

The background is a complex digital visualization. It features a dark blue and black base with numerous glowing lines and dots in vibrant colors including orange, yellow, green, and purple. These elements are arranged in a way that suggests a 3D perspective, with lines receding into the distance, creating a sense of depth and movement. The overall effect is reminiscent of a data center or a high-tech network environment.

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MINIMIZING EXPOSURE: PRACTICAL TIPS FOR DEALING WITH FINANCIALLY DISTRESSED CUSTOMERS

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A TIME OF UNCERTAINTY

A Time of Uncertainty

- New business arrangements are never without risk
- Now, more than ever, it is important to try and protect interests because virtually every industry is experiencing economic hardships
- The more you know and the more you prepare up front, the better positioned you will be in a bankruptcy situation
- Topics to be covered:
 - Drafting agreements that anticipate insolvency
 - How a customer's bankruptcy can affect your bottom line
 - How the COVID crisis is affecting the bankruptcy process
 - Anticipating avoidance actions

Bankruptcy Concepts

- The bankruptcy estate and the automatic stay
- The Bankruptcy Code's priority scheme
- Executory contracts and their treatment under the Bankruptcy Code
- Avoidance actions – Bankruptcy Code provides a two-year period during which debtors/trustees can seek to claw back certain payments:
 - Preferences
 - Voidable transfers
 - State fraudulent conveyance statutes can have much longer periods

BANKRUPTCY CONCEPTS

Bankruptcy Concepts – The Estate and The Stay

- Bankruptcy estate:
 - Filing bankruptcy creates an estate consisting of all of a debtor's property, wherever located
- Automatic stay:
 - Filing also triggers a broad stay that precludes taking any action against property of the estate, such as
 - litigation
 - Other collection efforts
 - Unilaterally terminating service without bankruptcy court approval *notwithstanding the language of the contract*

Bankruptcy Concepts – Priority Scheme

- Priority scheme
 - Secured creditors – up to value of their collateral
 - Administrative Claims – including services or goods provided post-bankruptcy
 - 503(b)(9) claims
 - Certain unsecured creditors are entitled to priority in payment, such as taxing authorities and employees
 - General unsecured creditors
 - Subordinated Creditors & Equity

Bankruptcy Concepts – Executory Contracts

- Typically described as contracts where performance is due and owing on both sides, such that a breach by one party will excuse performance by the other
- Automatic stay precludes the termination of contracts upon bankruptcy
 - *Ipsa Facto* clauses – language granting rights upon bankruptcy – are generally unenforceable
 - Bankruptcy will not terminate the contract
 - Restraints on assignment often will not be enforced
 - Exceptions: personal services contracts, certain IP contracts where the identity of the user is significant (but not “off the shelf” IP), partnerships and LLC member rights

Bankruptcy Concepts – Executory Contracts, cont'd

- The Bankruptcy Code requires counterparties under contracts to continue performing post-bankruptcy despite pre-petition defaults as long as the debtor performs post bankruptcy
- Debtor must decide before the confirmation of a plan how it plans to treat the contract
 - Assumption: ratifies or reaffirms obligations and requires cure of prepetition payment defaults
 - Rejection: effectively breaches contract and discontinues performance, leaving an unsecured claim for damages as of the filing date
 - Assignment: Assumes and assigns to a third party, who becomes counterparty; also requires cure

Avoidance Actions – Preferences

- Preferences
 - Transfer made to or for the benefit of a creditor,
 - on account of antecedent (*i.e.* pre-existing) debts,
 - within the 90 days preceding the bankruptcy (one year for insiders)
 - while the debtor is insolvent (presumed)
 - enabling the creditor to receive more than it would have in a chapter 7 liquidation
- Defenses, include transfers made in the ordinary course

Avoidance Actions – Voidable (or Fraudulent) Transfers

- Two types:
 - actual fraud: intent to hinder or defraud creditors
 - constructive fraud
 - the transfer of an interest in property;
 - the debtor was insolvent at the time of the transfer or became insolvent as a result thereof; and
 - the debtor received less than reasonably equivalent value in exchange for such transfer
- Voidable transfer claims arise under both the Bankruptcy Code and under state law
- Know your payor: if the contracting party has a related party making payments for its benefit, there may be fraudulent transfer risk.

Negotiating the Contract: Up Front Protections

- Security will protect a vendor both from exposure for unpaid invoices and from preference exposure
 - Cash deposit → evergreen is best
 - Letters of credit
 - Puts payment obligation on non-debtor third party, so stay should not be implicated
 - But mindful of terms and maintenance of L/C expiration
- Cash on delivery
- Retention of title may be helpful but is not a guarantee
 - Once goods are out of possession enforcing rights becomes difficult
 - Intervening bankruptcy may make repossession impracticable

NEGOTIATING THE CONTRACT

Negotiating the Contract: Up Front Protections

- Guarantees
 - Place the obligation on a third party in the absence of payment by the contract party
 - Good to have, but they are only as good as the guarantor's credit
 - Could be meaningless in a bankruptcy if the guarantor files too and has limited assets
- Payment Terms
 - If granting credit terms, be mindful of payment windows and credit caps and *enforce them* (outside of bankruptcy)
 - Build in rights to revisit terms if the purchaser's credit situation changes
 - *Could affect preference liability, but cash in hand is always better*

Negotiating the Contract – Restrictions/Termination

- While bankruptcy will ignore a provision terminating the contract upon a filing, it is still useful to include termination language:
 - Enforceable outside of bankruptcy
 - Non-bankruptcy related termination rights enforceable, subject to stay
 - Pre-petition termination can be effective after a filing, if self-executing
- Restrictions on assignment
 - Also typically unenforceable
 - But can be enforced, such as when a contract includes custom IP, the identity/user/licensee of the end product is significant, or applicable non-bankruptcy law so permits
 - Financial accommodations contracts cannot be assumed or assigned (the extension of credit terms is not a financial accommodation)

Anticipating Bankruptcy

- Maintain good communications with business contacts
- Follow press coverage and monitor industry distress
- Keep your trusty bankruptcy lawyer informed
- Strictly enforce credit terms and exercise rights if the customer starts to push out receivables or seeks credit in excess of caps
- Know your value: don't be afraid to say no, particularly if you are providing a key service

WORKING THROUGH A CUSTOMER'S BANKRUPTCY

Bankruptcy – Now What?

- Even the most vigilant monitoring cannot always protect a vendor from exposure
- A bankruptcy filing does not necessarily mean a write-off or a lost customer
 - Most companies file with the intention of surviving in some form, either through a recapitalization or a sale that results in a change of ownership, and will want to preserve relationships
- If a bankruptcy happens, you will want to pay close attention
 - Communicate with the customer
 - Reach out to business contacts to try to better understand the situation, understanding that customers will try to put the best spin on the situation
 - You can ask questions, but must cease all collection efforts
- If debtor fails to perform post-petition, seek relief sooner than later

Bankruptcy – First Day Orders

- Debtors cannot pay pre-bankruptcy invoices without bankruptcy court approval, but are obligated to continue paying post-filing
 - Administrative insolvency is a risk, particularly right now
- Typically file a number of “first day” motions that allow them to continue to do business in the ordinary course
- “Critical vendor” orders allow a debtor to pay certain key providers all or a portion of their prepetition claims, usually in return for continued terms
- Claims for goods delivered within the 20 days preceding the bankruptcy in the ordinary course of business (“503(b)(9) claims”) are entitled to treatment as administrative expense claims
 - Only applies to goods and not services

Bankruptcy – Critical Vendor Orders

- Orders provide a bucket of cash to be allocated among key vendors
 - Typically subject to entry into a trade agreement, pursuant to which the vendor agrees to continue providing trade terms during the bankruptcy
 - Credit terms usually equal to or better than those provided in the last 12 months
 - May be asked to waive rights or claims
 - Read carefully and do not be afraid to negotiate or to ask for more (better yet, call your bankruptcy lawyer!)
- How do I know if I'm a critical vendor?
 - Ask, and if the answer is initially no, then lobby for it
 - The list is not made public and is not carved in stone
 - Squeaky wheels get paid

Bankruptcy – The COVID Game Changer

- Generally, debtors continue to operate during bankruptcy, whether in the ordinary course, or through liquidation sales, or a combination
- Generally have DIP Financing or access to cash collateral sufficient to fund chapter 11 case expenses
- COVID-19 has seen unprecedented requests and unprecedented relief being granted
 - certain bankruptcy courts have permitted the temporary suspension of chapter 11 cases, with limited payments to only the most critical parties
 - Making creditors unwitting funders of chapter 11 cases
 - Creates greater risk of non-payment

Bankruptcy – Assumption/Assignment

- Debtors can assume, reject, or assume/assign any time prior to confirmation of a plan
- But it must be done on notice, and contract parties must be given the opportunity to object
- Look for notices of assumption/rejection and proposed cure amount
 - In the case of assumption, third-party assignee must provide adequate assurance of future performance
 - If you cannot consensually agree upon a cure amount you will need to timely object
 - Make sure you paper any consensual agreement as to cure amount
 - Failure to respond is usually deemed consent both to assumption/assignment and to cure amount

Bankruptcy – Assumption/Assignment

- The Bankruptcy Code provides for assumption of the contract as written absent consent of the non-debtor counterparty
- Advantages of Assignment:
 - requires cure of prepetition monetary defaults
 - usually insulates counterparty from preference risk
 - maintains ongoing business relationship
- Ultimately a business decision

Bankruptcy – Rejection

- Some debtors/purchasers will try to use rejection as a negotiating tool for better terms or to reduce their administrative expense burden
 - Rejection means no payment for cure
 - Rejection means no insulation from preference expense
- Rejection is a breach; it is not necessarily termination
 - Most parties treat the contract as terminated, but technically it is not
 - Certain rights may survive under the contract
- Typically rejection gives rise to a general unsecured claim

Bankruptcy – Proofs of Claim

- Generally, creditors will need to file a proof of claim to preserve their claims
- If you miss the bar date, you lose your rights to participate in the bankruptcy, and that may include any right to a distribution
- Proofs of claim should include delinquencies as well as contingent claims for other amounts that could become due under a contract
 - Where contract minimums apply, expectation damages can be asserted
 - Contingent obligations such as indemnity claims can also be listed in an unliquidated amount
- Claims maturing after the bankruptcy likely will be treated as prepetition claims under a prepetition contract *other than* amounts for goods provided or services rendered post-petition

POST-BANKRUPTCY RISKS

Post-Bankruptcy – Avoidance Actions

- If a debtor assumes (or assumes and assigns) your contract, you should not be subject to a preference claim
- If your contract is not assumed, you may find yourself defending an avoidance claim, usually for a preferential payment
- Avoidance actions are seen as a valuable asset of the bankruptcy estate, and litigation trustees institute broad campaigns (letter writing and litigation) in the hopes of recovering amounts for the benefit of creditors
- Being named in an avoidance action does not mean you have done anything wrong, but they can be an expensive nuisance if not resolved

Post-Bankruptcy – Some Common Defenses to Preference Actions

- Ordinary course of business
 - Looks at the course of dealing between the parties and in the industry generally
 - Examines payment terms and the historical time between billing and payment
 - Often becomes more of a negotiation tool than a complete defense
 - Changing up of payment terms pre-petition may affect availability of defense
 - A pre-petition settlement agreement can also negatively affect availability
- New value
 - Considers the extension of new value (additional goods or services) following the transfer
- Contemporaneous exchange for new value
 - Payment occurs substantially simultaneously with the extension of services (COD)

Post-Bankruptcy: Some Common Defenses to Preference Actions

- Earmarking
 - Creditor is paid with funds provided by a third party specifically for this purpose
 - A borrows from B to pay C
 - Idea is that the net effect to the bankruptcy estate is unchanged, so there has been no preference
 - Specific showing is required
- Contract assumption
- Security

INTELLECTUAL PROPERTY LICENSES – A SPECIAL CASE

Supply Side Risk: Intellectual Property – Related Considerations for Licensees

- Bankruptcy Code provides protections for intellectual property licensees
 - If the license is rejected by the debtor-licensor, can treat as terminated, or can elect to continue to exploit license – including for any renewal period – as long as licensee continues to pay royalties
 - Practical difficulty arises if debtor ceases operations and cannot force debtor to maintain/update the IP
 - An IP escrow can address some concerns, but will not be a complete answer if the licensee cannot maintain the IP
- Bankruptcy Code will also enforce certain restrictions on assignment of IP contracts, which can create advantages for licensees

Takeways

1. Be alert: stay in contact, watch press coverage, enforce contract terms, don't let exposure pile up before taking action.
2. Monitor bankruptcy proceedings closely and act quickly to protect your rights.
3. While these are always best practices, COVID-19 has made vigilance that much more important.
4. Keep in touch with your advisors! We can help you to mitigate and minimize exposure, especially before a customer issue becomes a crisis.

Questions?

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Morgan Lewis Coronavirus/COVID-19 Resources

We have formed a multidisciplinary **Coronavirus/COVID-19 Task Force** to help guide clients through the broad scope of legal issues brought on by this public health challenge.

To help keep you on top of developments as they unfold, we also have launched a resource page on our website at

www.morganlewis.com/topics/coronavirus-covid-19

If you would like to receive a daily digest of all new updates to the page, please visit the resource page to [subscribe](#) using the purple “Stay Up to Date” button.

Biography



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Jennifer Feldsher is a partner in the Finance practice. She focuses her practice on corporate restructuring and insolvency law. Jennifer represents interested parties in bankruptcy proceedings and complex corporate debt restructurings with an emphasis on the representation of secured creditors, special situations investment funds, ad hoc groups, and acquirers of assets in all aspects of distressed situations. She also has experience representing troubled corporate debtors in in-court and out-of-court reorganizations, asset sales, loan restructurings, and commercial loan transactions.

Jennifer has directed all aspects of the bankruptcy process for debtors and creditors, including contested plan confirmation hearings, contested relief from stay and cash collateral hearings, and DIP loan negotiations and related hearings. In addition, Jennifer is routinely called on to advise directors, managers, creditors, and institutional investors on zone of insolvency issues and fiduciary duties. She has acted as counsel to companies involved in many of the largest restructurings, including in the energy, retail, telecommunications, technology, healthcare, airline, automotive, gaming, and financial services industries.

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Rachel Jaffe Mauceri is Of Counsel in the Finance practice. She has more than 18 years of experience counseling clients in complex bankruptcy and restructuring matters. Her practice includes representing debtors in prenegotiated and traditional bankruptcy proceedings, debtor-in-possession financing, bankruptcy litigation, creditors' rights and workouts, the purchase and sale of assets out of bankruptcy, and other aspects of bankruptcy and reorganization. Rachel's clients include debtors, financial institutions, indenture trustees, pension and benefit plans, potential acquirers, and other significant creditors and parties in interest.

Rachel regularly moderates and participates in panel discussions on bankruptcy-related matters and writes on current issues in bankruptcy. She is an active member of the Turnaround Management Association, including as current co-chair of TMA's Global Network of Women and of TMA's Mid-Atlantic Regional Symposium, and as a member of TMA Global's board of directors and the board of TMA's Philadelphia-Wilmington chapter. She is also a member of the American Bankruptcy Institute and IWIRC, and sits on the board of the Consumer Bankruptcy Assistance Project. Rachel is the co-chair of the 2021 VALCON conference, and was a member of the VALCON advisory board from 2018-2020.

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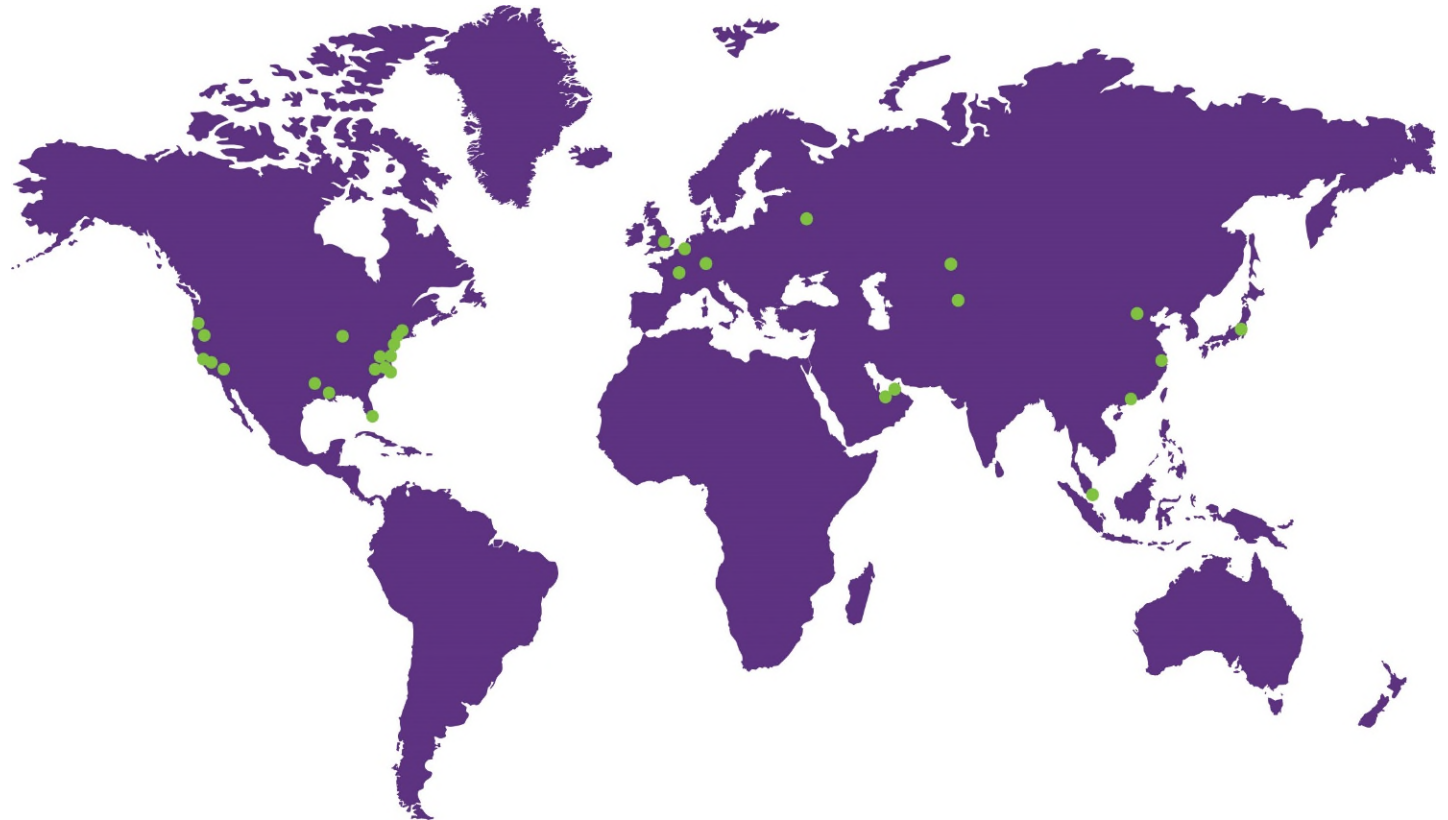
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