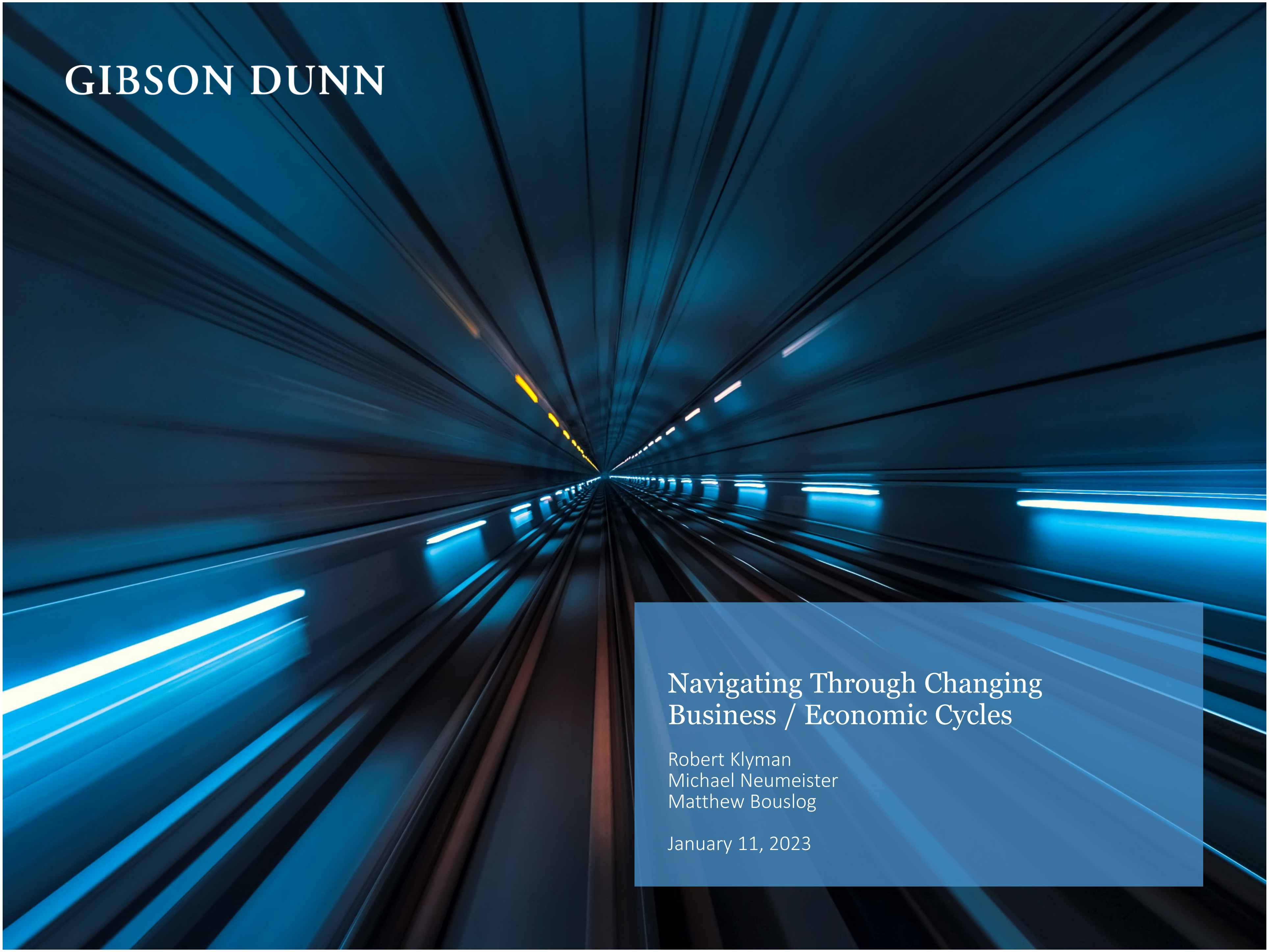

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Navigating Through Changing Business / Economic Cycles

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Agenda

The market has seen an ongoing increase in the number of distressed companies commencing in-court restructuring proceedings through chapter 11 of the Bankruptcy Code.

This presentation addresses the following issues that directors and management should consider when their company is nearing insolvency, or when customers or contract counterparties are facing financial distress:

- Fiduciary Duties in Distressed Situations
- Rights When a Customer or Counterparty Files for Chapter 11
- Understanding Preference Risk
- Navigating the Automatic Stay

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Fiduciary Duties in Distressed Situations

Fiduciary Duties: Ethical Considerations for In-House Counsel

- In-house general counsel must generally be aware of their ethical obligations to their clients in advising directors and/or management of their fiduciary duties.
- Who is my Client?
  - Generally, when representing an organization or corporate entity, the organization is the client—not its officers, directors, shareholders, or other constituents.
- Rule 1.13(a) of the California Rules of Professional Conduct ("CRPC"):

  "A lawyer employed or retained by an organization shall conform his or her representation to the concept that the client is the organization itself, acting through its duly authorized directors, officers, employees, members, shareholders, or other constituents overseeing the particular engagement."
- The mere fact a corporate client owns, or is owned by, another corporate affiliate does not create an attorney-client relationship between the attorney and the corporate affiliate.
- However, it is much easier than most attorneys think for an implied A-C relationship to arise. Sometimes attorney may have a duty to advise employees/other constituents that he or she is not representing them.

Fiduciary Duties: Ethical Considerations for In-House Counsel (Cont'd)

- Unity of Interest Test
  - The leading California decision regarding corporate family conflicts held that a client and an affiliated entity (in this case, a subsidiary of the entity client) should be treated as one client where the "unity of interests" test is met. (*Morrison Knudsen Corp. v. Hancock, Rothert & Bunshoft, LLP*, 69 Cal. App. 4th 223 (1999)). The court considered the following factors: (1) whether there is a substantial relationship between the representation of the current client and the proposed representation against its subsidiary; (2) whether the client controls the legal affairs of its subsidiary; and (3) whether the client and its subsidiary have integrated or shared operations, management and personnel.
  - If affiliated entities meet the unity of interest test, the attorney should consider them to be one entity for purposes of analyzing conflicts of interest and maintaining confidential information, and the attorney may be disqualified from representing a client with interests that are adverse to the non-client affiliate of the entity client.
- Corporate Family Conflicts
  - It is not uncommon for one attorney to represent a company and its subsidiary on matters of mutual interest. However, outside counsel (or conflict waiver) should be retained or obtained for the subsidiary company if the interests of the two companies diverge.

Overview of Fiduciary Duties

- Directors of a financially stressed company may be asked to approve certain transactions, financings, payments or restructuring strategies that could be attacked (with the benefit of 20/20 hindsight) if the company were subsequently to falter or if stakeholders perceive that they were harmed by the transaction or restructuring, or perceive a strategic advantage to asserting such claims.
- When a company is financially distressed, the fiduciary duties of its directors may expand to include stakeholders other than the company and its stockholders or corporate parent, such as lenders and other creditors.
- The environment in which directors of a financially stressed company operate has become much more difficult. Courts, regulatory agencies, lenders, bondholders, and other stakeholders have become more aggressive and willing to second-guess directors' decisions.

Fiduciary Duties

- The business affairs of a company are to be managed by its officers under the direction of the board of directors.
- The law of the state of organization of the company determines the scope and extent of management's and the board's fiduciary duties.*

* *This presentation focuses on Delaware and New York law.*

Fiduciary Duties in a Solvent Company Context

Stockholders	Creditors
• General Rule: Directors of a solvent company owe their fiduciary duties to the company and derivatively to its stockholders. • Stockholders have no contractual protections. Accordingly, they are entitled to a high degree of protection from mismanagement as a matter of law.	• Creditor Rights Are Contractual: Creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, general commercial law, and other sources of creditor rights.

Fiduciary Duties in Connection with an Insolvent Company

- At all times, directors owe a fiduciary duty to the entire "corporate enterprise" or the "community of interests that [sustain] the corporation."
  - When a company is insolvent, however, the community grows to include creditors.
  - Case law has clarified that directors do not owe direct fiduciary duties to creditors in an insolvent context. Rather, as with its stockholders, all duties to creditors are derivative: They flow through the directors' duties to the company.
- <u>When It Is Unclear if the Company Is Solvent</u>:
  - Often, it is prudent for directors to assume when making decisions that in hindsight, a court might find the company was insolvent.
  - Directors should act in a manner that preserves and maximizes the value of the company.

The Duty of Care

- Duty of Care
  - The actions and conduct of directors must be informed and considered, and decisions must be made with “requisite care.”
  - Directors are entitled to rely *in good faith* on reports prepared by officers of the company or outside experts.
- To establish that a board has acted with requisite care, it is important to create and follow a decision-making process and maintain good records to demonstrate that the board’s decision was informed after consideration of all relevant factors associated with the ultimate decision made.

The Duty of Loyalty

- Duty of Loyalty
  - Directors must act in good faith and in the best interests of the company.
    - As discussed, in an insolvency context, the company can be construed broadly to include the entire corporate enterprise, including creditors.
  - Traditionally, this has applied to self-dealing and corporation usurpation transactions.
    - The duty of loyalty is implicated where a director is not disinterested, e.g., (a) appears on both sides of the transaction, (b) receives a benefit from the transaction that is not received by stockholders generally, or (c) is beholden to a party involved in the proposed transaction such that the director is unable to exercise independent business judgment.
    - Even where some directors are "interested," the protections of the business judgment rule can be preserved if a special committee of disinterested members of the board separately approves the transaction.
    - However, to the extent the transaction is not so approved, a stricter "entire fairness" standard (discussed below) will be applied to evaluate the transaction.
- Case law has expanded the duty of loyalty beyond self-dealing and corporate usurpation to include a failure to act in good faith, which incorporates a duty of oversight.
- The **duty of oversight** includes a duty to monitor the company's operations.

The Duty of Loyalty (Cont'd)

- Under ***Caremark***, a board breaches its duty of loyalty if either (i) the directors completely fail to implement any reporting or information system or controls, or (ii) having implemented such a system or controls, consciously fail to monitor or oversee its operations, thus disabling themselves from being informed of risks or problems requiring their attention.
- Duty of oversight has also been implicated where directors (i) fail to place corporate assets up for sale prior to a liquidity crisis; (ii) fail to hire a restructuring advisor in a timely manner, and/or (iii) abdicate all responsibility to the restructuring advisor when one is hired.
  - Board members affiliated with the parent company/controlling shareholders may be seen as acting at the direction of the parent/those shareholders, which could lead to questions of conflict or interestedness (i.e., putting the interests of the parent company ahead of the stakeholders of a subsidiary).
    - Case law suggests that where a director designee of an insolvent subsidiary breaches the duty of loyalty at the direction of the parent company/controlling shareholder(s), the parent company/controlling shareholder(s) may be financially liable.
    - In insolvency, creditors are derivatively able to pursue these claims not only against members of the board, but also against the parent company/controlling shareholders.

Standards of Review of a Board's Decision Making
(1) The Business Judgment Rule

- The business judgment rule creates a legal presumption whereby courts are deferential to a decision of the board, even if the decision was ultimately unprofitable or a mistake in hindsight.
- Directors are presumed to have acted in good faith and in the best interests of the company.
- Directors must fulfill the duties of care and loyalty to receive the protection of this presumption.
- The following acts, for example, could result in the loss of this presumption:
  - Conflicts of interests
  - Failure to exercise proper oversight
  - Preferential treatment of certain creditors and other stakeholders (including insiders)
  - Failure of a director to disclose material aspects of a transaction
  - Acting without requisite information or deliberation (i.e., breach of the duty of care)

Standards of Review of a Board's Decision Making
(2) Entire Fairness

- The "Entire Fairness" standard applies where a board may be conflicted. It often arises in interested director transactions.
  - For a distressed company, it typically is prudent for the directors to put a process in place to defend all actions under the entire fairness standard.
  - The standard consists of two inquiries: (a) fair price and (b) fair dealing.
    - Fair price means a price that a reasonable seller, under all of the circumstances, would regard as within a range of fair value.
    - Fair dealing considers both the process that the board followed and the quality of the result achieved.

Additional Factors Criticized By Courts

- In evaluating breach of fiduciary duty claims, the following are factors that courts have mentioned in criticizing the actions of a fiduciary (typically a director of a corporation):
  - Acting too quickly
  - Passive or sole reliance on outside advisors or management
  - Utilizing advisors that are not independent and disinterested
  - Failure to negotiate aggressively
  - Failure to understand key documents or fundamental aspects of a transaction
  - Failure to review reasonably available information
  - Failure to ask questions
  - Failure to consider reasonable alternatives
  - Failure to understand the scope of the assignment
  - Failure to take into account different factual circumstances (i.e., one size does not fit all)
  - Failure to document key decisions
  - Falling victim to a controlled mindset and allowing a controlling party to dictate alternatives or terms

Considerations — No Duty to Liquidate or Continue Operating

- Assuming that decisions are made on an informed, good-faith, disinterested basis, directors are not liable for decisions they make nor actions they take in an effort to prolong the corporation's viability, even in the face of bankruptcy. *In re Midway Games*, 428 B.R. 303, 315 (Bankr. D. Del. 2010).
  - However, decisions not made on an informed, good faith, disinterested basis may include damages for deepening insolvency.
- Delaware law gives protection against challenges to a board's decision on when/whether to file for bankruptcy if the board's decision was informed, in good-faith, and disinterested.

Alternative Entity Considerations

- Delaware law allows LLCs and LPs to include a waiver of fiduciary duties in the operating or partnership agreement (but they cannot waive implied contractual covenant of good faith and fair dealing). (6 Del. Code § 17-1101(d)-(f), § 18-1101(c)-(e)).
  - In *Burtch v. Opus, LLC (In re Opus E., LLC)*, 528 B.R. 30, 67-70 (Bankr. D. Del. 2015), *aff'd*, 698 F. App'x 711 (3d Cir. 2017), the court recognized that waivers in an LLC Agreement can limit a bankruptcy trustee's ability to sue derivatively for breach of fiduciary duty.
- Delaware law also prevents creditors from derivatively asserting fiduciary duty claims as to LLCs and LPs. (6 Del. Code § 17-1002, § 18-1002).
  - In *CML V LLC v. Bax*, 28 A.3d 1037 (Del. 2011), the Delaware Supreme Court held that creditors of an insolvent Delaware LLC do not have standing under Delaware law to sue derivatively for breach of fiduciary duty. According to the court, § 18-1002 of Delaware's LLC Act limits standing to pursue such claims to members or assignees of the LLC's interests in the LLC. Creditors do not qualify as either a member nor an assignee.
  - In *Official Committee of Unsecured Creditors v. Comvest Group Holdings, LLC (In re HH Liquidation, LLC*), 590 B.R. 211, 284 (Bankr. D. Del. 2018), a bankruptcy court held that an unsecured creditors' committee also lacks standing to assert fiduciary duty claims derivatively.
  - Note that some Delaware bankruptcy courts have authorized a chapter 11 or chapter 7 trustee of an LLC debtor (standing in the shoes of the debtor/company) to pursue fiduciary duty claims.

Strategies to Minimize Risk of Director Liability

- Key steps to avoiding director liability in decision making:
  - Avoid interested director transaction issues and the application of the entire fairness standard
    - Form a subcommittee of independent directors to review and approve transactions or restructuring alternatives where there is a potential conflict of interest between equity holders and creditors;
  - Analyze the company's financial condition before and after the proposed transaction or restructuring;
  - Retain restructuring advisors and counsel to analyze proposed transactions and associated risks;
  - Document any decisions made, including any supporting advice; and
  - Take actions designed to maximize value of enterprise, rather than the interests of a particular stakeholder.
- Directors should evaluate and consider a distressed company's alternatives with the following questions in mind:
  - "Assuming the company is now insolvent, what is the best course of action that will maximize value?"
  - "Given our relationship with our equity investors and lenders, would our decision making process be subject to challenge?"
- Caution: A "home run" strategy that would benefit stockholders if successful but which imposes significant risk of loss to other stakeholders if not successful, is an action that requires careful scrutiny.

Fiduciary Duties: The Corporate Opportunity Doctrine

- Corporate Opportunity Doctrine: Directors and officers, as insiders, cannot use their strategic position for their own or their affiliate's advantage to the exclusion or detriment of the corporation they represent.
  - Arises from duty of loyalty.
- Delaware courts have held that the rule is also applicable in determining whether a parent company/controlling shareholder has preempted an opportunity that rightfully belongs to the corporation.
  - A "corporate opportunity" exists when a proposed activity, in which the corporation has the ability to engage, is related to the corporation's present or prospective business.
  - Could apply to corporate opportunities presented to insolvent subsidiary but utilized by parent entity.
  - But, note Alternative Entity Considerations above – i.e., may be reduced or eliminated if provided for in LLC/LP agreements.
- The determination of whether a controlling shareholder or corporate fiduciary has usurped a corporate opportunity that rightfully belongs to the corporation is a fact-intensive inquiry that turns on a number of elements:

Fiduciary Duties: The Corporate Opportunity Doctrine (Cont'd)

   - (1) Whether the corporation is financially able to undertake the opportunity
   - (2) Whether the opportunity is in the corporation's line of business
   - (3) Whether the corporation has an interest or reasonable expectancy in the opportunity
   - (4) Whether in taking advantage of the opportunity, the self-interest of the corporate fiduciary will come into conflict with the interests of the corporation

- Avoid corporate opportunity liability:
   - Waivers
      - In Delaware, a corporation can renounce its interest in certain types of corporate opportunities by providing so in its certificate of incorporation, or through action of its board of directors (*see* section 122(17) of the Delaware General Corporation Law).
      - Joint-venture members can also waive their expectations to corporate opportunities in the joint-venture agreement.
      - Alternative entity documents (limited partnership agreements/limited liability company agreements) can waive obligations altogether.
   - Disclose opportunity to corporation where necessary.
   - Establish record in support of corporation's decision to decline opportunity.
   - Conflicted directors should abstain.

Fiduciary Duties: Special Fiduciary Duty Issues for Parent Company Directors Who Also Serve On Insolvent Subsidiary Board

- Parent company directors also serving as directors of insolvent subsidiary companies have two sets of constituents to which fiduciary duties are owed:
  - (1) Fiduciary duties that the representative owes to the parent.
  - (2) Fiduciary duties owed to the subsidiary company (and derivatively its creditors).
- To avoid conflicts of interest, a directors should be mindful of blurring the line between these two sets of potentially diverging obligations.
- The general rule is that directors appointed by a shareholder may freely share information received as a director with the shareholder appointee. This, however, assumes an alignment of interests between the company and shareholder.
  - If the shareholder has divergent interests, or where the shareholder will use the information to the detriment of the company and other stakeholders, a director's disclosure of information to a shareholder may be a breach of fiduciary duty.
- If a shareholder-appointed director seeks to resign because the shareholder investment is deemed valueless or otherwise, that director must consider his/her fiduciary duties.
  - Directors are generally free to resign from a board. But where there are known legal or ethical violations by the company or insiders, the duty of loyalty may prevent resignation.

Fiduciary Duties: Takeaways for Directors

- Parent director-appointees must know and fulfill their duties.
- Directors should have protections provided by the company (*e.g.*, indemnification provisions in operating documents, individual indemnification agreements, exculpatory clause, D&O insurance policy including side A coverage, definition of loss, and tail policies).
- Draft LLC and LP agreements to maximize fiduciary duty waivers.
- Include waiver of corporate opportunities in certificate of incorporation.
    - Establish record in support of corporation's decision to decline specific opportunities.
- Ensure key negative controls are structured as a right of the equity holder of the portfolio company.
- Abstain from certain votes—if possible, an independent special committee should evaluate and approve potentially interested/conflicted transactions.
- Consider retention plans for key executives and employees.

Fiduciary Duties: In-House Duties of Disclosure

- Constituents’ Violations of Duties/Laws
  - A potential conflict of interest arises between an attorney’s organizational client and its officers or directors where the agent intends to act in violation of applicable law or regulation.
  - CRPC Rule 1.13(b) provides that if attorney believes agent of entity is acting in a manner that is (i) a violation of a legal obligation to the organization or a violation of law imputable to the organization and (ii) likely to result in substantial injury to the organization, the attorney shall take such actions that he or she believes to be in the best lawful interest of the entity.
    - Unless the lawyer reasonably believes that it is not necessary in the best lawful interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances, to the highest authority that can act on behalf of the organization as determined by applicable law.
  - If, despite the lawyer’s actions, the highest authority that can act on behalf of the organization insists on action that is a violation of law and the act is likely to result in substantial injury to the entity, the lawyer’s response is limited to resigning as the entity’s lawyer. Rule 1.13(c) expressly prohibits the lawyer from violating his or her duty to protect all confidential information.
  - The ABA Model Rules, however, do allow the attorney to reveal confidential information if the attorney’s efforts are to prevent harmful action.

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Rights When a Customer or Counterparty Files for Chapter 11

Executory Contracts and Unexpired Leases

- If a key customer or contract counterparty is in financial distress, a company should assess how its rights under any applicable contract or lease may be impacted by a potential bankruptcy filing.
- Section 365 of the Bankruptcy Code provides the debtor the power to determine which executory contracts and unexpired leases are beneficial to the debtor (and should be assumed), which are marketable (and should be assigned), and which are burdensome to the estate (and should be rejected).
- Until the debtor decides to assume or reject a contract or lease, the nondebtor counterparty is typically required to continue performing under the agreement and the debtor party is required to pay the reasonable value of goods and services received (though debtor may be able to defer payment).
    - If there is an executory contract or lease in place, failure to pay prepetition arrearages is not a valid ground to withhold performance.
    - For real property leases only, the debtor/tenant is required to pay post-petition payments on time at the contract rate (though the debtor can request that required payments in the first 60 days be delayed for "cause").

Executory Contracts and Unexpired Leases: Assumption and Rejection

- **<u>Assumption</u>**:
  - The decision by a debtor in possession or trustee to assume or reject an executory contract or unexpired lease is governed by the "business judgment rule"
  - Following assumption, the contract or lease becomes an administrative obligation that can be enforced against the bankruptcy estate
  - A contract or lease may be assumed only if the debtor in possession or trustee:
    - (1) cures outstanding defaults,
    - (2) compensates for actual monetary loss, and
    - (3) provides adequate assurance of future performance

Executory Contracts and Unexpired Leases: Assumption and Rejection (cont'd)

- **Rejection**:
  - Rejection of an executory contract or unexpired lease constitutes a breach by the debtor (relieving it of performance) and entitles the non-debtor counterparty to file a claim for damages resulting from such breach
  - Upon rejection of a non-residential lease where the debtor is the lessor, the counterparty may stay in possession but the debtor need not perform
- For real property leases where the debtor is the tenant, the decision to assume or reject must be made in the first 120 days of the case (though deadline can be extended up to 90 days without consent of landlord for "cause").

Executory Contracts and Unexpired Leases: Counterparties' Rights

- Before a contract can be assumed or assigned, the debtor must "cure" all existing defaults.
- No right to terminate contract absent an order of Bankruptcy Court granting relief from automatic stay.
- Non-debtor party may seek an order compelling assumption or rejection by a certain date, although this relief is frequently denied.
- Agreement that has effectively terminated prior to bankruptcy cannot be revived.
- Bankruptcy "ipso facto" termination clauses are generally unenforceable.
- Not only is right to terminate unenforceable in bankruptcy, no right or obligation may be modified by reason of bankruptcy filing or insolvency or financial condition of debtor.
- Pending the debtors' decision to assume, assign, or reject an executory contract, the debtor is generally required to perform under the contract or lease.
  - In the absence of performance by the debtor, the counterparty may be entitled to an administrative expense claim for all unperformed postpetition obligations, which have to be paid in full as part of a chapter 11 plan.

Executory Contracts and Unexpired Leases: Counterparties' Rights (cont'd)

- Following rejection, the counterparty has the right to file a proof of claim for rejection damages.
- A contract must generally be assumed, assigned, or rejected in whole, and courts generally do not have discretion to alter or modify a contract.
  - However, a debtor may attempt to "cherry pick" portions of a contract or lease if it is divisible/severable. This is a fact intensive inquiry, generally focused on the following:
    - Whether the contract expressly states the intent of the parties
    - Whether there are cross-default provisions
    - Whether some terms or provisions can be separately terminated
    - Whether terms or provisions have similar contract or lease terms
    - Whether there is a contractual severability provision
    - Allocation of fees/rent
    - Conduct of the parties

Executory Contracts and Unexpired Leases: 365(n) Rights

- Intellectual property license agreements are considered executory contracts.
- Bankruptcy Code section 365(n) provides that if a debtor is a licensor of "intellectual property" and rejects a license of "intellectual property," the licensee may elect to retain its rights under the license agreement immediately prior to the bankruptcy.
    - The licensee must continue to pay royalties under the prepetition agreement.
    - "Intellectual property" is defined to exclude trademarks, but the Supreme Court, in *Mission Product Holdings, Inc. v. Tempnology, LLC*, 139 S. Ct. 1652 (2019), held that a trademark licensee retained its rights after rejection of the license agreement by the debtor/licensor.

Preserving/Enforcing Claims: Filing a Proof of Claim

- In order to preserve the right to receive a distribution from a bankruptcy estate, a creditor must either (a) have its claim identified in the debtor's Schedules of Assets and Liabilities as non-contingent, liquidated, and undisputed, or (b) timely file a proof of claim in the bankruptcy case.
- Because a debtor is generally free to amend its Schedules, it is best practice to file a proof of claim by the "bar date" set by the bankruptcy court.
- <u>However</u>, by filing a proof of claim, the creditor is submitting to the equitable jurisdiction of the bankruptcy court, and waiving any jury trial rights with respect to <u>both</u> claims against the debtor, and claims by the debtor's estate against the creditor.
  - If there are any actual or potential claims that the debtor's estate may assert against a creditor, that creditor should carefully analyze with counsel whether filing a proof of claim is the best approach.
- While amounts owed prepetition are general unsecured claims, if a debtor fails to perform postpetition, the creditor may have an administrative expense claim that must be paid in connection with confirmation of any chapter 11 plan, and ahead of general unsecured claims.
  - The chapter 11 plan generally provides for a timeline and procedure for filing administrative expense claims.

Preserving/Enforcing Claims: Critical Vendors

- If important vendors refuse to continue shipping unless the debtor pays the pre-filing amounts, debtor may seek limited relief from court to pay pre-filing obligations owed to suppliers that are essential to its reorganization effort.
  - Debtor makes the decision, subject to court approval and right of creditors to object
- Court will often grant "first day" relief permitting payments of pre-petition amounts owed to a "critical vendor" in exchange for the vendor's agreement to continue supplying the debtor with goods or services post-bankruptcy.
  - Usually includes other terms such as credit terms or pricing
  - Vendor must truly be critical and not readily replaceable
- Classification as "critical vendor" is a good result from the vendor's perspective, particularly when the alternative is recovering pennies on the dollar for that pre-filing claim.
- If vendor is contractually obligated to deliver, debtor can require performance under contract and supplier may not be approved as critical vendor status; at minimum, significant concessions may be required of such counterparty.

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Understanding Preference Risk

Preferences: Overview

- When a debtor files for bankruptcy, payments made to non-insiders within 90 days, and to insiders within 1 year, prior to the petition date are subject to potential claw-back as potential transfers.
- Preference law is intended to assure equal treatment among similarly situated creditors whose claims existed around the time of the bankruptcy filing.
- Unlike fraudulent transfer claims, to successfully assert a preference claim, a trustee or debtor does <u>not</u> have to make any showing of fraud or lack of reasonably equivalent value for the transfer.
- When a counterparty is in financial distress, companies should consider preference risk in negotiating payment terms.

Preferences: Elements

- Transfer of an interest of the debtor in property:
  - Made to or for the **benefit of a creditor** [§ 547(b)(1)]
  - Made on account of an **antecedent debt** [§ 547(b)(2)]
  - Made while the debtor was **insolvent** [§ 547(b)(3)]
  - Made **within 90 days** before the filing of the bankruptcy petition (or within 1 year, if made to an insider) [§ 547(b)(4)]
  - That enabled the creditor to **receive more than it would have received in a chapter 7 liquidation** [§ 547(b)(5)]

Preferences: Transfer of Debtor’s Interest in Property

- “Transfer” includes:
  - creation of a lien;
  - retention of title as a security interest;
  - foreclosure of a debtor’s equity of redemption; or
  - each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with (i) property or (ii) an interest in property. [§ 101(54)].

Preferences: Insolvency

- Insolvency is defined as when the sum of a debtor's debts exceeds the fair value of its property, subject to exclusions. [§ 101(32)]
- Debtor is presumed to be insolvent in the 90 days before bankruptcy. [§ 547(f)]
- Presumption period does not extend beyond 90 when the look-back period extends to one year for transfers to an insider.
- If defendant rebuts the presumption of insolvency, plaintiff has the burden of proving insolvency at the time of the challenged transfer.

Preferences: Defenses

- **"Contemporaneous Exchange" of New Value** [§ 547(c)(1)]
  - Transfer was intended by debtor and creditor to be a contemporaneous exchange for new value given to the debtor.
  - Exchange was "substantially" contemporaneous.
- **Subsequent New Value** [§ 547(c)(4)]
  - Creditor gave new value to or for the benefit of the debtor.
  - New value not secured by an otherwise unavoidable security interest
  - Amount of "new value" can be used to offset the amount of the prior preference payment.
- "**New value**" means money or money's worth in goods, services, or new credit, or release by of property previously transferred. [§ 547(a)(2)]

Preferences: Defenses

- **Ordinary Course of Business** [§ 547(c)(2)]
  - Transfer was made in the ordinary course of business or financial affairs of the debtor and creditor; or
  - Transfer was made according to ordinary business terms.
- Ordinary course of business dealings: Court looks at "course of dealing" (actual pattern and practice in paying).
  - Past practices vs. any changes: Change in size of payments (sudden increase), change in payment methods (*e.g.*, wire transfer vs. prior payments by check), collection activity or threats of legal action.
- Ordinary business terms: Based on practices in industry or similar businesses.

Preferences: Defenses

- **Purchase Money Security Interest Perfected Within 30 Days** [§ 547(c)(3)]
  - Security interest secured new value that was:
    - given at or after the signing of a security agreement that contains a description of such property as collateral;
    - given by or on behalf of the secured party under such agreement;
    - given to enable debtor to acquire the property; and
    - used to acquire the property.
  - Security interest perfected within 30 days of debtor's receipt of the property.

Preferences: Defenses

- **Floating Liens** [§ 547(c)(5)]
  - Transfer creates a perfected security interest in inventory or a receivable or the proceeds of either.
  - Defense unavailable to the extent that transfer reduces any deficiency in the value of the collateral.
- **Statutory Liens** [§ 547(c)(6)]
  - Government tax liens
  - Possessory liens
  - Liens for wages, where granted by statute

Preferences: Takeaway Considerations

- Accepting a preferential transfer is not wrongful, it is only subject to potential clawback.
- Even if a transfer is potentially a preference, the general rule is that it is better to have cash in hand.
- Potential preference risk should be considered in entering into any settlement or workout of an existing relationship.
    - Consider delaying granting of releases or effect of material concessions until the 90-day window has passed on any actual payments.
- Preferences do not only apply to transfers. If a lender perfects its lien within the preference window, it may be avoidable as a fraudulent transfer.

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Navigating the Automatic Stay

Automatic Stay: Overview

- Once a bankruptcy case is commenced, all litigation and creditor enforcement actions against the entities that file come to a halt, including:
  - Acts to control property of the estate or recover property from the estate – this includes sweeping cash collateral
  - Any effort to collect, assess, or recover claims
  - Starting or continuing lawsuits
  - Creating, perfecting, or enforcing liens
  - Exercising setoffs (with exceptions)
- As a general rule, once a bankruptcy is commenced, any actions to collect on prepetition debts, including sending notices for past-due invoices, is a violation of the automatic stay.

Automatic Stay: Limitations on Automatic Stay

- Automatic stay is generally limited to debtors and does not protect third parties.
  - Section 362(a) stays only litigation against the debtor(s).
- With very few exceptions, stay does not bar continuation of litigation against co-defendants, including officers, directors, or affiliates.
  - *See In re Caesars Entm't Operating Co., Inc.,* 808 F.3d 1186, 1188-89 (7th Cir. 2015) (court should consider whether extending the stay would "enhance the prospects for a successful resolution of the disputes attending its bankruptcy" and whether denial would "endanger the success of the bankruptcy proceedings").
- Existence of indemnification claims by third-party defendants against the debtor probably does not bar continued prosecution against non-debtor defendants, but does bar pursuit of indemnification claims against the debtor and may justify debtor seeking an injunction against continuing litigation against individual officers or directors at least temporarily.

Automatic Stay: Limitations on Automatic Stay (cont'd)

- State and district courts may stay entire proceedings if some but not all defendants file for bankruptcy, at least pending further developments in the bankruptcy case.
- Exceptions to the automatic stay include:
  - Police and regulatory matters
    - This may include False Claims Act litigation where government has either intervened or not decided whether to intervene.
  - Third-party discovery against a debtor
- A debtor may continue litigation as plaintiff, notwithstanding the automatic stay.
- The automatic stay does not stay appeals if the underlying action was commenced by the debtor.

Automatic Stay: Relief from the Stay

- Creditor can seek relief from stay for “cause”.
  - Cause includes lack of “adequate protection”
    - Adequate protection, in effect, means that secured lender’s position does not deteriorate during case.
    - Oversecured creditor may be protected by equity cushion.
    - Often, periodic cash payments are required to satisfy adequate protection, but adequate protection does not guarantee current payment of interest—should be limited to decline in value of collateral (if any).
- Stay can be terminated if the collateral is not necessary to an effective reorganization AND the debtor has no equity in the collateral.
  - Absence of equity alone is not grounds to terminate the stay if the collateral is necessary to the debtor’s reorganization
  - If the debtor does not have a reasonable chance of successfully reorganizing in a reasonable period of time, the collateral is not “necessary to an effective reorganization”