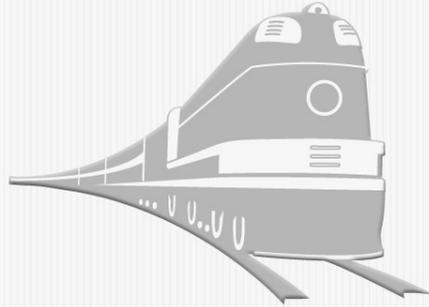


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When Bankruptcy May Strike Your Customer, Supplier, or Contractual Counter-Party: Maximizing Your Creditor Rights and Remedies and Minimizing Risks

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Minimizing Risk

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Identifying the Warning Signs

- » Financial Warning Signs
 - Use of Z-Score which measures five financial ratios which are multiplied by a factor depending upon if the company is publicly or privately held
 - Declining prices of credit default swaps which reflect increased default risk
 - Use of factoring agreements to provide liquidity

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Identifying the Warning Signs

- » Financial Warning Signs
 - Untimely financial reporting and/or financial restatements and significant change offs
 - Continued and significant disparity between actual and budgeted results
 - Renegotiated loan covenants or fully drawn lines of credit

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Identifying the Warning Signs

- » Financial Warning Signs
 - Deteriorated working capital ratios such as accounts receivable and payable or decline in inventory turns
 - Requests for changes to credit terms
 - Delay of dividend payments or bond payments

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Identifying the Warning Signs

- » Operational Warning Signs
 - Increasing reliance on affiliates or related corporate entities
 - High staff turnover
 - Significant exposure to depressed market or adversely affected industries
 - Captivity to a limited number of customers

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Identifying the Warning Signs

- » Operational Warning Signs
 - Acquisition of new product lines to resuscitate existing business model
 - Use of debt to fund rapid expansion
 - Cutbacks on capital expenditures, research and development, employee training, or other expenses viewed as non-essential or not time-sensitive

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Identifying the Warning Signs

- » Management Warning Signs
 - Change in key managers or officers
 - Sale of stock by insiders
 - Employment of financial advisors or other turnaround consultants by management
 - Shareholder disputes and class action litigation
 - SEC and criminal investigations

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Obviating and Minimizing Impact of Avoidance Action Litigation

- » Preference Liability – 11 U.S.C. § 547
 - Representative transfers that could fall within the purview of preference liability
 - » Grants of security interest
 - » Payments of invoices
 - » Issuances of guarantees
 - » Tendering of settlement payments
 - » Anything that would constitute a transfer of an interest in debtor's property

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Obviating and Minimizing Impact of Avoidance Action Litigation

- » Preference Liability – 11 U.S.C. § 547
 - Structuring pre-bankruptcy agreements to minimize preference liability
 - » Insist upon issuance of letter of credit
 - » Obtain guarantees by corporate affiliates
 - » Obtain representations and warranties that the debtor is not pledging and the third party is not receiving any property from the debtor

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Obviating and Minimizing Impact of Avoidance Action Litigation

- » Preference Liability – 11 U.S.C. § 547
 - Structuring pre-bankruptcy agreements to minimize preference liability
 - » Structure settlement to the extent possible as a contemporaneous exchange of obligations for new value
 - » Obtain representations and warranties that the debtor is solvent and include specific recitations regarding such solvency within the agreement
 - » If the agreement involves payment to you followed by a release by you or a reduction in the claims against the debtor, provide that such releases or reductions are effective 91 days after receipt of payment

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Obviating and Minimizing Impact of Avoidance Action Litigation

- » Utilizing statutory safe harbors under the Bankruptcy Code and common law defenses
 - Ordinary course of business
 - » Favorable change in the law for ordinary course defense
 - Prior Law
 - New Law

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Obviating and Minimizing Impact of Avoidance Action Litigation

- » Utilizing statutory safe harbors under the Bankruptcy Code and common law defenses
 - Ordinary course of business
 - » Practice pointers
 - Keep customers on a regular and routine payment cycle, if possible
 - Exercise caution when making demands for payments that are late
 - Be careful if you modify the payment schedule to require faster payment
 - If negotiating a settlement agreement with the debtor, ALWAYS ask for an avoidance action waiver (which includes a preference waiver)

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Obviating and Minimizing Impact of Avoidance Action Litigation

- » Utilizing statutory safe harbors under the Bankruptcy Code and common law defenses
 - Contemporaneous exchange of new value
 - New value
 - Status conduit versus initial transferee – 11 U.S.C. § 550
 - Property transferred by the debtor was subject to a statutory or constructive trust
 - Earmarking Doctrine - where a third party provides necessary funds to retire a specific obligation a debtor owes to an existing creditor, the payment to the existing creditor is not a transfer involving the debtor's property and, therefore, cannot be avoided

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Fraudulent Transfer Liability

- » Statutory grounds for fraudulent transfer liability
 - Federal Bankruptcy Code – 11 U.S.C. §§ 548, 550
 - State Law
 - » Uniform Fraudulent Conveyance Act (UFCA)
 - » Six year look-back period
 - Uniform Fraudulent Transfer Act (UFTA)
 - » All other states
 - » Four year look-back period

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Types of Fraud

- » Actual fraud (Fraud in Fact)
 - A transfer is actually fraudulent if it was made “with actual intent to hinder, delay, or defraud any entity to which the debtor was or became... indebted.” 11 U.S.C. § 548(a)(1)(A)
 - Because intent to defraud may be difficult to prove, courts rely upon certain “badges” of fraud to establish such intent

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Types of Fraud

- » Constructive fraud (Fraud in Law)
 - Two key components
 - » Lack of reasonably equivalent value
 - » Existence of one of the following “plus” factors
 - Debtor was insolvent or rendered insolvent by the transfer
 - The transaction left, or would have left, debtor with unreasonably small capital
 - Debtor intended or believed that it would incur debts that it could not pay when those debts matured
 - Debtor made the transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business

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Limiting Fraudulent Transfer Liability

- » Use of revival clauses
- » Document the transaction carefully
- » Use common sense when documenting the transaction
- » Establish good faith

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Maximizing Creditor Rights and Remedies

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Remember the Acronym S.C.R.A.P.S.

- » S – Section 503(b)(9) Claim
- » C – Critical Vendor Status
- » R – Reclamation
- » A – Assumption
- » P – Performance Demands (Including Adequate Assurance)
- » S – Setoff/Recoupment

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Section 503(b)(9) Claim

- » 20-Day Administrative Expense Claim: Creditors have an administrative expense claim for the value of any goods received by the debtor within 20 days before the debtor's bankruptcy filing as long as the goods were sold to the debtor in the ordinary course of debtor's business
- » In a Chapter 11 case, all administrative expense claims must be paid in full in order for a plan to be confirmed
- » Payment of such administrative claims may be deferred until the "Effective Date" of the plan
- » Normally payment of administrative expense done through application

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Critical Vendor/Essential Supplier Status

- » Supplier can be paid in advance of and at higher percentages (usually in full) than others on account of its prepetition unsecured claim
- » Treated differently in different jurisdictions
- » Certain creditors (usually trade creditors) can be deemed “essential” or “critical” in bankruptcy proceeding if they are:
 - Irreplaceable supplier
 - Crucial to continued operation and successful reorganization of debtor

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Critical Vendor/Essential Supplier Status

- » Creditor may argue that it is a “critical” vendor if
 - The creditor has no continuing obligation to continue to do business with the debtor
 - There is an inability to replace that creditor
 - If the creditor would be forced into bankruptcy as a result of its unpaid claim or where the creditor does not have an alternative market for the goods it is producing

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Reclamation

- » Pre-Bankruptcy
 - U.C.C. § 2-702
 - Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply. Except as stated herein, the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

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Reclamation

- » Post-Bankruptcy
 - Section 546(c)(1) of the Bankruptcy Code has been amended by Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA)
- » Caveats
 - Secured lender's lien may (and often does) affect right of reclamation because reclamation claims are "subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof"
 - In re: Dana Corp., 367 B.R. 409 (Bankr. S.D.N.Y. 2007)

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Assumption of Executory Contracts and Unexpired Leases

- » Executory Contract – A contract under which the obligations of both the debtor and the other party to the contract are so far unperformed that the failure of either to complete performance constitutes a material breach excusing the performance of the other
- » Assumption – The debtor assumes by filing a motion stating that it agrees to continue to be bound by the terms of the contract

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Assumption of Executory Contracts and Unexpired Leases

- » Why is assumption important?
 - Debtor must cure – or provide adequate assurance that the debtor will promptly cure – all defaults under the contract in order to assume the contract
 - This means that all prepetition amounts owed by the debtor to the creditor are paid, and the creditor obviates the possibility of receiving only cents on the dollar for its prepetition claim
 - No preference liability on contracts that are assumed

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Assumption of Executory Contracts and Unexpired Leases

- » Possible drawbacks to assumption
 - Debtor can assume a contract and then assign it to a third-party
 - Creditor would be forced to perform for a party that was not an original party to the contract
 - Assignment typically seen when a debtor's assets are sold as a going concern
 - Assignee must comply with the terms of the original agreement
 - Assignee must provide adequate assurance of future performance regardless of whether or not there has been a default under the contract by the debtor

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Assumption of Executory Contracts and Unexpired Leases

- » Special Considerations
 - Lenders: Debtor may not assume a contract that is a contract to make a loan or extend other debt financing or financial accommodations to or for the benefit of the debtor, or to issue a security of the debtor
 - Landlords
 - Adequate assurance concerning shopping center leases

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Performance Demands – Demand for Adequate Assurance of Future Performance

» Overview

- When reasonable grounds for insecurity exist concerning a contracting party's willingness or ability to perform a future obligation under a contract for goods, the other party can issue a demand for adequate assurance of performance under U.C.C. § 2-609
- Reasonable grounds for insecurity vary with the circumstances and may include credit insecurity, late payments and stated illiquidity
- Party receiving demand must provide assurances concerning its ability to perform future obligations

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Performance Demands – Demand for Adequate Assurance of Future Performance

» Critical Benefits

- Party issuing demand may suspend or modify performance until appropriate assurances are provided
- Can treat contract as repudiated if adequate assurances are not received within a reasonable time (may permit new contract terms)
- Mechanism to force issues into negotiation (and perhaps litigation) before the actual breach occurs
- Provides opportunity to fortify position with a customer or supplier before a bankruptcy filing
- A useful strategy is to use U.C.C. § 2-609 demand to establish cash-on-delivery or cash-in-advance payment terms

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Setoff/Recoupment

» Setoff

- Allows parties with mutual claims to offset such claims against one another – even different transactions and possibly affiliates
- Setoff permitted in bankruptcy where creditor and debtor hold prepetition claims against each other and the claim and debt are mutual

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Setoff/Recoupment

» Setoff

- Benefits of setoff
 - » Creditor that has a valid setoff claim has a secured claim in a bankruptcy, up to amount of the setoff
 - » Creditor that exercises setoff in essence recovers 100 cents on the dollar rather than pennies on the dollar because creditor receives dollar for dollar reduction of its own liability
 - » Any amount due over the setoff amount is considered an unsecured claim
 - » Can ask for adequate protection with respect to right of setoff

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Setoff/Recoupment

» Setoff

- Triangular Setoff – ability to assert setoff among the debtor’s affiliates
- Relief from the automatic stay is required before a party may set off except in the case of administrative holds

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Setoff/Recoupment

» Recoupment

- Recoupment is an equitable principle that is not codified by the Bankruptcy Code
- Automatic stay is not required to be lifted in order for recoupment to be effectuated
- Recoupment requires a “same” transaction
- Right of recoupment does not constitute a secured claim. In re: Photo Mech. Servs., Inc., 179 B.R. 604 (Bankr. D. Minn. 1995)

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Other Items for Consideration

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Sale of Claims to Vulture Purchasers

» Advantages

- Known distribution
- Payment early in the case
- Offers provide insight as to what the market believes the distribution will be

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Sale of Claims to Vulture Purchasers

- » Disadvantages
 - Fairly onerous reps and warranties regarding validity of claims
 - If claims found invalid or if the purchaser receives less than what it paid for the claim, then the seller might be required to pay the difference PLUS interest
 - Often includes indemnification of purchaser INCLUDING attorney's fees
 - In other words, purchase offers are frequently structured as heads-I-win, tails-I-win deals

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IpsO Facto Clauses

- » IpsO Facto Clauses – clauses that predicate a default upon
 - The insolvency or financial condition of the debtor at any time before the closing of the case
 - The commencement of a bankruptcy case
 - The appointment of or taking possession by a trustee in a case under the Bankruptcy Code or a custodian before the bankruptcy filing
- » May not be enforced in bankruptcy

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Involuntary Bankruptcy

- » May be brought by three or more creditors with non-contingent and undisputed claims
 - Claims must aggregate \$12,300.00
- » Why file an involuntary?
 - Chapter 7 – To wrest control away from a debtor that is acting fraudulently
 - To impose court supervision

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Involuntary Bankruptcy

- » Drawbacks to involuntary filing
 - If a case is dismissed other than on the consent of all petitioners and the debtor, the court can grant costs and attorneys' fees against the petitioners and in favor of the debtor
 - If the court finds bad faith, it may award proximate damages or punitive damages

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