

ENERGY BOOTCAMP SERIES

Session 3 Bankruptcy and Buying Distressed Assets

Thursday, July 18, 2013



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Disclaimer

- General legal principles should not be relied upon with respect to specific factual/legal issues without consultation with counsel.



Overview

- Bankruptcy Background
 - Major Types of Bankruptcies
 - Parties Under Bankruptcy Law
 - Case Commencement
 - Automatic Stay
- Bankrupt or Distressed Counterparty
 - Setoff and Recoupment
 - Reclamation Claims
 - Preference Actions
 - Fraudulent Transfers
 - Safe Harbors
 - Executory Contracts
 - Administrative Claims
- Distressed Asset Purchases
 - Sales in Bankruptcy
 - Sales Not in Bankruptcy
 - Assignment for Benefit of Creditors

Bankruptcy Background

Major Types of Bankruptcy Cases

- Chapter 7 – Liquidation
 - Liquidate all non-exempt property and distribute proceeds to creditors according to the priorities established under the Bankruptcy Code
- Chapter 11 – Reorganization / Liquidation
 - Financially restructure a business so it can continue to operate, provide employment and pay creditors
 - Debtor retains, manages and operates assets as a debtor in possession (“DIP”)

Bankruptcy Background

Major Types of Bankruptcy Cases

- Chapter 9
 - Applies to a municipal entity, specifically authorized to be a debtor, that is insolvent, that desires to adjust its debts, and
 - Has obtained agreement from a majority of impaired claims,
 - Has negotiated in good faith but failed to obtain such agreement,
 - Is unable to negotiate as impracticable, or
 - Reasonably believes a creditor may obtain a preferential transfer

Bankruptcy Background

Major Types of Bankruptcy Cases

- Chapter 12
 - Applies to a family farmer or family fisherman with regular income
- Chapter 13
 - Applies solely to individuals with regular income and within certain debt levels and allows for a 3-5 year personal debt repayment plan
- Chapter 15
 - Applies to cross-border cases

Bankruptcy Background

Parties Under Bankruptcy Law

- Debtor or Debtor in Possession
- Trustee
- United States Trustee
- Official Committees
 - Unsecured Creditors
 - Equity Holders
 - Other Interests



Bankruptcy Background Case Commencement

- Voluntary Case
 - Debtor files a bankruptcy petition, designating the chapter for the case.
 - The voluntary commencement of a case constitutes an “order for relief.”
 - The effect of filing a bankruptcy case is to stop almost all kinds of actions to recover claims against debtor that arose before the case was filed – the automatic stay.
 - Actions taken in violation of the automatic stay are void *ab initio*.



Bankruptcy Background Case Commencement

- Involuntary Case
 - Creditors (not contingent or subject to bona fide dispute) file a bankruptcy petition for debtor.
 - The automatic stay applies upon filing of the involuntary petition.
 - Debtor still controls its assets, unless a trustee is appointed.
 - Debtor may contest the involuntary petition.
 - If petition is dismissed, petitioning creditors may be liable for costs and, in limited circumstances, proximate and punitive damages.



Bankruptcy Background Automatic Stay

- The filing of a petition for relief under the Bankruptcy Code operates as a stay, applicable to all entities, of most kinds of actions to recover claims against the debtor or property of debtor's estate that arose before the commencement of the bankruptcy case.
- Certain actions explicitly enumerated in section 362(b) of the Bankruptcy Code, are not stayed by the order for relief.
- Violations of the automatic stay are usually held to be void as a matter of law and may result in sanctions by the Bankruptcy Court.
- The automatic stay is broad – so consult with bankruptcy counsel before taking any action when dealing with a debtor or its property.



Bankruptcy Background Automatic Stay

- Example: Vendor has an unsecured claim against debtor for unpaid invoices in the amount of \$100,000, and debtor files for bankruptcy.
- Postpetition, vendor sends debtor a demand letter and files a complaint against debtor to recover the claim.

Bankrupt or Distressed Counterparty Setoff and Recoupment

- Setoff is a cancellation of cross-demands: A is indebted to B, and B independently is indebted to A; the parties may net these obligations.
- Recoupment also is a cancellation of cross-claims; however, the cross-claims must each arise out of the same transaction or occurrence. Recoupment is a right to reduce the amount of a claim and does not involve independent obligations.
- Both rights are extremely important creditor protections. Remember to advise your bankruptcy counsel of any amounts owed to debtor.

Bankrupt or Distressed Counterparty Setoff and Recoupment

- Formal Requirements of Setoff:
 - 1) A debt owed by the creditor to debtor which arose prepetition (prior to the commencement of the bankruptcy case);
 - 2) A claim of the creditor against debtor which arose prepetition (prior to the commencement of the bankruptcy case); and
 - 3) The debt and the claim are mutual obligations, owed by the same parties, acting in the same capacity and in the same right.
 - Example: A claim is not “mutual” where a partnership has a claim against an individual but the individual has a claim against a partner of the partnership.

Bankrupt or Distressed Counterparty Setoff and Recoupment

- Several provisions in the Bankruptcy Code operate to preserve, protect and limit setoff rights in bankruptcy cases:
 - The automatic stay prevents a creditor from effecting a setoff without obtaining leave from the Bankruptcy Court; however, administrative freezes on deposit accounts do not violate the automatic stay.
 - The Bankruptcy Code treats setoff right as a secured claim; thus, a creditor with setoff rights can seek adequate protection against diminution in value.
 - Setoff rights are a valid defense to a turnover action.
 - Cross-obligations must either both arise prepetition or postpetition – prepetition obligations cannot be setoff against postpetition obligations.
 - Bankruptcy Code limits a creditor’s ability to acquire claims for the purpose of setoff.

Bankrupt or Distressed Counterparty Setoff and Recoupment

- The Bankruptcy Code does not mention or define the term “recoupment”; yet, recoupment is an equitable doctrine that has long applied in the bankruptcy context.
- Unlike setoff, recoupment does not require that both obligations be either prepetition or postpetition. Prepetition obligations can be recouped against postpetition obligations.
- The automatic stay does not apply to bar or restrain the right of recoupment.

Bankrupt or Distressed Counterparty Reclamation Claims

- Assume that vendor sold goods to debtor within 45 days of debtor's filing for bankruptcy for which vendor was not paid.
- Section 2-702 of the Uniform Commercial Code gives vendor the right to reclaim such goods by sending debtor a reclamation demand. Section 2-702 of the Uniform Commercial Code also gives vendor the right to stop goods in transit to debtor.
- This right to reclaim is facially recognized in bankruptcy under section 546(c) of the Bankruptcy Code.
- To properly assert this right, vendor must send debtor a demand letter within the applicable time period.

Bankrupt or Distressed Counterparty Reclamation Claims

- Administrative Claim for 20 Day Goods. Vendors receive an administrative expense priority claim for goods delivered to the debtor with 20 days of the petition date, regardless whether a reclamation demand is made.
- Section 503(b)(9) grants administrative expense priority status to: "the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business."

Bankrupt or Distressed Counterparty Preference Actions

- The Bankruptcy Code permits debtors to avoid certain transfers to creditors within 90 days of the petition date. Such transfers are considered “preferential” if the following elements are present:
 - 1) A transfer;
 - 2) Of an interest of debtor in property;
 - 3) To or for the benefit of a creditor;
 - 4) For or on account of an antecedent debt;
 - 5) Made while debtor was insolvent (statutory presumption of insolvency within 90 days of the petition date);
 - 6) Made within 90 days of the petition date; and
 - 7) Which enables the creditor to receive more than such creditor would receive if the transfer had not been made and the creditor received a normal distribution in debtor’s bankruptcy.

Bankrupt or Distressed Counterparty Preference Actions

- Defenses to a preference action include:
 - Contemporaneous Exchange for Value – payment received in contemporaneous exchange for goods (e.g. COD (cash on delivery) terms)
 - Ordinary Course of Business Exception – payment made in the ordinary course of business or made according to ordinary business terms
 - New Value Exception – creditor provided subsequent new value for which it was not paid after receipt of the preferential payment

Bankrupt or Distressed Counterparty Fraudulent Conveyances

- Bankruptcy Code permits debtor to void certain transfers within 2 years (and up to 4-6 years under incorporated state law) of the petition date, where:
 - 1) Actual Fraud - a transfer made with the actual intent to hinder, delay, or defraud any entity to which debtor was or became indebted on or after the date that such transfer was made; or
 - 2) Constructive Fraud - debtor receives less than a reasonably equivalent value in exchange for such transfer and debtor:
 - was insolvent on the date that such transfer was made or became insolvent as a result of such transfer; or
 - was engaged in a business or transaction or was about to engage in a business or transaction for which any property remaining with debtor was an unreasonably small capital; or
 - intended to incur, or believed that debtor would incur, debts that would be beyond debtor's ability to repay as such debts matured; or
 - made such transfer to or for the benefit of an insider under an employment contract and not in the ordinary course of business.

Bankrupt or Distressed Counterparty Safe Harbors

- Section 546(e) of the Bankruptcy Code provides special protections to parties to commodity or forward contracts from preference and constructive fraud claims.
- To qualify for this protection, the transfer recipient must demonstrate the following elements:
 - One of the transaction parties is a forward contract merchant;
 - The transfer must be made in connection with a forward contract; and
 - The transfer must be considered a settlement payment.

Bankrupt or Distressed Counterparty Safe Harbors

- Forward Contract. A contract for the purchase, sale or transfer of a commodity, which is presently or in the future becomes the subject of dealing in the forward contract trade, with a maturity date more than two days after the date of entry into the contract.
- Forward Contract Merchant. An entity the business of which consists on whole or in part of entering into forward contracts as or with merchants in a commodity or any similar good, article, service, right or interest which is presently or in the future becomes the subject of dealing in the forward contract trade.
- Settlement Payment. A preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade.

Bankrupt or Distressed Counterparty Safe Harbors

- Recent case law has protected payments for electricity provided under a requirements contract, holding that the plain language of the Bankruptcy Code draws no distinction between financial forward contracts and ordinary purchase and sale forward contracts.
- Forward contracts, as opposed to commodity contracts, are agreements in which physical delivery of the subject commodity actually is expected by the parties. Forward contracts that concern the future delivery of goods that are subject of trading in the forward contract market appear to be protected from avoidance.
- Supply contracts between commodity producers and end users appear to be shielded from preference recovery.

Bankrupt or Distressed Counterparty Executory Contracts

- Countryman Definition: Executory contracts generally are defined as contracts under which the obligations of both debtor and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.
- Examples: intellectual property licenses, purchase agreements with warranties, employment agreements, franchise agreements, partnership agreements, etc.

Bankrupt or Distressed Counterparty Executory Contracts

- In bankruptcy, debtor has the option of assuming, assuming and assigning, or rejecting its executory contracts.
- Assumption: If a debtor determines that an executory contract or unexpired lease is advantageous to the estate, debtor will seek to assume it. To assume an executory contract or unexpired lease, debtor must first obtain bankruptcy court approval.
- Cure and Adequate Assurance: If a default exists under the executory contract or unexpired lease, debtor must cure the default and provide adequate assurance of future performance under the terms of the contract or lease to assume.

Bankrupt or Distressed Counterparty Executory Contracts

- Assignment. The Bankruptcy Code permits a debtor to assume and assign an executory contract or unexpired lease to a third party.
- Contract Must First Be Assumed. A debtor that wants to assign an executory contract or unexpired lease to a third party must first assume the contract or lease.
- Adequate Assurance of Future Performance. Debtor also must provide the nondebtor party to the contract or lease with adequate assurance of future performance by the proposed assignee, which is an important protection for nondebtor contract parties because debtor has no liability for a post-assignment breach.

Bankrupt or Distressed Counterparty Executory Contracts

- Enforceability of Anti-Assignment Clauses: The contract may contain a provision restricting the ability of debtor to assign its rights to a third party.
 - *Generally Invalid*. Such clauses generally fall within the scope of section 365(f)(1) of the Code and are unenforceable against a debtor in bankruptcy.
 - *Exception – section 365(c)(1) Contracts*. Section 365(c)(1) of the Bankruptcy Code, however, has been construed to make anti-assignment clauses enforceable where applicable non-bankruptcy law makes the contract unassignable outside of bankruptcy. Examples: Partnership agreements, certain intellectual property licenses, government contracts, franchise agreements, personal service contracts

Bankrupt or Distressed Counterparty Executory Contracts

- Rejection. Rejection allows debtor to shed burdensome contracts. The primary purpose of section 365 of the Bankruptcy Code is to allow a debtor to reject executory contracts in order to relieve the estate of burdensome obligations while at the same time providing a means whereby a debtor can force others to continue to do business with it when the bankruptcy filing might otherwise make them reluctant to do so.
- Business Judgment Standard. A debtor's decision to reject an executory contract or unexpired lease is governed by the business judgment standard. A debtor generally need only show that the contract is burdensome for a court to approve rejection.

Bankrupt or Distressed Counterparty Executory Contracts

- Impact of Rejection
 - *Unsecured Claim for Rejection Damages*. Rejection constitutes a breach of the contract or lease that dates back to the petition date and, thus, results in a general unsecured claim for rejection damages unless the contract has already been assumed.
 - *Administrative Expense Priority Claim for Postpetition Pre-Rejection Goods and Services*. The nondebtor party to the contract may also have a valid administrative expense priority claim under the Bankruptcy Code for performance during the postpetition pre-rejection period for goods and services provided to the estate.

Bankrupt or Distressed Counterparty Executory Contracts

- Timing of Assumption or Rejection. In general, debtor can assume or reject an executory contract at any time prior to the confirmation of its plan of reorganization. The bankruptcy court, however, on the request of a party to such contract or lease, may order debtor to determine within a specified period of time whether to assume or reject the contract or lease. A court's determination of whether to establish a specified time period within which a debtor must assume or reject an executory contract is a fact specific inquiry. Courts generally require a showing of some manifest unfairness before the time period will be shortened.
 - Exception: In a case under chapter 11, unexpired commercial leases must be assumed or rejected within 120 days, subject to a 90-day extension for cause shown. No further extensions may be granted without the landlord's written consent.

Bankrupt or Distressed Counterparty Executory Contracts

- Enforceability of Contract Prior to Assumption. During the postpetition and pre-assumption or rejection period, an executory contract remains in existence and is enforceable by, but not against, a debtor in possession.
 - Exception: Debtor must timely perform all obligations under a commercial lease of real property from after the petition date and all obligations arising under an unexpired lease of personal property after 60 days from the petition date.

Bankrupt or Distressed Counterparty Executory Contracts

- IpsO Facto Clauses. *IpsO facto* clauses are provisions providing for the termination of the contract or lease in the event of the insolvency or bankruptcy of one of the parties. As a general rule, *ipso facto* clauses are unenforceable in bankruptcy.
- Exception for Section 365(c)(1) Contracts. *IpsO facto* clauses in contracts where applicable non-bankruptcy law requires consent to an assignment may be enforceable in bankruptcy.

Bankrupt or Distressed Counterparty Administrative Claims

- Bankruptcy Code section 503(b)(1)(A) allows administrative claims against the debtor's estate for the "actual and necessary costs and expenses of preserving the estate."
 - When dealing with a debtor postpetition, vendor, whether under a prepetition contract or not, generally is entitled to payment as an administrative claim for the value of goods or services provided.
 - Administrative claims have higher priority to payment than, and are paid in full before, prepetition general unsecured claims.

Bankrupt or Distressed Counterparty Administrative Claims

- Administrative claims are not paid in full if debtor becomes administratively insolvent (e.g. prepetition and postpetition secured claims exceed the value of debtor's business / assets).
- Chapter 11 cases usually do not become administratively insolvent - to confirm a chapter 11 plan, all administrative claims must be paid in full in cash.
- Creditors may monitor the postpetition financial status if the debtor through the debtor's monthly operating reports.
- Unless vendor has a prepetition executory contract with debtor specifying payment terms, vendor may set and enforce postpetition payment terms.

Distressed Asset Purchases Sales in Bankruptcy

- Bankruptcy Code section 363 permits debtor to sell assets not in the ordinary course of its business.
 - Assets include executory contracts and unexpired leases.
 - Generally, such sales require an auction, the procedures for which are approved by the Bankruptcy Court.
 - The stalking horse (or first bidder) may negotiate for a "break-up" fee if not successful bidder at auction, "topping fees," overbid requirements, bidder qualifications and other auction procedures.
 - With, and sometimes without, consent, section 363 sales are free and clear of liens, claims and encumbrances, which are transferred to sale proceeds, but there are exceptions.
 - The Bankruptcy Code prohibits collusion among potential purchasers
 - collusion is grounds to unwind the sale.

Distressed Asset Purchases Sales in Bankruptcy

■ Bankruptcy Code section 363 sale process:

- | | |
|--|---|
| 1 Debtor markets assets | 6 Court approves bid procedures |
| 2 Prospective buyers submit LOIs | 7 Debtor conducts (second) auction |
| 3 Debtor selects stalking horse | 8 Court enters order to approve sale |
| 4 Debtor and stalking horse negotiate:
Asset purchase agreement
Deal protections
Bidding procedures | 9 Unless court orders otherwise, sale
order becomes final and non-
appealable 14 days after entry |
| 5 Debtor files motion to approve sale
and bidding procedures | 10 Closing |

Distressed Asset Purchases Sales in Bankruptcy

- Buyer may choose contracts and leases to include in the sale, and is not obligated to accept any or all
- Anti-assignment clauses otherwise enforceable, may not be enforceable in bankruptcy
- Debtor must assume and assign
 - Cure defaults
 - Provide adequate assurance of future performance



Distressed Asset Purchases Sales in Bankruptcy

- Usually, but not always, debtor will negotiate the sale of its assets to a stalking horse bidder.
- The stalking horse bidder sets the floor sale price and is entitled to favorable protections at auction.
 - Break up fee of 2 - 4% of purchase price compensates stalking horse for due diligence if it is not the successful bidder at auction. A break up fee may be incorporated into the stalking horse's subsequent overbid.
 - Overbid protections set the amount of the initial and subsequent overbids.
 - Closing deadline requirement may drive the time debtor has to market and auction its assets.
 - Competing bidder qualification requirements may limit auction participants.



Distressed Asset Purchases Sales in Bankruptcy

- Section 363 permits the sale of assets free and clear of liens upon satisfaction of one of the following conditions:
 - Applicable non-bankruptcy law permits sale of such property free and clear
 - Lienholder consents
 - Sale price of the assets is greater than the "aggregate value of all liens on such property"
 - Lien / interest in sold asset is subject to a bona fide dispute
 - Lienholder could be compelled in a legal or equitable proceeding to accept a money satisfaction of its interest
- Some liabilities cannot be eliminated (e.g. environmental, successor exposure to labor claims, etc.)



Distressed Asset Purchases Sales in Bankruptcy

- Bankruptcy Code section 363(k) generally permits secured parties to credit bid at auction for face amount of such claim
- Credit bidding may chill auction
- Bankruptcy court may deny secured party's right to credit bid "for cause"



Distressed Asset Purchases Sales in Bankruptcy

- Bankruptcy Code section 363(m) provides the purchaser with protection and finality after closing, even from reversal or modification of sale authorization on appeal.
 - Purchaser must have acted in good faith, and
 - Appellant has failed to obtain a stay of the sale pending the appeal.

Distressed Asset Purchases Sales in Bankruptcy

- Bankruptcy Code section 363(n) prohibits collusion – sale price may not be controlled by agreement among potential bidders
- If collusion occurs, debtor may:
 - Avoid sale
 - Recover the value of the property in excess of the colluded purchase price
 - Recover costs, attorneys' fees and expenses incurred in such avoidance or recovery
 - Recover punitive damages against colluder acting in willful disregard of the Bankruptcy Code

Distressed Asset Purchases Sales Not in Bankruptcy

- Other forums for the purchase of distressed assets include:
 - Foreclosure and Uniform Commercial Code sales (public or private)
 - No reps or warranties, but not free and clear of all liens, claims and encumbrances
 - May be challenged by debtor in subsequent bankruptcy case
 - Anti-assignment provisions enforceable
 - Assignment for Benefit of Creditors



Distressed Asset Purchases Assignment for Benefit of Creditors

- Due to costs of bankruptcy filings, more distressed companies are exploring alternative methods for liquidating their assets
- Assignments for the Benefit of Creditors (an “ABC”) are becoming increasingly popular, particularly in California
- In an ABC, the company assigns all of its assets to an independent third party who liquidates the assets through a private sale



Advantages of ABCs

- Typically less expensive, no creditors committee or U.S. Trustee oversight or fees
- Company has control over selection of assignee who will liquidate assets
- Private transaction without the publicity of a bankruptcy proceeding



Disadvantages of ABCs

- No ability to sell “free and clear” of liens or successor liability claims, just a typical asset sale
 - If company has a secured creditor, it will be necessary to obtain consent in connection with a sale through an ABC
 - More lenders are willing to accommodate an ABC due to the lower costs and lower risk than bankruptcy
- Seller is independent third party who is unlikely to make any reps and warranties and request indemnification
- No ability to assign contracts without consent of counter parties or other advantages of a bankruptcy sale



Q&A Session