper Source. Vendors should be prepared to navigate the bankruptcy process, and potentially retain bankruptcy counsel, to protect their interests in the event that a customer files for bankruptcy.