

COMPANIES IN FINANCIAL DISTRESS: MINIMIZING RISKS AND MAXIMIZING OPPORTUNITIES

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RISK # 1

Page 3

You are a board member of a Company that is either insolvent or in the “zone of insolvency.”

What are your duties, to whom are they owed and how are such duties discharged? And what is your potential liability for an alleged breach of these duties?

(Or, you are General Counsel for this Company. How do you advise your board members regarding these matters?)

MANAGING RISK # 1

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General Fiduciary Duties of Officers and Directors:

Duty of Care: to make business decisions with the care an ordinarily prudent person would exercise under the same or similar circumstances including, among other things, by informing themselves of all material information reasonably available to them, including reasonable alternatives. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 746 n. 402 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

Duty of Loyalty: to advance the interests of the Company as a whole and not the individual interests of Officers and Directors or another person or organization. Must refrain from conduct injurious to the Company and its shareholders. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* 506 A.2d 173, 180 (Del. 1986).

Duty of Good Faith (generally a subsidiary component of the Duty of Loyalty): to act in good faith when making business decisions, in a manner the Officers and Directors honestly believe to be in the best interests of the Company. *Stone ex rel. AmSouth Bancorp. v. Ritter*, 911 A.2d 362, 370 (Del. 2006); *Aronson*, 473 A.2d at 812.

BUSINESS JUDGMENT RULE protects the Officers and Directors when making decisions: Presumption that decisions are made on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the Company. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

MANAGING RISK # 1

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Duties Upon Insolvency or Entry Into the Zone of Insolvency:

- Nature of duties are the same as for a solvent company, but duties expand to include the Company's "entire community of interests," including creditors. *Pepper v. Litton*, 308 U.S. 295, 307 (1939).
- As a practical matter, this means the Company must be managed in a way that maximizes its value for the benefit of creditors as well as shareholders. *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 355 (1985); *Pepper v. Litton*, 308 U.S. at 307.
- Business Judgment Rule still applies.
- Directors and Officers still have benefit of exculpatory provisions of Company charters and bylaws.
- Independent tort of "deepening insolvency" has now been rejected as a stand-alone cause of action, though it may still be a measure of damages. *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006), *aff'd*, 931 A.2d 438 (Del. 2007); *Miller v. McCown De Leeuw & Co., Inc. (In re The Brown Schools)*, 2008 WL 18497790 at *8 (Bankr. D. Del. April 24, 2008).

OPPORTUNITIES

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- Reevaluate the business/business plan; divisions and segments of business; chance to restructure or shed underperforming units.
- Consulting with valuation experts and turn around/restructuring professionals can bring insights into the business/divisions; provides Officers and Directors with objective information regarding performance and enterprise value.
- Reinforcement of Board's duties.
- Opportunity to negotiate with stakeholders.
- Review protections afforded to Directors by applicable state law and in corporation's organizational documents – ensure documents are updated and accurate.

RISK # 2

Page 7

You recently delivered goods to a customer who later files for bankruptcy.

Now what?

MANAGING RISK # 2

Page 8

Right of Reclamation

UCC § 2-702(2): Right to reclaim goods sold to insolvent buyer by making written demand within ten days after goods are received. Ten day rule does not apply when solvency has been misrepresented by buyer within three months before delivery.

11 U.S.C. § 546(c)(1): Section 546(c)(1) of the Bankruptcy Code provides that seller has 45 days to reclaim goods from the time of delivery to the debtor. Demand must be made not later than 45 days after delivery, or not later than 20 days after the case is commenced if the 45-day period expires after the commencement of the case (thus, if bankruptcy is filed and the 45 day period expires the next day, the seller has until day 20 of the case to demand reclamation).

MANAGING RISK # 2

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Defenses to Reclamation: Goods are resold or not identifiable/have been used or consumed; reclaiming seller's right is subject to prior rights of lien creditor with a security interest in the goods or the proceeds.

11 U.S.C. § 503(b)(9): Provides that a seller of goods has an administrative claim for the value of goods delivered within 20 days before bankruptcy. Applies regardless of reclamation.

Risk of Payment under 503(b)(9): Estate may be administratively insolvent; payment not required until the time a plan is confirmed – need to show exceptional circumstances to get paid earlier; potentially subject to setoff (if debtor has a claim against the seller) or disallowance if avoidable transfer has been made to seller prepetition.

OPPORTUNITIES

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- Evaluate/reevaluate customers and credit risks.
- Take back a purchase money security interest (PMSI) in the goods sold.
- Move to COD terms or cash in advance.
- Implement procedures to limit (i) amount of goods sold to any one buyer and/or (ii) credit exposure.

RISK # 3

Page 11

Your company has a line of credit with a syndicate of lenders, one or more of whom have filed or are about to file for bankruptcy.

What rights do you have under your agreement?

MANAGING RISK # 3

Page 12

- Review agreement to determine whether borrower has any of the following remedies :
 - ❖ Option to force defaulting lender to assign its commitment and outstanding loans to another financial institution (“yank-a-bank” clause).
 - ❖ Terminate a defaulting lender’s existing commitments and repay its outstanding loans in lieu of finding a replacement lender (thus reducing overall commitment).
 - ❖ Defaulting lender forfeits its right to vote on amendments and waivers of loan documents.
 - ❖ Ability to offset defaulting lender’s right to share in repayment of loans prior to maturity against amount that defaulting lender has failed to fund.
- Borrower may also attempt to pursue additional remedies not set forth in loan agreement:
 - ❖ Under general contract law, borrower may be relieved of its obligation to pay commitment fees or be able to set off commitment fees.
 - ❖ Sue defaulting lender on a breach of contract claim; must establish damages for failure to fund.

OPPORTUNITIES

Page 13

- Analyze short and long term funding needs to determine whether there is adequate capacity under lines of credit based on the assumption that defaulting lender(s) will not fund.
- Contact the administrative agent for existing credit facilities to discuss amending the economic and business terms of current loan agreements.
- For new credit facilities, carefully review defaulting lender provisions and proactively seek to include provisions which will protect the borrower under such circumstances.

RISK # 4

Page 14

You filed a proof of claim in a customer's bankruptcy and you are receiving calls and letters from people who want to buy your claim for a fraction of the face amount.

Is this permitted? What should you know/consider before you sell your claim?

MANAGING RISK # 4

Page 15

- Claims trading is permissible and happens all the time.
- Key considerations include (i) what are prospects for recovery/reorganization; (ii) how long will it take? (iii) time value of money; and (iv) is your claim valid/did you receive any prepetition transfers that could be avoided?
- If you are member of the creditors' committee you may not be able to sell your claim; there could be court-ordered restrictions on trading claims or equity (to preserve the Debtor's NOLs) (Inside Information).
- **READ THE FINE PRINT!!**
 - ✓ Reps and warranties
 - ✓ Right to defend against claim objection
 - ✓ Limitations on right to setoff or recoup
 - ✓ Requirement to “put” the claim back to you

OPPORTUNITIES

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- Creates immediate liquidity
- Time value of money
- Price paid for your claim could exceed ultimate distributions in the case and put you “ahead of the game”

RISK # 5

Page 17

Your Company is considering a reduction in force (“RIF”). Does the WARN Act apply? What happens in the event of a later-filed bankruptcy? What if you make the RIF during the bankruptcy?

MANAGING RISK # 5

Page 18

➤ WARN generally requires 60 days notice to affected employees (or their union reps) and local governments of a “plant closing” or “mass layoff” that results in an “employment loss”

- ✓ Generally applies to employers with 100 or more employees (100 full time or 100 or more full and part time who work at least 4,000 hours per week in the aggregate, not including overtime).
- ✓ “Employment loss” means (i) termination of employment for any reason other than for cause, voluntary departure or retirement, (ii) layoff for more than six months or (iii) reduction in hours of more than 50% during each month of a 6-month period.
- ✓ “Plant closing” means permanent or temporary shutdown that results in employment loss for 50 or more employees during any 30-day period (includes shutdown of one or more facilities operating as a “single site” of employment if 50 or more employees are affected).
- ✓ “Mass layoff” means a reduction in force that is not a plant closing but which results in loss of employment at a single site for (i) 500 or more employees or (ii) 50 or more employees and at least 33% of active full-time employees.

MANAGING RISK # 5

Page 19

- If notice not provided and no defenses apply, liability will be up to 60 days of pay and benefits, plus potential civil penalties and attorneys' fees
- If WARN violation occurs prepetition, amounts payable to employees are treated as a wage priority under 11 U.S.C. § 507(a)(4) (up to \$10,950)
- If WARN violation occurs postpetition, amounts payable to employees are treated as postpetition administrative claims

MANAGING RISK # 5

Page 20

- Need to check rules for counting number of employees
- “Rolling” layoffs reviewed for the 30-day rolling period; extends to 90 days if two or more layoffs arising from the same cause take place
- Exceptions
 - ✓ Faltering company – plant closings only; employer actively seeking new business or capital and providing notice of layoff/shutdown would make it impossible to obtain the business/capital
 - ✓ Unforseeable business circumstances – mass layoffs and plant closings; business circumstances not reasonably foreseeable at the time notice would have otherwise been required
 - ✓ Natural disaster
- Some states have “mini-WARN” legislation: examples include CA, CT, IL, KS, MN, NJ, NY, PA and WI

OPPORTUNITIES

Page 21

- Determine if voluntary resignation/retirement program is viable alternative.
- Review performance standards and procedures to ensure compliance with employment standards (could result in terminations “for cause”).
- Consult with HR and counsel before layoff(s) made to determine WARN applicability.
- If WARN applies consult with HR and counsel to ensure notice is legally sufficient and correct.

RISK # 6

Page 22

You supply goods to a company and historically have offered a 2% discount for payment within 15 days of receipt. You find out that the company is financially distressed and accounting decides to change payment terms to COD.

Are there any risks to implementing this or any other change of payment terms?

MANAGING RISK # 6

Page 23

- Potential for payments pursuant to new terms constituting a preference
 - ✓ Elements
 - ❖ Payment made within 90 days before bankruptcy (one year for “insiders”)
 - ❖ While debtor was insolvent (presumed insolvent during 90 days, but presumption is rebuttable)
 - ❖ On account of an antecedent debt owed by the debtor
 - ❖ That allows the creditor to recover more than if debtor were liquidated under chapter 7

MANAGING RISK # 6

Page 24

- ✓ Defenses (2 most likely to apply)
 - ❖ Contemporaneous exchange of new value
 - ❖ Payment was for a debt incurred in ordinary course of business

- ✓ Tips to avoid preference exposure (hard to do)
 - ❖ Avoid having an “antecedent” debt – COD or prepayments
 - ❖ If changing payment terms, find a way to contend that new terms are industry standard and the change was to conform to industry rather than to be a better debt collector

OPPORTUNITIES

Page 25

- Evaluate changes in payment terms before implementing.
- Do your best to fit within the exceptions/affirmative defenses.
- Take back security for new advances.
- Get a security deposit up front which can be drawn on in event you are sued for a preference.
- Move to COD or prepayment to avoid “antecedent debt.”
- Not often litigated; work towards settlement.

RISK # 7

Page 26

Your landlord just filed for bankruptcy.
How is your lease affected, if at all, by the bankruptcy?

MANAGING RISK # 7

Page 27

- Landlord may assume (keep) or reject (get rid of/breach) the lease.
- Assumption means “business as usual.”
- If landlord chooses to reject, 11 U.S.C. § 365(h) allows the tenant to choose one of two paths:
 - ✓ Treat the lease as terminated; or
 - ✓ Elect to retain rights under the lease for the remaining lease term and any renewal or extension periods (to the extent such rights are enforceable under nonbankruptcy law).
- If tenant elects to retain its rights, tenant may offset against rent (for the term of lease and any extensions thereof) the value of any damage caused by landlord’s nonperformance after the date of rejection.
- Rejection does not affect provisions relating to radius, location, use, exclusivity or tenant mix or balance.
- Protections afforded to “lessee” includes successors, assigns and mortgagees permitted under the terms of the lease.

OPPORTUNITIES

Page 28

- May be able to utilize leverage to renegotiate lease/sublease.
- Entitlement to cure of defaults and “adequate assurance of future performance” in event of assumption/assumption and assignment – use to protect your rights or use as bargaining chip.
- If currently negotiating lease (no bankruptcy yet), should consider incorporating one or more of the following:
 - ✓ Ability to review landlord’s financial statements.
 - ✓ Escrow of tenant improvement funds or letter of credit.
 - ✓ Obtain non-disturbance agreement from landlord’s lender.
 - ✓ In cases of subleases, landlord’s consent to the sublease should include right to remain in the premises if sublandlord defaults or files for bankruptcy.
 - ✓ Self help remedies and right to offset against rent for landlord’s failure to perform.

RISK # 8

Page 29

You are a licensee of intellectual property and your licensor files for bankruptcy.

Now what?

MANAGING RISK # 8

Page 30

- Licensors have the right to assume or reject the license
- Licensor – upon written request of licensee – shall perform pending assumption or rejection
- If assumed, generally “business as usual.”
- If rejected, licensee has a choice:
 - ✓ Treat the license as terminated; or
 - ✓ Retain rights under the license (including the right to enforce any exclusivity provision but not including right to specific performance) as the same existed immediately before bankruptcy for (i) the duration of the license and (ii) any period for which the license may be extended by licensee as of right under applicable nonbankruptcy law.
 - If rights retained, licensee shall make all royalty payments as due and is deemed to waive (i) any right to setoff and (ii) any administrative claim licensee may have.
 - If rights retained, upon written request, licensor shall provide to licensee any IP held by licensor (to extent provided by the agreement) and not interfere with licensee’s rights under the agreement, including the right to obtain the IP from another entity.
- Bankruptcy Code definition of IP does not include trademarks; thus, trademarks do not enjoy the above protections

OPPORTUNITIES

Page 31

- License agreement should state that it and all supplements are directly addressed by section 365(n) of the Bankruptcy Code.
- Termination of restrictive covenants regarding access to licensor's employees in the event licensor fails to fulfill obligations.
- Enter into separate software escrow agreement and insist that source code be placed with professional escrow agent who will release code upon certain occurrences, including licensor's rejection of license.
 - ❖ Escrow agreement should state that it is supplementary to license agreement and is covered by section 365(n).
 - ❖ Escrow agreement should state that source code is not property of estate under section 541.
- Take security interest in all assets of licensor to secure payment of licensor's obligations under the license agreement.
- Itemize royalty or license fees set forth in license agreement so that after rejection, licensee is not paying for those services which licensor not obligated to perform.

RISK # 9

Page 32

You are a sole-source or otherwise “critical” provider to a company that has filed for bankruptcy.

Can you require the company to pay your outstanding invoices as a condition to continued business?

MANAGING RISK # 9

Page 33

- Any actual “threat” to cease doing business unless paid, or any other action to attempt to collect payment, violates the automatic stay of 11 U.S.C. § 362(a) (but, no violation of the stay if there is no contract and you simply cease doing business – be sure you can’t be accused of trying to collect the debt).
- More often than not, debtors file “first day” motions to pay “critical vendors.”
- Most courts have historically allowed “critical vendor” payments, but some courts have made the test more stringent (*Co-Serv*) or called the doctrine into doubt (*Kmart*, 359 F.3d 866 (7th Cir. 2004) (contending that the “doctrine” is nothing more than an unauthorized re-ordering of the Bankruptcy Code’s priority scheme).
- 3-part test of *Co-Serv*, 273 B.R. 487 (Bankr. N.D. Tex. 2003):
 - ✓ Debtor has critical need to deal with the vendor.
 - ✓ Unless debtor deals with vendor, debtor risks (i) probability of harm or (ii) loss of some economic benefit to the estate’s going concern value that is disproportionate to the payment.
 - ✓ No other practical or legal solution other than payment of the claim.

OPPORTUNITIES

Page 34

- Diligently pursue collections (potential preference exposure) and limit amount of outstanding receivables
- Enforce credit limits
- Evaluate ways you are, or can become, “critical” to your customers in financial distress
- Section 503(b)(9) administrative expense priority
- Reclamation rights

RISK # 10

Page 35

You have contract containing a provision that allows you to terminate the agreement in the event your counterparty files for bankruptcy (bankruptcy is an event of default that triggers the right to terminate).

Is this provision enforceable in the counterparty's bankruptcy?

MANAGING RISK # 10

Page 36

- *Ipso facto* provisions in most contracts are unenforceable in bankruptcy
- Exceptions:
 - ✓ Certain “protected” financial contracts: securities contracts, commodities contracts, forward contracts, swaps, repos, master netting agreements
 - ✓ Contracts to make loans/financial accommodations or to issue a security of the debtor
 - ✓ Applicable law excuses a party (other than the debtor) from accepting performance from (or rendering performance to) the debtor or the debtors’ assignee, regardless of any prohibition or restriction on assignment or delegation of duties and such party does not consent to the assignment or assumption

OPPORTUNITIES

Page 37

- Review default language in contracts
- Take prebankruptcy precautions (keep receivables minimal, COD or prepayment terms, etc)
- Amend/modify contracts (if possible, or write new ones) to include other provisions that will assist in bankruptcy, such as liens, other security or deposits, letters of credit)
- Give yourself the ability to terminate before bankruptcy is filed

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ATTORNEY BIOS

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See Attached Bios for Jason S. Brookner and Gogi Malik