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Doing the Deal Right: Mitigating the Threat of Insolvency Before It's Too Late

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The risk of insolvency is a commercial reality that can wreak havoc on commercial transactions. Although bankruptcy law is designed to facilitate the efficient repayment of debt, it often achieves that goal by modifying rights and obligations upon which parties previously agreed and relied when deciding to enter into those transactions. This can result in significant unintended consequences when parties fail to take into account what might happen should one of the parties to a commercial transaction file for bankruptcy.

Fortunately, the risks of insolvency often can be mitigated through familiarity with the bankruptcy process, proper planning, and the advice of competent insolvency counsel. To that end, this article provides a few practice pointers that should be considered in the context of addressing four typical commercial scenarios: (1) drafting and negotiating supply contracts; (2) entering into settlement agreements; (3) dealing with a contract counterparty's bankruptcy; and (4) buying and selling distressed companies.

1. Drafting a Supply Contract

Scenario: A vendor is negotiating a contract with a new customer, but is worried about the customer's financial stability. What can the vendor do to protect itself from the customer's insolvency risk?

Three fundamental bankruptcy concepts underlie almost any contract negotiation:

- **Automatic Stay.** The filing of a bankruptcy case triggers the automatic stay, a broad injunction that generally precludes creditors and contract counterparties from taking unilateral action to enforce their rights absent further relief from the bankruptcy court. If a contract counterparty files for bankruptcy, any effort to collect outstanding prebankruptcy receivables or to enforce other rights could have negative consequences for the nonbankrupt party.
- **"Ipso Facto" Clauses.** The Bankruptcy Code generally disfavors the enforcement of contractual provisions that are tied to a contract party's bankruptcy or insolvency. Thus, a bankruptcy court usually will ignore an ipso facto provision that permits a nondebtor party to terminate a contract due to the counterparty's bankruptcy.
- **Avoidance Actions.** Debtors or trustees may seek to avoid—or claw back—"preferential" payments: those made by a debtor, to or for the benefit of a creditor, on account of an antecedent (or preexisting) debt, within the 90 days prior to bankruptcy. See 11 U.S.C. § 547. Ordinary trade terms—for example, payment on 30-day terms—give rise to an antecedent debt: the payment is due, and the debt is paid, within 30 days after delivery or the issuance of the invoice. If a payment is successfully avoided, the nondebtor contract party is left with a general unsecured claim in the bankruptcy equal to the amount of the avoided payment. Bankruptcy may also give rise to clawback claims relating to fraudulent transfers if the debtor is found to have paid less than reasonably equivalent value for the goods or services in question, even when the transferee had no fraudulent intent. (Fraudulent transfers are discussed in further detail below.)

There are a number of defenses to preference actions, and the vast majority are resolved without going to trial (and often before a complaint is even filed). Thus, *it is almost always better to accept a payment that may later be attacked as preferential* than it is to forego payment altogether. Because defense costs can quickly accrue, however, the ideal scenario is one in which the debtor or trustee cannot even allege a preference. Set forth below are a few ways that vendors can prevent a preference claim.

- **Payment in Advance.** Given that a payment cannot be preferential without an antecedent debt, the best way to avoid being subject to a preference attack is to avoid granting credit in the first place. If payments are made on a true "cash in advance" basis, the element of antecedent debt cannot be met, and the payment cannot be subject to attack at all.
- **Letters of Credit and Other Security.** Absent the ability to put the purchaser on cash-in-advance terms, the next best protection is to obtain a letter of credit. Because a letter of credit is issued, and any payments thereunder are made, by a third-party bank, payments made pursuant to a letter of credit typically are not subject to avoidance. In addition, the automatic stay is not implicated by a contract counterparty's bankruptcy, given that the nondebtor may go directly to the issuer bank to be made whole for any outstanding amounts. Other forms of security, such as a lien on accounts receivable or inventory may be available, but generally they offer less protection. First, the collateral may be subject to other secured claims, giving rise to potential intercreditor issues and requiring perfection and maintenance. Additionally, given that vendors can recover only from the debtor, vendors must obtain relief from the automatic stay before foreclosing on the lien.
- **Guarantees.** A guarantee from a more stable third party, such as a corporate parent, affiliate, or shareholder, is another option. Like letters of credit, guarantees allow creditors to bypass the automatic stay by enforcing their rights against someone other than the debtor. Vendors should carefully vet potential guarantors, however. Corporate bankruptcies often involve multiple related debtors seeking protection simultaneously in a jointly administered proceeding. If the guarantor also files for bankruptcy, the guarantee becomes worthless. Additionally, if a guarantor is insolvent or becomes insolvent when a guarantee payment is made, that payment may be subject to avoidance as a fraudulent transfer. Upstream guaranty payments generally are more susceptible to challenge than downstream guarantees.
- **Forward Contracts.** Another potential option, particularly in a commodity scenario, is to structure the agreement as a "forward' contract. By doing so, vendors can take advantage of special Bankruptcy Code provisions exempting such creditors from the automatic stay and from the bankruptcy trustee's avoidance powers.
- **Title.** Depending on the nature of the goods sold, the contract may specify that title does not transfer to the customer until the vendor is paid in full. However, the owner must be careful to follow all state laws pertaining to identification of property held by another, including tagging, registration, and notice requirements. The owner also remains subject to the automatic stay and must still apply to the bankruptcy court for permission to recover its property from the debtor.
- **Self-effectuating Termination.** If a contract is properly terminated pre-petition, the debtor should not be able to "resurrect" the relationship and force the vendor to deliver goods. To bypass the automatic stay, vendors should make their right to terminate the contract self-effectuating and not require notice or other action. To avoid classification as an ipso facto clause, the termination rights should not be tied to the debtor's financial condition.

2. Settlement Agreements

Scenario: A vendor previously entered into a contract with 60-day payment terms and no security. When its business deteriorated, the customer fell behind on payments to the vendor. The vendor filed suit to collect its debt, and the customer offered to settle the case by paying a lesser amount over time. What are the vendor's risks and how can they be mitigated?

Although a settlement may be the most cost-effective way for a vendor to resolve credit exposure, settlement agreements are inherently risky because they involve payment on antecedent debt, and the usual arsenal of preference defenses often will not apply. Moreover, it is particularly unpleasant to agree to settle for a lesser amount, learn that the payment received is subject to preference attack and that, by agreeing to accept less on the claim, the vendor has consequently limited its bankruptcy claim to the settlement amount (as opposed to the initial claim).

Although there is no foolproof method of preventing an attempt to claw back a settlement payment, there are a number of measures creditors can take to mitigate the risk associated with entering into the settlement agreement.

- **Springing Releases.** To avoid having a payment avoided and the claim limited to the settlement amount, the creditor should consider including a "springing release" specifying that the claim will not be reduced or released until 91 days have passed after the last payment without a bankruptcy filing. The settlement agreement should also clarify that the full claim remains in effect for all defense purposes (for example, to defend any claims brought by the debtor or creditors).
- **Escrows.** Alternatively, the settlement funds may be placed into an irrevocable "true" escrow with payments released pursuant to an escrow agreement 91 days after funding. It should be noted that an enforceable escrow requires satisfaction of numerous steps under state law. Moreover, an escrow means that the settling vendor does not immediately receive cash in hand. In addition, funds placed into escrow during the 90-day period are still likely to be subject to a preference claim.
- **Earmarking.** Another option is to source the settlement payments from earmarked funds from a third-party who effectively steps into the shoes of the debtor so that there is no overall effect on the debtor's balance sheet. For earmarking to be effective, the parties must adhere to specific guidelines: (a) there should be an agreement between the debtor and the payor that

the new funds will be specifically used to pay the vendor's antecedent debt; (b) the agreement should specify that the debtor does not have control over the disposition of the funds; (c) the vendor should retain evidence that the agreement has been performed according to its terms; and (d) the transaction should not negatively impact the debtor's balance sheet, for example, by replacing an unsecured obligation with a secured obligation.

3. Pending Bankruptcy

Scenario: A vendor calls its attorney in a panic when its customer filed for bankruptcy. Must the vendor keep supplying? What about outstanding prebankruptcy obligations? Will the customer try to claw back prior payments? Can the vendor object to the assignment of its contract to a third party?

Vendors must understand the effect of a counterparty's bankruptcy on their commercial relationship. If both parties to the contract have significant unperformed obligations remaining, the contract is likely "executory" and subject to the debtor's assumption (or reaffirmation), rejection (or breach), or assignment to a third party. In most circumstances, the debtor need not decide whether to assume or reject the contract until a plan is confirmed at the end of its case, thereby leaving the vendor in limbo during the bankruptcy proceedings. If the vendor's contract is rejected, all obligations under the contract will be relieved, leaving the vendor with a general unsecured claim.

With some limited exceptions, contract provisions purporting to condition assignment on consent of the nonassigning party are unenforceable. Absent consent of the nonbankruptcy party, however, the contract must be assumed in its original form. If the debtor assumes or assigns the contract, the debtor or assignee must cure (or pay) any outstanding defaults and provide "adequate assurance" of its ability to perform under the contract going forward. The assumption (or assignment) of a contract also insulates any 90-day payments from preference avoidance. Thus, when dealing with a debtor or assignee that wants to negotiate more advantageous contract terms, the nondebtor vendor should insist on the assumption and modification of an existing contract rather than the execution of a new supply agreement, which will result in the rejection of a prior agreement and possibly create preference exposure. Even if the vendor does not have the bargaining power to have its contract assumed and paid in full, a vendor subject to preference exposure may have enough bargaining power to, for example, have its contract assumed, but waive affirmative recovery on its claim, thereby protecting it from a preference attack.

Vendors may find themselves in no-man's land where their contract has been neither assumed nor rejected, but a prebankruptcy payment default remains outstanding, and the debtor still seeks performance. In such a case, the vendor remains obligated to perform under the nonterminated contract so long as the debtor complies with its terms. Although the Bankruptcy Code mitigates further exposure by giving the vendor administrative-expense priority over even secured claims, payment is not guaranteed. Vendors in this situation should closely monitor the debtor's post-bankruptcy performance and seek relief from the bankruptcy court if necessary. The Bankruptcy Code does not require creditors to incur unmitigated exposure.

Vendors faced with a customer's bankruptcy should almost always file a proof of claim in the bankruptcy case before the claims deadline expires. Creditors should recognize that submitting a proof of claim likely will subject them to the bankruptcy court's jurisdiction, which may lead to unintended results, such as waiving their right to a jury in avoidance actions and allowing themselves to be sued in bankruptcy court on other claims. Creditors may also decide not to file a proof of claim if they are wary of unwanted attention; however, failing to do so might subject a creditor to an absolute bar of its claim. Creditors should carefully consider the consequences before determining not to file a claim.

4. Mergers & Acquisitions

Scenario: A client has asked generally about the risks associated with the purchase or sale of a distressed company, both inside and outside of Chapter 11.

Distressed companies often are prime acquisition targets—buyers believe they can turn the business around; sellers are eager to cut their losses and move on. However, the sale of distressed companies implicates important bankruptcy considerations not present in other M&A deals.

These issues arise even when a company is sold in an arms-length transaction outside of Chapter 11. If the buyer ultimately fails to turn the business around and files for bankruptcy, the seller may be subject to a fraudulent transfer claim on the grounds that the buyer-debtor overpaid. Conversely, if the business improves post-sale, the seller or its equity holder may assert a fraudulent transfer claim, alleging that the buyer underpaid.

To mitigate that risk, parties should obtain a fairness opinion from a reputable third party to support the transaction value. Although not dispositive, a fairness opinion verified by thorough due diligence could provide a court with strong evidence that reasonably equivalent value was exchanged. In the leveraged buyout context, the Bankruptcy Code contains special safe-harbor provisions that might provide a defense to a fraudulent transfer claim asserted against the purchased entity's shareholders. This continues to be a developing area, however, and litigation is time-consuming and costly.

In any event, if a party to a transaction files bankruptcy, there is a significant risk that the debtor or its creditors will seek to investigate the transaction, which also can be time-consuming and costly. Bankruptcy Rule 2004 provides a broad discovery opportunity for the debtor and creditors "fishing" for information and potential causes of action.

Purchasers enjoy greater protections when they acquire assets through formal bankruptcy proceedings. A sale in bankruptcy usually is subject to higher and better offers, and a bankruptcy court order approves the sale. The court order often contains findings of fact and conclusions of law that undermine the ability to make claims against the buyer.

A bankruptcy sale also causes transfer of the assets free and clear of all liens, claims, and interests, which attach to the sale proceeds.

A "free and clear" order may reduce exposure to many types of successor claims, but will not fully insulate the buyer from the risk of all types of claims. Litigation over the scope of the free-and-clear language often arises in the environmental, employment, and personal-injury contexts, which means that, even if the free-and-clear order is upheld, the buyer might be forced to incur legal fees defending against the barred claim. Purchasers should also note that the debtor's representations and warranties typically are worthless after the deal has closed. Indemnities are meaningless if the debtor lacks the funding to satisfy them. Accordingly, purchasers should insist that any indemnity be funded through an escrow with a reputable, financially stable third party pursuant to a negotiated escrow agreement.

In sum, insolvency-related risks accompany nearly every commercial transaction. Although the ramifications of a contractual partner's bankruptcy can be alarmingly counterintuitive, companies can mitigate their exposure by taking the steps discussed in this article.

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