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Mayday! Bankruptcy is Looming or Filed — Now What?

Outline for Presentation to ACC Charlotte Chapter – Jan. 19, 2016

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We regularly work with clients, and in particular, industrial manufacturing clients, whose customers and suppliers are in financial distress. We prepared the following outline to accompany our presentation on (A) issues – and best practices for – dealing with distressed customers and suppliers before bankruptcy, (B) some basic bankruptcy principles, (C) issues – and best practices for – dealing with distressed customers and suppliers after a bankruptcy filing and ways for protecting your rights in a bankruptcy proceeding, and (D) preference and fraudulent transfer claims and defenses.

Before a Bankruptcy Filing

For Customers

Look for the usual warning signs

- Clues from types and timing of payments received
- Clues from trade credit
- Collection lawsuits
- New liens – UCC liens, judgment liens and tax liens
- Inaccessibility of senior management
- Changes in management or on board of directors
- Loan covenant defaults
- Inability to deliver financial statements
- Inability to meet sales or financial projections

Monitor customers

- Google Alerts
- Websites
- UCC and real property searches
- Subscription services, like Dunn & Bradstreet, Bloomberg News, Debtwire

Consider seeking to obtain credit support for continued supply of goods

- Purchase money security interest and perfect with UCC filing

- Standby letter of credit
- Third-party guaranty
- Credit insurance
- Surety bond

Consider changing payment terms

- Cash on delivery (COD), ideally with wire transfer or cashier's check
- Cash in advance (CIA)
- Evergreen retainer or cash deposit
- Reduce credit terms, ideally to less than 20 days
- Lower credit limit

Deposit payments promptly

For Suppliers

Look for usual warning signs - In addition to all those mentioned earlier

- Production and delivery delays
- Request for expedited payments
- Reduction in workforce or furlough of employees

Monitor suppliers

Evaluate status of tooling, patterns and molds

- Paperwork
- Identification
- Segregation

Evaluate status of work in process

Consider timing for qualifying other potential suppliers

For Both Customers and Suppliers

Demand adequate assurance of performance

- UCC § 2-609
- Trigger: Reasonable grounds for insecurity – i.e., doubt ability to perform

- Make written demand for adequate assurance of future performance
  - Letter of credit
  - Change in payment terms to COD or CIA
  - Obtain guaranty
- Pending receipt of adequate assurance, suspend performance and stop delivery of goods sold on credit

Maintain accurate and complete records

Consider terminating any existing supply contracts following default

- Will permit change in payment terms
- Avoid potential bankruptcy-related risk
  - Existing contracts likely "executory" contracts under the Bankruptcy Code
  - Absent proper termination before bankruptcy filing,
    - Duty to perform after bankruptcy
    - Little chance of termination absent default after filing

Exercise setoff or recoupment rights

- Powerful remedy
- Protects a party from having to pay its debt in full and risking not getting paid on debt owed
- Must have mutuality of parties and mutuality of debts for both setoff and recoupment
- For setoff, not necessary that debts arise out of same transaction or contract
- Recoupment is a subset of setoff; it requires the mutual debts to arise from same contract or transaction

Basics of Different Types of Business Bankruptcy Cases and Basic Bankruptcy Principles

Chapter 7

- Liquidation or "straight" bankruptcy
- Typically no continuing operations
- Court-appointed trustee takes possession of assets and manages liquidation

Chapter 11

- Reorganization case
- More often than not – an asset sale under Bankruptcy Code § 363 to preserve going concern value

- Not like the “old days” when a true reorganization
- Continuing business operations – even if temporary to get an asset sale completed -- subject to Bankruptcy Court oversight
- Debtor in possession or DIP
- Unsecured Creditors Committee
- United States Trustee
- No court-appointed trustee

Involuntary case

- Case filed by creditors
- Typically a Chapter 7 filing
- Debtor can convert to Chapter 11

Receiverships and assignments for the benefit of creditors

- Bankruptcies have gotten expensive
- Often more cost-effective than bankruptcy (particularly Chapter 11)
- Remedies based on state statute, so not consistent statutory schemes
- Outcomes potentially similar – and often are similar – to outcomes in bankruptcy cases, but may be different

Distribution scheme in bankruptcy

- First, secured creditors paid based upon the value of collateral
- Second, administrative claims – essentially costs and expenses incurred following the bankruptcy filing and as provided in Bankruptcy Code § 503
- Third, general unsecured claims elevated to priority claim status based on Bankruptcy Code § 507
- Fourth, general unsecured claims
- Fifth, equity to extent all other creditors paid in full – a rarity

After a Bankruptcy Filing

The automatic stay

- Bankruptcy Code § 362
- Self-effectuating statutory injunction
- Enjoins actions to collect on debts owed or take control of property of the bankruptcy debtor
- Enjoins efforts to terminate pre-bankruptcy contracts

- Bankruptcy Court can impose sanctions for willful violations of § 362 stay
- § 362 stay does not apply to any non-debtors

Goods in transit

- Permissible to stop goods in transit if not yet delivered to debtor or its agent

Post-filing supply

- Adequate assurance of performance (UCC § 2-609) continues to apply
- Executory contracts - Bankruptcy Code § 365
    - Each party owes the other performance
    - May be assumed or rejected in the bankruptcy case
    - Pending assumption/rejection decision, both parties must perform
    - In a Chapter 11 case, debtor will typically have until plan confirmation or asset sale to assume or reject
    - In a Chapter 7 case, deemed rejection 60 days after bankruptcy filing absent a Bankruptcy Court extending the deadline
- "Critical Vendor" doctrine
    - Not expressly provided in Bankruptcy Code but allowed under case law in Chapter 11 cases
    - Requires a Bankruptcy Court order
    - Permits payment on pre-bankruptcy balance if truly critical to debtor's continued operations
        - Not permitted if alternative supply sources readily available
        - Not permitted if post-bankruptcy shipments on credit made

Reclamation for goods supplied during the 45 days before bankruptcy

- Bankruptcy Code § 546(c) and UCC 2-702(2)
- Applies to goods delivered to debtor in 45 days before bankruptcy filing
- Must make written demand on debtor within 20 days following bankruptcy filing
- Might have limited effectiveness because of senior bank liens
- Failure to invoke right = waiver
- Typically, reclamation claims resolved, subject to any senior bank liens

Supply of goods during the 20 days before bankruptcy filing

- Bankruptcy Code § 503(b)(9)
- Grants priority status for the value of these goods

- Elevates amount supplied above general unsecured claims
- Requires that goods are received by debtor in 20 days before filing
- Requires that goods be purchased in debtor's ordinary course of business
- Requires proof of claim to be filed – be aware of any filing deadline
- Administrative expense claims are usually paid in full
- Might limit new value defense to a preference claim for amount paid under § 503(b)(9)

Setoff and recoupment

- The right of setoff is preserved in bankruptcy
- Effecting setoff is prohibited by § 362 stay without Bankruptcy Court approval
- Recoupment is not prohibited by § 362 stay
- Recoupment is requires the mutual debts to arise from same contract or transaction

Debtor in possession financing

- DIP financing allows debtor to operate business in Chapter 11 and pay post-petition vendors
- Normally lined up before the bankruptcy filing and is approved very early in the case and on an expedited timeline

Asset sales under Bankruptcy Code § 363

- Sale of assets free and clear of liens outside the ordinary course of business
- Includes contracts asset buyer wants to assume
- Typically occurs fairly early in a bankruptcy case
- Occurs in both Chapter 7 and Chapter 11 cases but sale as going concern does not typically occur in a Chapter 7 case
- Requires Bankruptcy Court approval of both process and sale
- Be aware of court-imposed deadlines for objections to sale and assignment of contracts

Proof of Claims

- Must be aware of "bar" date for filing claims and proper place for filing
- Should receive notice of bar date and filing instructions
- By filing a claim, consent to jurisdiction of Bankruptcy Court and likely waive jury trial right
- Required in Chapter 7 case to protect right to distribution
- Required in Chapter 11 case only if debtor lists claim on claim schedules as unliquidated, contingent or disputed

- Failure to file by "bar" date waives claim
- Generally unsecured creditors are not entitled to post-bankruptcy interest, even if permitted under contract documents
- Official Bankruptcy Form 410 – in hard copy of materials
    - New form as of December 1, 2015
    - Fairly simple and straight-forward
    - Important to attach any contract documents and invoices (or a summary of invoices)
    - Not required, but we typically include an exhibit containing short summary of background facts and basis for claim

Preferences - Bankruptcy Code § 547

Essentially payments on account of existing unsecured debt within 90 days of bankruptcy filing -- § 547(b)

Defenses

- Contemporaneous exchange of new value
- Ordinary course of business
- Subsequent new value
- Purchase money security interest
- Total payments less than $6,225

Likely won't hear about preference claim until close to two years after bankruptcy filing

Fraudulent Transfers - Bankruptcy Code § 548

Pre-bankruptcy transfers and payments that diminish the bankruptcy estate

Actual fraudulent transfers

- The debtor made transfer with the actual intent to hinder, delay or defraud
- The "smoking gun"

Constructive fraudulent transfers

- The debtor received less than reasonably equivalent value for transfer
- The debtor:
    - Was insolvent at the time of the transfer or was rendered insolvent
    - Was engaged in business or transaction, or was about to so engage, with unreasonably small capital

- Intended to incur, or believed it would incur, debts beyond the ability to repay as they matured
- Made transfers to or for the benefit of an insider under an employment agreement and not in the ordinary course of business

Two-year “look back” period under Bankruptcy Code § 548

Longer “look back” period under state law made applicable under Bankruptcy Code § 544

Litigation typically focuses on:

- Reasonably equivalent value in exchange for transfer
- Insolvency issues

Likely won’t hear about fraudulent transfer claim until close to two years after bankruptcy filing