Santa Clara County Bar Association

"What Every Business Lawyer Needs To Know About Bankruptcy"

or

"What the Frog Needs to Know About the Scorpion at the Riverbank"

May 18, 2010
5:30 pm

Patrick M. Costello
Vectis Law Group

The Scorpion and the Frog

A scorpion and a frog meet on the bank of a stream and the scorpion asks the frog to carry him across on its back. The frog asks, “How can I know you won’t sting me?” The scorpion says, “Because if I do, I will die too.”

The frog is satisfied, and they set out, but in midstream, the scorpion stings the frog. The frog feels the onset of paralysis and starts to sink, knowing they both will drown, but has just enough to gasp, “Why?”

Replies the scorpion, “Its my nature …”.

Attributed to Aesop (but nothing is certain, and bankruptcy lawyers like it that way).

Scorpion	= Distressed Company
Frog	= Client
“Its my nature …”	= “Bankruptcy Happens …”

- This presentation is intended for the business/corporate lawyer whose business client is transacting business with a distressed entity that may at some point file for bankruptcy relief. My focus is how to draft agreements and structure transactions in anticipation of a bankruptcy rather than the nuts and bolts of what happens in a bankruptcy case – with, of course, two notable exceptions.

1

Overview of Types of Bankruptcy Cases

- Chapter 11
  - Debtor continues to manage assets subject to significant constraints and judicial oversight.
- Chapter 7
  - Trustee, not debtor, takes control of and liquidates assets.
  - Trustee ordinarily does not operates business: business shuts its doors.
- Chapter 13
  - Available only to “individuals with regular income”: material debt limitations.
  - The goal is to permit individual to retain assets and make payments to creditors out of future disposable income.
- Chapter 12
  - The family farmer or fisherman.
- Chapter 9
  - Municipalities.
  - Expect to see more of these.

2 Attorneys Working For A Debtor In Possession or Trustee

- 11 USC §327: An attorney representing a debtor in possession must be approved by the Bankruptcy Court.
  - Failure to have employment approved by court means attorney is not entitled to compensation.
- 11 USC §327: Attorney employed for a “special purpose” does not have to be “disinterested” so long as attorney does not hold or represent any interest to the debtor or to the estate with respect to the matter on which employed.
  - “special counsel” is not disqualified if it has a claim for unpaid fees against the debtor.
- FR BP 2014: Attorney must disclose all “connections with the debtor, creditors, any other party in interest, their representative attorneys and accountants and United States Trustee.
- 11 USC §328: Any compensation arrangement other than straight hourly wage requires special approval under Section 328(a).
  - Failure to obtain specific approval means the arrangement may not be honored.

Practice Pointers

- Require bankruptcy counsel to prepare and file your employment application and follow up to obtain approval order. Do not undertake material work before the employment application is at least filed with the bankruptcy court.
- "Nunc pro tunc" or approval retroactive to a date before the filing of the application is difficult to obtain and all fees incurred prior to that are at risk.
- If your compensation arrangement is anything other than hourly, confirm with bankruptcy counsel that the application is seeking authority under Section 328. If you have such an arrangement, it is advisable for you to consult with your own bankruptcy counsel.
- Approval of employment is only half the battle, you need to know that there is money to pay your compensation. In most cases, debtor's cash is encumbered and you need to confirm:
  - That the budget approved by the bankruptcy court for use of cash includes a line item for payment of your compensation.
  - That the budgeted funds are "committed", i.e., they do not disappear if there is a default under the financing arrangements.
  - That the committed amount is adequate to pay your compensation as well as any other professionals entitled to draw on that budget line item.

3

Clients Transacting Business With A Debtor In Possession Or Trustee

- 11USC §363(a): Trustee/DIP can enter into transactions “in the ordinary course of business” without notice or hearing or court approval.
- 11 USC §363(b): A transaction outside of ordinary course of business requires notice and a hearing.
  - Recommended to have bankruptcy court order.
- 11 USC §363(c): Trustee/DIP cannot use “cash collateral” without either (i) consent of entities with interests in the cash collateral or (ii) court authorization.
- 11 USC §549(c): The trustee can avoid a post-petition transfer of property of the estate that is not authorized under the Bankruptcy Code or by the Bankruptcy Court.
  - Trustee can avoid payments that are outside of cash collateral authorization or transaction outside of ordinary course of business that is not noticed with opportunity for hearing.

Practice Pointers

1. Be very conservative in concluding that transaction is "in the ordinary course of business": it is your client, not the DIP/trustee, that bears all the risk that a transaction is not in the ordinary course of business. If it is not in the ordinary course and is not authorized, DIP gets all the benefit but your client does not get paid. If there is any doubt, require court order authorizing transaction. Even if fairly certain, request that DIP's bankruptcy counsel confirm in writing that transaction is "in the ordinary course of business" and no notice and hearing is required.
2. Separate from the question of whether transaction requires court authorization, confirm that DIP has funds to pay and is authorized to use those funds. Determine:
   - Whether the funds are cash collateral.
   - If they are cash collateral, that DIP is authorized to use funds for the transaction.
   - Request that DIP's bankruptcy counsel confirms in writing that DIP is authorized to use funds to pay your client.
   - Remember, if either the transaction or use of cash collateral are not authorized, the payment to your client can be clawed back when case converts to a Chapter 7.

4

The Automatic Stay

- 11 USC §362: The filing of a voluntary or involuntary bankruptcy petition operates as a stay applicable to <u>all entities</u> of:
  - Commencement or continuation of any action or proceeding <u>against the debtor</u> that was or could have been commenced before the bankruptcy petition based on a pre-petition claim against debtor.
    - [Note: applies only to pre-petition claims, not post-petition claims.]
  - Enforcement of a judgment against the debtor or property of the estate of a pre-petition judgment.
  - Any act to obtain possession of property of the estate or property from the estate or exercise control over property of the estate.
    - [Not limited to recovery on pre-petition claims.]
  - Any act to create, perfect or enforce any lien against property of the estate.
    - [Not limited to recovery on pre-petition claims.]
  - Any act to collect, assess, or recover on a pre-petition claim.
  - The setoff of a pre-petition amount due the debtor against a claim against the debtor.

The Automatic Stay (Continued)

- The stay has the power and force of a court injunction without any requirement of advance notice or service on creditors or other entities.
- Actions in violation of the stay are typically held to be void and with effect, but can also result in liability for damages for contempt.
- There are multiple exceptions to the stay, i.e., acts that are permitted, but none of which are likely to apply to the business client.
- The stay against any acts to (i) exercise control over property of the estate and (ii) recover on a pre-petition debt are very broad and powerful.

The Automatic Stay (Continued)

- Impact on Business Client
  - No collection activities on debt, including notices of delinquency or default, against debtor.
    - Does not stay collection against non-debtors, i.e., guarantor or letter of credit.
  - No termination of a contract to which the debtor is a party.
  - No reclamation of goods.
    - Although stoppage of goods during shipment is permissible if it is your carrier rather than debtor's.
  - No setoffs.
    - While setoff is stayed, the right is not lost and can be asserted as secured claim or relief from stay may be obtained to allow setoff.
    - Must be vigilant to ensure this setoff right is not lost. It can be lost by (i) failure to properly reflect in a proof of claim, or (ii) plan provisions.
    - Stay of setoff may be problematic where business relationship involves material credits to debtor, e.g., returns or sales incentive programs.

Practice Pointers

- Having the debtor in default can have important consequences on the non-debtor's liabilities under a contract.
- Consider the following drafting points:
  1. Have default for material performance default, i.e., non-payment or other non-performance, be automatic: specifically, do not require written notice as a condition to event of default so stay does not prevent an event of default.
     - See discussion under Executory Contracts for related drafting suggestions.
  2. Consider obvious credit enhancement measures such as third party guarantees, security interests, and letters of credit.

5 Ipso Facto Clauses

Ipso Facto = by reason of the mere fact itself.

- 11 USC §365(c): Neither lease nor executory contract nor any right or obligation there under can be terminated or modified based solely on a provision that is conditioned on the insolvency or financial condition of the debtor at any time prior to the closing of the case, the commencement of a bankruptcy case or the appointment of a trustee in the case or custodian (e.g., receiver) before the case.
  - Does not apply to a “personal services” contract or a debt financing or financial accommodation agreement.
- 11 USC §541(c)(i): Property of the debtor becomes property of the estate notwithstanding any provision in an agreement, transfer instrument, or applicable non-bankruptcy law that is conditioned on the insolvency or financial condition of the debtor, or appointment of trustee or custodian and that effect a forfeiture, modification or termination of the debtor’s interest in property.
- The rationale for “ipso facto” provisions is that mere insolvency, financial condition or bankruptcy does not mean that the debtor has not and will not fully perform its obligation: insolvency or bankruptcy does not mean that the non-debtor will not receive the benefit of its bargain. Tying the debtor’s rights under an agreement to the status, i.e., insolvent or bankrupt, rather than performance is likely to effect a forfeiture.
- §365(e) effectively reads all such “ipso facto” clauses out of the contract.

Practice Pointers

- In most cases, lawyers use bankruptcy or insolvency as a “short hand” for a failure of consideration or failure to perform.
- Rights which “spring into existence” or become effective on an ipso facto clause will never “spring” or become effective.
- Lawyers can avoid the risks of relying on an “ipso facto” clause by “drilling down” and specifying performance defaults.
  – This may be very industry/contract specific, but it is readily achievable.
  – Ask precisely what performance does client need to be concerned about and focus on defining events of default that capture that performance obligation.

6

Preferences

- 11 USC §547(b): DIP/trustee can avoid any transfer of property (money or property) of debtor that satisfies the following:
  - To or for benefit of a creditor.
  - For or an account of an antecedent debt of creditor owed before transfer.
  - Made with 90 days prior to the date of petition [one year for an insider].
  - Made while debtor was insolvent (insolvency presumed within 90 days of petition).
  - Enables creditor to receive more than if transfer was not made and creditor received payment in a Chapter 7 liquidation.
- Defenses to Preference:
  - Contemporaneous exchange.
  - Ordinary course of business.
  - New value given after transfer.
- 11 USC §550
  - DIP/trustee can recover either (i) property transferred or (ii) value of property.
  - DIP/trustee can recover not just from creditor, but the initial or mediate transferee.

Potential Preferences Scenarios

- Scenario A
  - Client sells product to distressed company on 30 day terms. Distressed company pays:
    - In 15 days because it knows it is in trouble and desires to maintain relationship.
    - In 30 days per the invoice terms.
    - In 45 days.
- Practice Pointers
  1. All the requirements for a preference are satisfied when distressed company received the goods: the “credit transaction” created an antecedent debt. There is no assurance that any of the defenses would apply under any of the payment scenarios.
  2. Eliminate the preference risk by requiring cash in advance or cash on delivery (no checks).

Potential Preference Scenarios

- Scenario B
  - Client proposes to purchase the operating assets of distressed company. As part of the purchase price, client agrees to assume responsibility for amounts due employees and key suppliers.
- Practice Pointers
  1. Amounts owed employees and suppliers are antecedent debt. Even though client was not a creditor of distressed company, client is liable for preference as initial transferee because assets were transferred on account of antecedent debt.
  2. Alternative transaction structures to mitigate preference risk:
     i. Pay full amount to distressed company with distressed company covenanting to use purchase price to pay employees and suppliers.
        - Employees and suppliers still have a preference exposure, but client/purchaser does not.

     ii. Reduce purchase price and separately purchase the claims of employees and suppliers.

     iii. Reduce purchase price and "volunteer" payments to employees and suppliers.

Potential Preference Scenarios

- Scenario C
  - Client obtained letter of credit as credit support for sales to distressed company. Client ships product to distressed company and distressed company pays late, but before client draws on the letter of credit. Distressed company files bankruptcy petition within 90 days of payment.
- Practice Pointers
  1. Delinquent payment is likely avoidable as preference even though client would have drawn on letter of credit – which would not have been a preference – if the payment had not been made.
  2. Alternative transaction structures to mitigate risk:
     - i. If client has a letter of credit, require payments be made through a draw on letter of credit. The letter of credit is no longer just “stand-by” – it is the exclusive payment mechanism. No payments from distressed company.
     - ii. Provide that in case of a bankruptcy filing, client can draw an amount equal to all amounts paid and/or due within 91 days of the date of a petition.

7

Fraudulent Transfers

- 11USC §548: DIP/trustee can avoid any transfer made or obligation incurred within 2 years of filing of the petition where either:
  - Actual Intent
    - Transfer made/obligation incurred with actual intent to hinder, delay or defraud a creditor.
  - Constructive
    - Debtor received less than reasonably equivalent value in exchange and debtor was insolvent or became insolvent.
      - “insolvent” encompasses 3 distinct tests for insolvency.
    - Special rule for transfers/obligations under insider employment contract: DIP/trustee not have to satisfy insolvency requirement.
- 11 USC §550: As with preference, DIP/trustee can recover from initial or subsequent transferee.

Potential Fraudulent Transfer Scenarios

- Scenario A
  - Client makes loan to corporate group (parent and subsidiary) secured by all assets of members of corporate group with proceeds paid to parent and no covenants as to how or by which entity the funds are to be used.
- Practice Pointers
  1. This is a version of the "upstream guarantee": the subsidiary is pledging its assets – incurring an obligation – without any assurance that it will receive reasonably equivalent value for the obligation. Whether there is reasonably equivalent value depends on whether discernable benefit flows to subsidiary: this is an uncertain matter without any designation of how funds are to be used.
  2. Loan documentation should designate how funds are to flow or be used. At a minimum include recitals as to benefits received by subsidiary.

Potential Fraudulent Transfer Scenarios

- Scenario B
  - Client is purchasing line of business as going concern from a corporate group, and assets are split among members of group: IP held by parent and tangible assets by subsidiary. The purchase price is a lump sum with allocation to be determined by client based on tax considerations.
- Practice Pointers
  1. Be very careful about allocating purchase price solely in order to maximize tax benefits: if a material portion of purchase price is allocated to one member of the corporate group, there is a risk that another member of the corporate group did not receive reasonably adequate consideration.
  2. Requiring that all assets be transferred to single entity in the corporate group to act as seller solves the purchase price allocation issue, but it only removes the fraudulent transfer risk by a single step. The fraudulent transfer now occurs between members of the corporate group, but purchaser is still a subsequent transferee.

Potential Fraudulent Transfer Scenarios

- Scenario C
  - Client is an investor and is going to provide secured bridge financing to distressed company. Investor reasons that a 3X return on loan is necessary to appropriately represent risk/return ratio.
- Practice Pointers
  1. The only practice pointer is “Do Not Do it”. Requiring a debtor to pay that 3 dollars for every dollar advanced = lack of reasonably equivalent value. Such terms put the entire secured loan at risk: The entire obligation will be avoided and the security interest “cancelled” if it is a fraudulent transfer.

8

Executory Contracts

- 11 USC §365: DIP/trustee can generally assume or reject an executory contract or lease.
  - “Executory Contract” means material unperformed obligations – other than the payment of money – remain due on both sides.
  - A contract where the debtor has material unperformed performance obligations will be deemed an executory contract.
  - A license of intellectual property – whether debtor is licensor or licensee – will be considered an executory contract because the license is deemed a continuously performed covenant not to sue.
  - Rejection is treated as a breach of the contract or lease, but it is more helpful to consider it a repudiation: Debtor is saying I will not render any further performance.
  - Assumption means honoring the contract and requires a cure of defaults. If an executory contract can be assumed, it can be assumed and assigned to a third party.
  - In Chapter 7, all executory contracts and leases automatically rejected after 60 days if not assumed before that.

Executory Contracts

– In Chapter 11:
  - Lease for non-residential property is deemed rejected after 120 days, but court can extend this deadline.
  - **There is no deadline for assumption or rejection with respect to executory contracts**.
– Non-debtor counter-party can request the bankruptcy court to set a deadline for assumption or negation, but likelihood of court granting relief are low, unless non-debtor can demonstrate that executory contract cannot be assumed and/or irreparable material harm.
– Special provisions on effect of rejection and tenants under rejected leases and licensees under IP licenses
  - those protections may provide materially less than lease/license contemplated.

Practice Pointers

- Question of whether non-debtor is required to perform obligations prior to assumption is not free from doubt. Consult bankruptcy counsel before staking out a position on obligation to perform post-petition/pre-assumption.
- Prior to an assumption or rejection, executory contract is in “limbo”: Non-debtor may have to perform at some point, but may never have to perform. Maintaining the ability to perform for an indefinite period of time can impose significant non-recoverable resource allocations costs on non-debtor. For that reason, non-debtor is generally better served if contract can be terminated (without breach or penalty) before a petition is filed.
- Consider the following contract provisions:
  – Include a clear statement to the effect that non-debtor has no obligation to perform or take action to place itself in a position to perform during debtor’s default.
  – Include a clear statement to the effect that the running of any time-period or deadline for non-debtor is tolled/suspended for the entire time the debtor is in default.
  – Include a provision to the effect that no credit is due or payable to debtor while any amount due non-debtor remain unpaid.
  – Keep initial term of contract relatively short with renewal terms. If renewal is automatic (i.e., no notice from either party), condition it upon no default continuing at time of renewal (Note: 9th Circuit case permitted renewal with default, in bankruptcy and without on assumption). If entity is truly distressed, condition renewal on client’s written consent to renewal (do not use client’s notice on non-renewal because stay may prevent such a notice).
  – For supply agreements, condition obligation to accept purchase orders on (i) no defaults and (ii) credit department approval or credit limit.
- Do not require a notice of default be given with respect to distressed company’s performance default.