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LEVERAGING TECHNOLOGY FOR EFFICIENCY

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LEGAL VIEW: CHAPTER 11 FILINGS SOAR

US AND CHINA TRADE TENSIONS

FOREST PRODUCTS CREDIT GROUP

Chapter 11 filings soar in the first half of 2020 in USA

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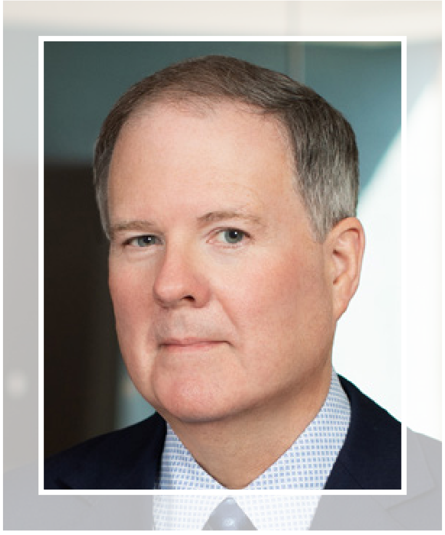


According to the American Bankruptcy Institute, 3,600 companies filed Chapter 11 in the first half of 2020. Chapter 11 filings for 2020 are on pace to eclipse any year since 2012. During the same period, businesses worldwide sold $2.1 trillion of bonds, up 50 percent from 2019, according to the July 17, 2020 New York Times.

In a number of key U.S. industries (e.g., automotive, aviation, dairy, energy, retail, hospitality), existing market conditions and/or COVID-19 have caused significant disruptions in operations, roiling EBITDA and asset values, and restricting access to financial liquidity. In short, the pie is smaller yet the forks at the table are the same. It is the ultimate zero-sum game with intense competition over allocation of value to stakeholders.

Companies are well-advised to prepare for a significant increase not only in the number of restructurings or Chapter 11 filings but also more difficult ones, with respect to their customers, supply chain partners, and contract counter-parties.

Chapter 11 filings create risk for:

(1) payment of pre-bankruptcy accounts receivable, **(2)** payment of invoices for goods and services provided during the Chapter 11 case, **(3)** continuation of important contracts with the debtors, and **(4)** retaining invoice payments received 90 days prior to the Chapter 11 filing. Specifically, Chapter 11 filings of debtors have the following impacts on their counter-parties:

1. PRE-CHAPTER 11 ACCOUNTS RECEIVABLE

Accounts receivable owed prior to the Chapter 11 filing often receive little or no payment, and result in a write-off. This is because Bankruptcy Code Section 362 prohibits all collection activities on pre-petition debt, allowing debtors to shelve unsecured debt, to be addressed in a Chapter 11 Plan of Reorganization or Liquidation in the event of a Section 363 sale of assets.

Sources of Payment. There are only two realistic sources of payment for unsecured claims of trade creditors (other than Section 503(b)(g) claims, discussed below):

a. Cash flow from debtors' ongoing business operations arising from a confirmed plan of reorganization, or

b. Sales proceeds in excess of secured debt and the costs of administration (post-petition goods and services and professional fees).

The "Type" of Chapter 11 Makes a Difference. In the case of a reorganization, there have been a number of "balance sheet restructurings" where massive "capital structure" debts have essentially been converted to equity, and trade creditors "ride through" the Chapter 11 case being paid unabated in the ordinary course of business. In a far greater number of cases, the companies' financial distress is such that a write-off of ALL pre-petition debt is essential to survive. In these cases, plans of reorganization often provide pennies on the dollar, or maybe even a small slice of the reorganized debtors' equity. Any true reorganization requires the ongoing financial support of the working capital and term lenders.

In most of the large, recent Chapter 11 cases, particularly in troubled industries with rapidly changing market dynamics (e.g., Borden Dairy, Dean Foods, LSC Communications), these lenders are alternatively seeking an exit strategy, usually a Section 363 sale of all of the debtors' assets. Keeping in mind that the secured lenders' target sales price is the amount of their debt, plus transaction costs and maybe some of the costs of administration, the sales process (marketing, bidding, and auction) often does not produce good results for trade creditors. In many cases, the lenders credit bid their debt to acquire the assets to kick the can for a better recovery if conditions improve. Credit bids never exceed the secured debt, leaving no value for other stakeholders, unless the lender elects to contribute to their recoveries.

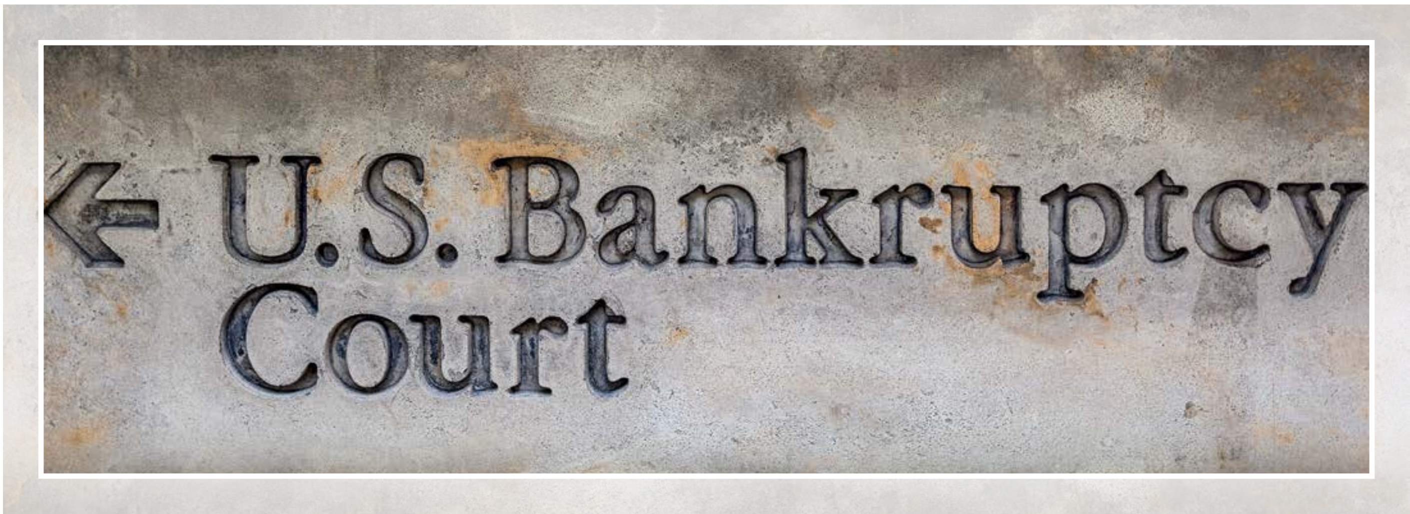
Chapter 11 cases that feature a Section 363 sale put payment of pre-petition claims of unsecured creditors at extreme risk, and payment of costs of administration are often at high risk.

Creditor "Remedies." Creditors' best options for payment of their pre-petition claims are asserting a Section 503(b)(g) claim for goods provided to the debtor within 20 days prior to the Chapter 11 filing, payment as a critical vendor, and the exercise of rights of setoff or recoupment relating to any amounts owed to the debtor such as rebates, sales incentives or account credit.

a. 20 Day Administrative Claim. Under Section 503(b)(g) of the Bankruptcy Code, sellers of goods are entitled to an administrative expense priority claim for the value of goods delivered to and received by a debtor within 20 days prior to the bankruptcy filing. Generally, such claims fare significantly better than general unsecured claims, and often receive 100 percent payment.

However, in cases where the debtor's Chapter 11 proceeding is "administratively insolvent," the likelihood of payment of administrative expense priority claims is compromised.

b. Critical Vendor. Becoming a critical vendor is a creditor remedy based on a



theory that a particular vendor is so essential to a debtor's ability to continue operating that without the uninterrupted flow of the seller's goods, the debtor cannot continue to operate and thus has no realistic chance of a successful reorganization. A bankruptcy court has broad authority to order relief that facilitates a successful reorganization.

Only a debtor can make the determination that a particular vendor is critical and seek court approval of the same. A creditor cannot independently impose its critical vendor status on a debtor.

Some jurisdictions refuse to entertain critical vendor motions. However, Delaware and New York continue to be jurisdictions where critical vendor payments can be approved in appropriate circumstances.

Point of Interest: Texas has recently become a Chapter 11 hub, based in large part on the troubled energy sector and also on the efforts of Judge David Jones (a North Carolinian) whom the September 1, 2020 Houston Chronicle reports "saved the Texas bankruptcy practice." We currently have four significant cases pending before Judge Jones, Dean Foods, McDermott International, Neiman Marcus and Technicolor (Chapter 15).

Vendors who are truly critical to a debtor-customer should continue to seek critical vendor status as a means of getting paid. In doing so, vendors should be careful to not violate the automatic stay by conditioning future business on payment of pre-petition debt. Moreover, vendors should be aware that getting paid as a critical vendor will likely be conditioned on providing normal lines of credit, pricing and terms, or other "customary trade practices."

It is most important that vendors calculate the amount and risk of payment of the required post-petition extensions of credit, compared to the amount of the critical vendor payment. There have been numerous recent instances where vendors have elected to not accept critical vendor payments due to the amount and risk of the post-petition extensions of credit.

c. Setoff and Recoupment. Setoff, an often overlooked remedy, arises from the settlement of mutual debts or accounts owed between a debtor and a creditor. Simply, if A owes B \$100 and B owes A \$50, then the debts can be resolved as follows: \$100 - \$50 = \$50, so A pays B \$50 and the accounts are settled. The Bankruptcy Code codifies this common law remedy and in fact, provides that the creditor has a secured claim to the extent of the value of its setoff claim.

The debts that are owed must be owed to and from precisely the same legal entities and the debts must arise either both pre-petition or both post-petition. The debts do not, however, have to arise out of the same transaction.

Triangular setoffs are not allowed in Chapter 11, though are generally enforceable outside of bankruptcy.

The exercise of a setoff remedy requires relief from the automatic stay from the Bankruptcy Court. Moreover, there are somewhat complicated rules regarding exercise of setoff during the 90 days prior to the bankruptcy filing, which if not followed, could result in preference exposure. Good legal advice on this point is essential.

Recoupment is similar to setoff, except that the mutual debts must arise from the same transaction.

We have noted a significant increase of sales contracts providing rebates and other sales incentives to the customer. Under applicable law, suppliers may setoff or recoup these obligations owed to customers against the accounts receivable owed. This effectively provides the supplier a 100 percent recovery to the extent of the setoff or recouped amount.

Upon a Chapter 11 filing, suppliers should press pause on issuing rebate payments to first evaluate potential setoff rights.

2. POST-PETITION SALES

Post-petition sales to Chapter 11 debtors are inherently high risk. In addition to operational and financial risks, there are risks created by the Chapter 11 process and the Bankruptcy Code.

a. Costs of Administration.
Post-petition sales are costs of administration under the Bankruptcy Code, which are junior in priority to lenders' secured claims, but ahead of all other classes of creditors. Moreover, the Bankruptcy Code requires that costs of administration be paid as a condition of confirmation of a plan of reorganization. There is no such requirement in a Section 363 sale, unless lenders or buyers are compelled to assume the liabilities or fund a plan of liquidation. As a result, in Section 363 sales, whether costs of administration will actually be paid depends on asset values and if lenders or buyers assume liabilities or fund a plan of liquidation.

With more financially stressed Chapter 11's on the horizon, it is predictable that lenders and buyers will resist such funding, to conserve cash.

b. Liquidity.
Liquidity during the Chapter 11 case is dependent on debtor in possession (DIP) financing, which is discretionary and often based on a strained lender-borrower relationship. The critical 13-week budget attached as an exhibit to the DIP financing documents

is often razor thin, leaving little or no margin for error.

c. Management Authority.
The decision making authority of the debtors' management, with whom creditors have the historical business relationship, is compromised, as other stakeholders, including lenders, private equity sponsors, and potential buyers, are able to influence business decisions in Chapter 11.

d. The Liquidity Slide.
Even if there is sufficient liquidity initially in the Chapter 11 case, it can deteriorate as the case progresses.

In the Dean Foods Chapter 11 case, pending in Texas, the debtors filed a number of first day motions including approval of DIP financing, that was presented as providing sufficient "runway" for Dean to achieve a successful Chapter 11 reorganization or a "successful" Section 363 sale. Dean also filed a first day motion to prohibit contract counter-parties from altering their contracts, including the obligations to continue providing goods and services, on credit terms. Dean asserted that the Bankruptcy Code prohibits a contract party from terminating or modifying the contract, period. Actually, the Bankruptcy Code provides that contracts cannot be terminated or modified "solely because of a provision in such contract ... that is conditioned on" the insolvency of the debtor, the this limitation is not applicable "if ... applicable law excuses a

party, other than the debtor ... from rendering performance ...". Section 2-609 and 2-702 of the Uniform Commercial Code is "applicable law" that protects suppliers. However, in Dean Foods, on day one, vendors' rights to withhold shipment or credit terms were impaired, without regard to increased risk of payment later in the Chapter 11 case.

Fast forward to July, 2020, Dean Foods filed a proposed "administrative claims protocol" offering to pay administrative claims at a 20 percent discount, including the post-petition invoices that Dean failed to pay, and the Section 363 sale buyer refused to assume such liabilities. The administrative protocol indicates that Dean is or may become administratively insolvent, meaning it does not have or may not have sufficient assets to pay Section 503(b)(g) claims and unpaid post-petition invoices in full. Yet, vendors' rights in that regard were impaired on the first day of the Chapter 11 case.

The use of administrative protocols to administrative claims is a growing trend, used also in Toys R Us and Sears. Suppliers are well-advised to anticipate this possibility in making business decisions at the outset of a Chapter 11 filing.

e. Super-priority Administrative Claims Impact Suppliers.
In virtually all DIP financings, lenders obtain a "super-priority" administrative claim that has priority over all other administrative claims, including Section 503(b)(g) claims and unpaid post-petition invoices. Professional fees are often structured as "carve-outs" from the lenders' super-priority administrative claims effectively elevating professional fees above other administrative claims.

f. Section 363 Sale Asset Purchase Agreements.
In the event of a Section 363 sale, usually asset purchase agreements specifically exclude assumption of all pre-closing liabilities, including administrative claims based on Section 503(b)(g) and unpaid post-petition invoices.

Buyers assert that such claims are obligations of the debtors' estates.

g. Risk Mitigation.
Trade creditors must carefully evaluate these risk factors for post-petition sales during all phases of Chapter 11 cases. For material exposures, vendors need to engage, and possibly object to first day motions. If extending credit terms is too risky, the simplest strategy is to ship goods on a cash before delivery basis.

Generally, if a vendor is selling on the basis of purchase orders and invoices, there is no obligation to ship goods or to extend credit terms. However, if the parties are doing business under a sales or supply agreement. Debtors will assert that the Bankruptcy Code requires the vendor to continue shipping goods and provide historical credit terms. Trade creditors can assert that Sections 2-609 and 2-702 of the Uniform Commercial Code provide for a suspension of seller's performance obligations (shipment and/or credit terms) and for cash before delivery shipments upon insolvency, regardless of the contract terms.

3. EXECUTORY CONTRACTS

Executory Contract is the Bankruptcy Code term given to essentially any contract between a debtor and a non-debtor party where both parties owe material performance to the other. A supply contract or other sales agreement almost always meets the requirements of an executory contract under the Bankruptcy Code. The Bankruptcy Code Rules for rejecting executory contracts are debtor-friendly which is often incentive for Chapter 11 filings, particularly retail filings.

The Bankruptcy Code provides debtors the unfettered right to assume or reject executory contracts and leases. If a debtor rejects an executory contract, the non-debtor party receives a general unsecured claim for damages arising from the debtor's "breach" of contract. Thus, a debtor escapes the contract with little cost. On the other hand, the debtor also has the right to assume or assume and assign a contract. In this instance, the Bankruptcy Code requires that the debtor "cure" the contract by paying existing defaults. Presumably, debtors, or Section 363 sale buyers, would assume contracts that they deem to be valuable either because they insure an uninterrupted supply of goods or contain favorable pricing or terms. For a creditor who is a party to an executory contract, the assumption of such contract can be an effective vehicle to obtain payment of pre-petition debt.

In many Section 363 sales, buyers elect to assume only absolutely essential contracts to avoid payment of the cure costs. Instead, buyers reject many contracts and attempt to negotiate with suppliers separately for revised contracts, and no cure payment.

The Bankruptcy Code requires that the non-debtor party to an executory contract must continue to perform its obligations under the contract during the Chapter 11 case pending the debtor's decision to assume or reject such contract, and provided that the debtor is in fact performing its obligations of the contract post-petition.

Generally, the obligation to continue performance is subject to a seller's UCC Article 2 rights including UCC 2-609 and UCC 2-702, though Chapter 11 debtors often challenge this (usually at the behest of their financiers), though as indicated from the Dean Foods case, creditors will likely need to object to first day motions.

Please note my article, When Worlds Collide: Article 2 of The Uniform Commercial Code and Chapter 11, for a deeper dive on the interplay between the Bankruptcy Code and a supplier's rights under the Uniform Commercial Code.

Please note my article, Dumbing Down Intellectual Property: Chapter 11 Impact on IP License Agreements, regarding the impact of the Chapter 11 on licensing agreements.

4. CHAPTER 11 AVOIDANCE ACTIONS: KEEPING PRE-PETITION PAYMENTS

a. Preferences.
Bankruptcy Code Section 547 allows the debtor to recover pre-petition payments to third parties that were made within go days prior to filing as to non-insiders and within one (1) year prior to filing with respect to insiders. The requirements to assert a preference are that the payment in question be made within the appropriate time period, made while the debtor is insolvent, the payment is on account of antecedent debt and the payment allows the creditor to receive more than it would in Chapter 7 liquidation. Debtors or trustees pursuing preference claims rarely have difficulty establishing these basic requirements.

Preference claims are normally highly defendable based on statutory defenses. Creditors who have received allegedly preferential payments have several defenses, the most common three being that:

(1) the payment was made in the ordinary course of business,

(2) the creditor provided subsequent new value after the payment at issue, or

(3) the payment constituted a contemporaneous exchange for value.

The Small Business Reorganization Act of 2019 (SBRA) contained amendments to preference laws, applicable to all Chapter 11 cases. In asserting preference claims, the Chapter 11 debtor now must exercise reasonable due diligence, taking a creditor's defenses into account. Also, for claims of $25,000 or less, the Chapter 11 debtor must assert the claim in the creditor's jurisdiction.

Upon a customer's Chapter 11 filing, suppliers should assess and understand the potential preference risk as part of the overall customer risk profile, in connection with its internal accounting decisions and its strategy for doing business with the customer in Chapter 11. To do this, suppliers must analyze their subsequent new value "credit" and whether the payments received were in the "ordinary course of business" consistent with Chapter 11 case decisions and analytical methodologies.

b. Fraudulent Transfers.
Fraudulent transfers are a partial misnomer because fraud is not required. Under the Bankruptcy Code, the debtor can recover payments made to creditors occurring within two years of the bankruptcy filing, that were made for "less than reasonably equivalent value." A debtor can also use applicable state law to avoid certain transfers under similar legal principles. This is particularly important with respect to fraudulent transfers as most states have a two to six year "look-back" period, which often exceeds the two-year

look-back period available under the Bankruptcy Code.

Fraudulent transfer claims against vendors are not as common as preference claims. However, we have seen these claims asserted when the customer has numerous affiliates and a supplier invoices one entity, but payment to the supplier is made from a parent of the affiliate under a consolidated cash management system. Technically, the parent received no value for the payment to the supplier.

We successfully defeated a fraudulent transfer claim by establishing that pursuant to a company group cash management system, affiliate cash was swept upstream to the parent, but redistributed to affiliates to fund operations.

c. Unauthorized Post-Petition Transfers.
The Bankruptcy Code allows Chapter 11 debtors, or more likely, their residual estates after a Section 363 sale, to recover post-petition payments to vendors that were not approved by the Bankruptcy Court. This would include:

(1) payments on post-petition transactions that were outside the ordinary course of business between the supplier and customer, or payments were made without court-approved DIP financing or an order allowing the customer's use of the lender's cash collateral, and

(2) post-petition payments of pre-petition claims in the absence of a critical vendor or other court order allowing payment of pre-petition claims. It is important for suppliers doing business with Chapter 11 customers to verify that the payments they will receive have been authorized by the Bankruptcy Court, otherwise, the payments may be subject to later disgorgement.

In light of the likelihood of a substantially greater number of Chapter 11 filings in the coming years, and the heightened financial stress and challenges these cases will present, suppliers to and customers of Chapter 11 debtors should be prepared with knowledge of the areas of risk and the best strategies for mitigating such risk. This will include pro-active engagement from the beginning. ■

David H Conaway is an Attorney at Schumaker, Kendrick LLP and writes regularly for ICTF and also presents at our members' conferences.



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