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ASSOCIATION OF CREDIT EXECUTIVES
PRESENTATION:

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Chapter 11 Searching for the New Normal:

Strategies to Avoid the Loss Trifecta

A. Introduction

- 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% 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.

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A. Introduction
(continued)

- Companies are likely accustomed to the prospect of a pre-petition A/R write-off, and later preference demand. Increasingly, companies are at greater risk for non-payment of post-petition A/R's, creating the risk for a "loss trifecta".
- 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.

B. Chapter 11 Risk of Loss

- 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.

  1. Pre-Chapter 11 Accounts Receivable

     - The Usual Outcome. Accounts receivable owed prior to the Chapter 11 filing often receive little or no payment, and result in a write-off.

B. Chapter 11 Risk of Loss
(continued)

- Sources of Payment. There are only two realistic sources of payment for unsecured claims of trade creditors (other than Section 503(b)(9) 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).

   c. Third-party guarantees and credit insurance.

B. Chapter 11 Risk of Loss
(continued)

- The “Type” of Chapter 11 Makes a Difference.
    - Balance Sheet Restructurings or Pre-packaged or Pre-arranged Plans of Reorganization.
    - Traditional Chapter 11 Plan of Reorganization.
    - Section 363 Sale of Assets.
    - 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.

B. Chapter 11 Risk of Loss
(continued)

- Creditor "Remedies."

    a. 20 Day Administration Claim.

    - Under Section 503(b)(9) 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.
    - Impact of "administrative insolvency".

B. Chapter 11 Risk of Loss
(continued)

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.
- Only a debtor can make the determination that a particular vendor is critical and seek court approval of the same.
- Court Approval.

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B. Chapter 11 Risk of Loss
(continued)

- 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.

B. Chapter 11 Risk of Loss
(continued)

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.

B. Chapter 11 Risk of Loss
(continued)

- 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.

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B. Chapter 11 Risk of Loss
(continued)

- 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% recovery to the extent of the setoff or recouped amount.

B. Chapter 11 Risk of Loss
(continued)

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.

B. Chapter 11 Risk of Loss
(continued)

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

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B. Chapter 11 Risk of Loss
(continued)

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.

B. Chapter 11 Risk of Loss
(continued)

d. The Liquidity Slide.

- Even if there is sufficient liquidity initially in the Chapter 11 case, it can deteriorate as the case progresses.

- Dean Foods Chapter 11 (Texas).

    - First Day Motions

    - Prohibition from Alterations to Contracts.

    - Bankruptcy Code Section 365(c)

    - Impact on UCC Sections 2-609 and 2-702

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B. Chapter 11 Risk of Loss
(continued)

- Dean Foods Administrative Claims Protocol".
- 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.

B. Chapter 11 Risk of Loss
(continued)

e. Impact of DIP Financing Super-priority Administrative Claims Impact Suppliers.

- DIP Milestones
- 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)(9) 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.

B. Chapter 11 Risk of Loss
(continued)

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)(9) 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.

B. Chapter 11 Risk of Loss
(continued)

- 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.

B. Chapter 11 Risk of Loss
(continued)

3. Executory Contracts
   - Definition of Executory Contract.
   - Debtors' Rights to Assume, Assume and Assign, or Reject.
   - 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.

B. Chapter 11 Risk of Loss
(continued)

- The Bankruptcy Code Obligation of Continued Performance.
- Impact of UCC Article 2 Rights: Sections 2-609 and 2-702.
- Bankruptcy Clauses in Contracts – “Ipso Facto” Clauses

B. Chapter 11 Risk of Loss
(continued)

- 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.

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B. Chapter 11 Risk of Loss
(continued)

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 90 days prior to filing.
- Elements Debtors Must Prove.

B. Chapter 11 Risk of Loss
(continued)

- Section 547(c): Statutory Defenses to Preference Claims.
  - Subsequent New Value
  - Ordinary Course of Business
  - Contemporaneous Exchange for Value
- Setoff as a Preference.

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B. Chapter 11 Risk of Loss
(continued)

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

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B. Chapter 11 Risk of Loss
(continued)

- Consolidated Appropriations Act of 2021.
  - Limited Scope. The protections only apply to payments of arrearages:
    - Made after March 13, 2020 in connection with an agreement entered into.
  - Thus, suppliers or landlords seeking to avoid themselves of these new payment protections must have:
    - Entered into an executory contract or lease;
    - Amended the contract or lease after March 13, 2020; and
    - The amendment must have deferred or postponed payments otherwise due under the contract or lease.

B. Chapter 11 Risk of Loss
(continued)

- 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.

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."

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B. Chapter 11 Risk of Loss
(continued)

- A debtor can also use applicable state law (Uniform Fraudulent Transfer Act or Uniform Voidable Transaction Act) to avoid certain transfers under similar legal principles, having a two to six year "look-back" period.
- Fraudulent Transfer Claims Against Vendors.
  - Multi-entity customers
  - Cash management systems

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B. Chapter 11 Risk of Loss
(continued)

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. Otherwise, the payments may be subject to later disgorgement.

A “Black Swan Event”: New York Federal Court Rules that Lenders are Entitled to Keep $500 Million Mistakenly Paid by Citibank

- Revlon 2016 $1.8 billion term loan
- May/June 2020 Re-Finance due to “extreme tight” liquidity
- August 11, 2020 wire transfers
    - $7.8 million interest payments
    - $984 million principal payments
    - $500 million “non-returning lenders”

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A "Black Swan Event": New York Federal Court Rules that Lenders are Entitled to Keep $500 Million Mistakenly Paid by Citibank

- August 12, 2020 Recall Notices
- August 17, 2020 Citibank lawsuit *In re Citibank August 11, 2020 Wire Transfers* (NY Federal District Court)
- December, 2020 bench trial
- February 20, 2020 Court Ruling
  - Restitution/Unjust Enrichment
  - Discharge-for value exception

A "Black Swan Event": New York Federal Court Rules that Lenders are Entitled to Keep $500 Million Mistakenly Paid by Citibank

- Arguments of the parties
- Evidence at trial
  - Wigpro Ltd.
  - Flexcube Software
  - Checking/Unchecking Boxes

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Creditors' Committees – To Serve or Not to Serve

- Benefits of Serving – "Inside" Information
- Requirements to Sit on the Committee
- American "Bankruptcy" Idol – How to be Selected
- Duties as an Uncompensated Fiduciary

Recent Articles

- A "Black Swan Event": New York Federal Court Rules that Lenders are Entitled to Keep $500 Million Mistakenly Paid by Citibank
- Do Prohibitions Against Ipso Facto Clauses Push Suppliers in the Insolvency Abyss?
- Unpaid Motor Carrier Claims: What Shippers Can Do to Reduce the Risk of Liability When Using Third-Party Brokers
- Chapter 11 Filings Soar in the First Half of 2020 in USA
- Winning Solutions for Suppliers in a Zero-Sum Game. Parts 1 and II
- COVID-19 Impact for Manufacturing Companies: Strategies to Flatten the Curve with Customers and the Supply Chain

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Thank you for your attendance.

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