Introduction And Topics

- Dealing with Distress
- UCC Rights
- Bankruptcy – Automatic Stay and Priorities
- Contract Terms, Executory Contracts and Leases
- Critical Vendors
- Preferences and Fraudulent Transfers
- Settlement and Forbearance Agreements
- 363 Sales
- Proofs of Claim
- Recent Developments
Dealing with Distress

- Understand your counterparty risk.
- Watch for red flags of distress.
- Take steps to minimize exposure including stricter payment terms, guarantees and security interests.
- Carefully consider contract terms and exercise rights.
- Understand and exercise UCC and common law rights.
- Understand bankruptcy pitfalls and seek to avoid them.
UCC Rights

- Adequate Assurance (UCC 2-609) – if a seller has reasonable grounds for insecurity regarding the buyer’s ability to perform, the seller may demand adequate assurance of performance.
  - If the buyer fails to provide assurance, the contract is deemed repudiated.

- Reclamation (UCC 2-702) – a seller generally has a right to reclaim goods delivered to an insolvent buyer (typically within 10 days) and also may stop goods in transit.
UCC Rights

- Section 546(c) of the Bankruptcy Code expands a seller’s right to reclaim to goods delivered within 45 days, but “subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof.”

- Section 503(b)(9) of the Bankruptcy Code grants sellers an administrative priority claim for the value of goods the debtor receives within 20 days of its bankruptcy filing.
Bankruptcy – Automatic Stay

- Bankruptcy automatically triggers an stay enjoining all collection efforts against the debtor and its property (but generally not against others like guarantors) including:
  - Litigation
  - Collections calls or demand letters
  - Serving written notice of a termination
  - Action to terminate a contract
  - Action to take possession of property
Bankruptcy – Priority of Claims

- Secured claims, up to the value of collateral
- DIP loan (often senior secured or super-priority)
- Administrative claims, including:
  - Goods delivered within 20 days pre-bankruptcy
  - Assumed executory contracts
- Critical vendors (when applicable)
- Priority unsecured claims (e.g. wages, taxes)
- Pre-petition unsecured claims
- Subordinated claims (penalties and contractual)
- Equity
Contract Provisions

- Bankruptcy Courts disfavor pre-emptive waivers of bankruptcy rights, including agreements:
  - Not to seek bankruptcy protection;
  - To prospectively waive bankruptcy protections such as the automatic stay; or
  - To prospectively waive bankruptcy claims such as preference actions.

- Contract provisions that condition performance on the debtor’s financial condition or bankruptcy filing are usually unenforceable “ipso facto” provisions.
Contract Provisions

- Termination and default provisions tied to insolvency may be enforceable in a non-bankruptcy context.

- Termination must be fully effective pre-bankruptcy.
  - If a contract is fully terminated pre-petition, the debtor may not be able to force the supplier to supply post-petition.
  - If the supplier is critical to customer operations, prepetition termination can lead to a replacement contract that provides better protections to the supplier.
Executory Contracts and Leases

- An executory contract is an agreement where substantial performance is due and owing by both parties to the contract.

- Put another way, the breach or failure to perform by one party must be significant enough that it excuses further performance by the non-defaulting party.

- Supply agreements are usually “executory” contracts.

- Special rules for real property leases and subleases

- Special rules for IP licenses
Executory Contracts and Leases

- So long as the debtor performs its obligations post-petition, the non-debtor party is generally bound to continue perform as well.
  - While not a guarantee of payment, the Bankruptcy Code attempts to protect from further exposure by giving contract parties administrative expense priority for obligations incurred post-bankruptcy.
  - The Code does not mandate that creditors continue to incur unmitigated exposure, but the court controls the timing of hearings.
Executory Contracts and Leases

A chapter 11 debtor may, at any time before plan confirmation, seek to:

- **Reject**: Rejection is a breach (not termination) that will excuse any further performance by the non-debtor but may leave it with a general unsecured claim.

- **Assume**: The debtor may seek to assume the contract or lease, but must first cure any defaults and provide adequate assurance of future performance.

- **Assign**: The debtor may seek to assign its contract or lease to a third party.
Executory Contracts and Leases

- Anti-assignment provisions are generally unenforceable:
  - Examples: (i) non-bankruptcy law excuses the non-debtor’s continued performance absent consent (IP license); (ii) personal service contracts; and (iii) gov’t contracts.

- An assignee must:
  - Cure any outstanding payment defaults.
  - Provide adequate assurance of its ability to perform.

- No “cherry picking”
  - Absent agreement, it must be assumed “cum onere.”

- Special rules for some commercial real estate leases, IP
Critical Vendors

- Bankruptcy courts often enter orders permitting operating debtors to name certain suppliers as critical or essential vendors, and granting authority to pay those suppliers all or a portion of their pre-petition indebtedness.

- In exchange the debtor will typically seek:
  - Post-petition payment terms that are consistent with or more favorable than pre-bankruptcy terms
  - Commitment to continue supplying on credit

- Critical vendors are chosen at the debtor’s discretion.
Preferences

Transfers of property of the debtor may be subject to avoidance (i.e. clawback) if they are made:

- By the debtor;
- To or for the benefit of a creditor;
- on account of antecedent (i.e. pre-existing) debt;
- While the debtor was insolvent;
- Within the 90 days (one year for insiders) prior to its bankruptcy filing; and
- Enable the creditor to receive more than it would have in a chapter 7 liquidation.
Preference Defenses

A preference claim may be defeated (in whole or in part) if:

- The transfers were made in the ordinary course of business (the “ordinary course” defense);
- After receiving a transfer, the non-debtor party provided new value (the “new value” defense); or
- The transfer was intended to be, and was, a “contemporaneous exchange” for new value.
Poll – Preference Protection

Which of these best protect you from a preference claim?

1. Payment in advance
2. Standby letter of credit
3. Contemporaneous payment by cashier’s check
Preference Protections

- Collateral/security
- Letter of Credit
- Guarantees
- Bankruptcy safe harbors
- COD or CIA payment terms
- Retention of title
- Consignment sale
Preference Protections

- Fully secured creditors are usually protected (the plaintiff cannot show the transferee received more than it would in a liquidation).
  - Liens granted during the preference period that improved the creditor’s position may be preferences.
  - Consider statutory liens.

- Payments received under “forward” contracts may be immune from avoidance under the Bankruptcy Code.
  - Consider whether a supply contract may be drafted as a forward contract.
Preference Protections

- Letter of Credit – because an L/C is issued by a third-party bank, the automatic stay is not implicated.
  - An L/C is only as good as its language for the draw down and expiration date.
  - Be aware of L/C expiration provisions.
  - An underlying agreement should either expire prior to the L/C expiration or contain default provisions conditioning continued performance on L/C’s maintenance.
  - L/C should permit a draw for failure to renew.
Preference Protections

- Guaranty – bankruptcy typically does not preclude a party from enforcing its rights against a third party, such as a parent entity or affiliates.
  - The court may enjoin collection in certain circumstances.

- Guaranty is only as valuable as the guarantor
  - A clawback action (preference or fraudulent conveyance) might be brought to recover the payment if the guarantor itself files bankruptcy.
  - Upstream guaranty payments are typically more susceptible to challenge than downstream guaranties.
Preferences

- Advance payments are by definition not on account of “antecedent debt” and therefore are not subject to avoidance as preferences.

- This is also true for COD payments if made by cash or wire.

- A transfer by check (even a cashier’s check) does not occur until the check has cleared.

- A transfer from a third party generally is not a preference because the transfer did not involve property of the estate.
Preference Protections

- For certain types of goods, a contract may specify that title does not transfer to the debtor.
  - Consignment arrangements
  - Delayed transfer of title

- The seller must carefully follow all state laws
  - Consignment perfection laws
  - Laws pertaining to identification of property held by another such as tagging, registration, notice, etc.
Fraudulent Transfers

- Claims can arise under state law (typically 4-6 year lookback) or the Bankruptcy Code (2 year lookback)

- Two types:
  - “Actual” fraud: Intent to hinder or defraud creditors
  - “Constructive” fraud (intent is not a element):
    - Transfer of an interest in property;
    - The debtor was insolvent at the time of the transfer or became insolvent as a result thereof; and
    - The debtor received less than a reasonably equivalent value in exchange for the transfer.
Poll – What are the risks?

Your counterparty is in financial distress but offers payment to you from an affiliate. What are the risks?

- Preference
- Fraudulent Transfer
- Both
- No risk
Fraudulent Transfers

- Defenses
  - The transfer was received in good faith and for value.
    - “Red flags” may destroy a good faith defense.
  - “Safe harbored” transfers

- Know your payor
  - If an affiliate makes the payments and it then seeks bankruptcy protection, there may be a fraudulent transfer risk.

- Pre-bankruptcy settlements, lease terminations might be challenged as fraudulent transfers
Settlement Agreements

- Risk of clawback of settlement payment
  - Payments under a settlement agreement often constitute *prima facie* evidence of a preference
  - Bankruptcy trustee is likely to seek to avoid payment
  - May be a fraudulent conveyance if paid by third party that is insolvent

- Note: It is usually better to take and have to give (some) back, than not to take at all.
Settlement Agreements

Settlement Agreement Terms:

- **Springing release**: Delay the effectiveness of any release of claims (and the dismissal of any pending litigation) until 91 days after the last payment is made.

- **Preservation of the claim**: Provide for the preservation and reinstatement of the full amount of the claim in the event any clawback is sought.

- **Escrow**: May be helpful in some circumstances.

- **Reps and warranties from solvent affiliates/principals**
Forbearance Agreements

- Payments on account of unsecured antecedent debt made under a forbearance agreement often constitute \textit{prima facie} evidence of a preference.

- Fees and charges associated with new extensions of credit to, or property released for use by, the debtor, typically are not a preference.
  - If fees are excessive, it may be a fraudulent transfer.
Section 363 Sales

- Buyer acquires some or all of the debtor’s assets free and clear of existing liens, claims and encumbrances
- Bankruptcy sale is subject to higher and better offers
- Bankruptcy court approval eliminates fraudulent conveyance and other risks to a good faith arms’ length buyer
- Sale orders typically contain numerous “bells and whistles” that further protect and benefit buyer
Section 363 Sales

- “Free and clear” language will not always insulate a buyer from all creditor claims.
  - Particularly in the context of employment, environmental and personal injury claims, a free and clear order may not foreclose a creditor’s pursuit of claims against a new owner.
  - Even if the order is ultimately enforced, the purchaser may be forced to incur legal fees defending against the claim.
Section 363 Sales

- **As-Is, Where-Is:** The debtor’s representations and warranties are typically worthless after closing, and the buyers take what it gets.
  - Purchase through bankruptcy may reduce diligence costs associated with investigating claims that the bankruptcy order clearly cuts off.
  - Indemnities and the like are meaningless if the debtor does not have the funding to satisfy them.
Poll – Section 363 Sales

Buyer in 363 Sale has designated your contract for rejection. Supplier should:

- Don’t waste any more time and energy on it.
- Contact buyer and seek to enter into new contract.
- Contact buyer and ask to have contract assumed and negotiate cure and going forward costs.
Section 363 Sales

- Buyer may seek to reject executory contracts (to avoid paying cure costs) and to enter into new contracts.
  - Agreement between buyer and supplier to waive/reduce cure costs, but which requires assumption of the contract, will often protect the supplier against preference exposure.

- Contract parties must be vigilant about protecting their rights in a 363 sale.
  - Parties with IP, subleases, etc. should monitor the sale process and terms.
Proofs of Claim

- In most cases a creditor will want to file a claim.

- A creditor should consider including a contingent claim for potential additional damages, particularly for warranty, indemnification and similar rights.

- Consider priority claims, including section 503(b)(9) and any setoff rights.

- Lawyers (both outside or inside counsel) should avoid signing the proof of claim on behalf of creditor.
Recent Developments

- The Small Business Reorganization Act, Subchapter V
  - Previously applied to small businesses with debt amounts up to $2.75 million, but CARES upped the debt threshold to $7.5 million
  - No absolute priority rule

- PPP eligibility and bankruptcy

- “COVID Cover”

- “Mothball Motions”
Conclusion

- Consider whether contractual relationships can be structured to better shield against bankruptcy risks.
- Be alert to the warning signs of distress.
- Don’t hesitate to exercise contractual and UCC rights pre-bankruptcy.
- Don’t miss opportunities to potentially turn bankruptcy lemons into lemonade.
Thank you