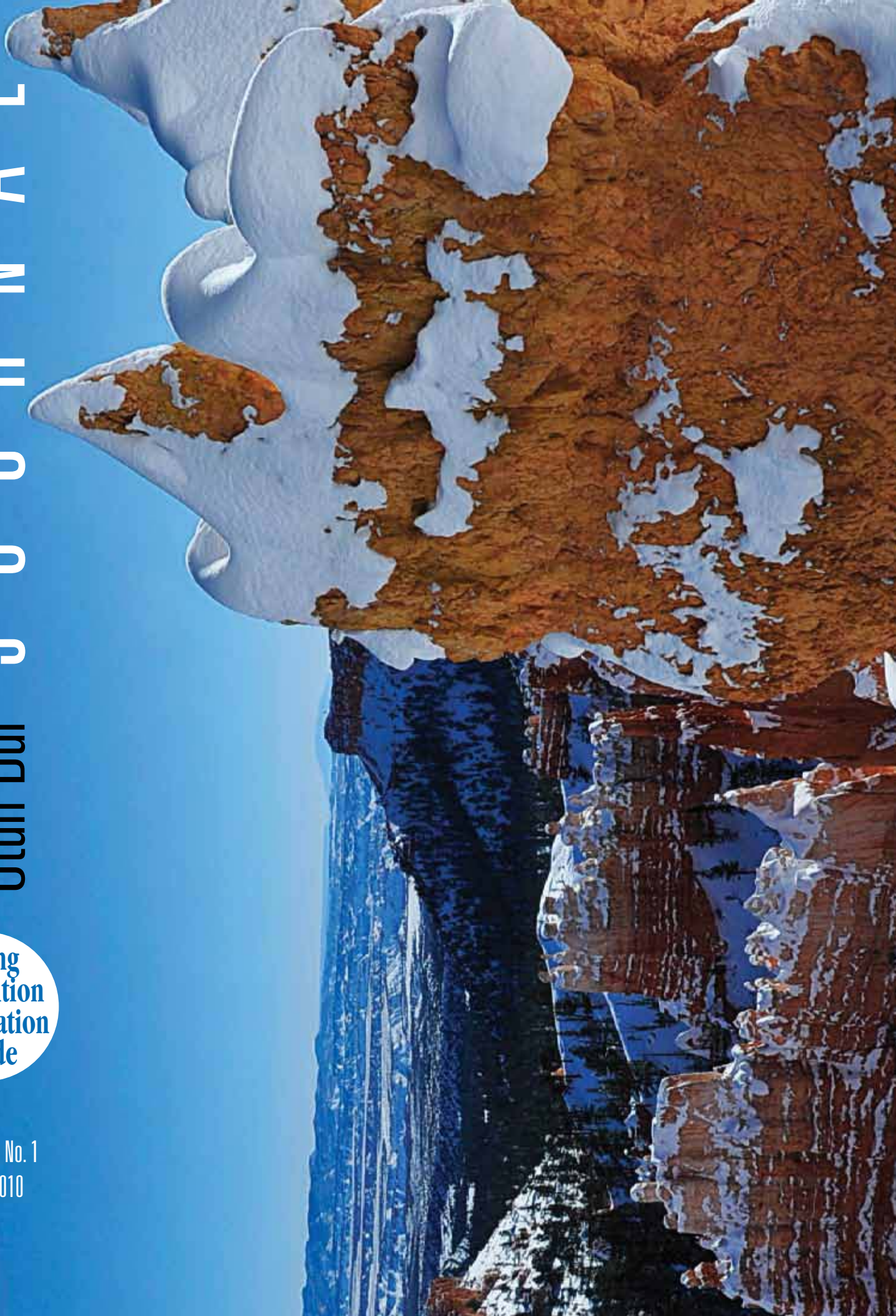


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The Not-So-Secret Crucible of Bankruptcy

by J. Robert Nelson

Judging by the popularity of some recent novels, there seems to be a deep-rooted fascination with the mysterious world of codes, secret symbols, and rituals. For some, my topic is equally arcane – the implications of a bankruptcy filing for the dealings, transfers, and transactions that precede it.

Many years ago, I attended a series of lectures delivered by George Treister, a nationally-recognized authority on bankruptcy law. Treister began the first lecture by noting that bankruptcy was more important than any of us novices realized. He went on to argue that it was a veritable crucible in which the adequacy of pre-bankruptcy transactions received their ultimate testing. At the time, my experience was so limited that I did not fully appreciate his point. Since that lecture, I have had ample opportunity to work with financially distressed businesses and individuals. One of my early involvements was with Global Marine Drilling, a Houston-based company with oil and gas drilling operations in the Gulf of Mexico, the North Sea, and Indonesia. My clients, a syndicate of national banks that had financed acquisition of deep water drilling rigs, found themselves in the proverbial cross hairs as the debtors, other creditors, and creditors committees scrutinized the loan and security documents hoping to expose flaws in the banks' liens on rigs, which constituted the debtor's most valuable assets. The loan had been negotiated and documented by a transactional lawyer at my firm, and she spent sleepless nights worrying that some minor mistake would prove fatal to the banks' position. Ultimately, the liens stood up to examination, and the banks' secured position gave them substantial leverage when the debtor eventually formulated its plan of reorganization.

Global Marine Drilling was an early exposure to the bankruptcy crucible. Since then, I have witnessed many other examples of how bankruptcy opened the door to investigation of pre-filing mistakes, how it permitted changes in operating control of troubled companies, how it could be used to invalidate pre-bankruptcy transfers, terminate pre-bankruptcy contracts and leases, and even modify fundamental terms of loan agreements.

For “outsiders,” there is an element of the surreal in the bankruptcy system. Indeed, in a domain governed by its own statutes and rules, its own court system, and an unfamiliar vocabulary, legal experience in other areas, intuition, and common sense are not always reliable guides for the uninitiated. I began to appreciate this the first time I tried to explain to a client why he had to return

a pre-bankruptcy debt payment even though he still was owed money, or to another client why, just because a Ponzi scheme was involved, he might have to surrender a payment that was only what he had been promised. Bankruptcy has a number of “unusual” provisions that can have broad ramifications for pre-bankruptcy dealings and transactions. I will touch upon some of the more significant ones and conclude with a few practical implications of the bankruptcy crucible.

The Automatic Stay

Bankruptcy is synonymous with delay. When a case is filed, all of those carefully drafted contractual default and remedy provisions bump up against the Bankruptcy Code (all statutory references are to title 11 U.S.C. known as the Bankruptcy Code). Section 362 automatically stays all actions against or related to property of the bankruptcy estate. Continuation of suits, enforcement of liens, and termination of contracts and leases all come within the ambit of the statutory stay. Generally, the stay continues for the duration of the case. The bankruptcy court can lift the stay if a non-debtor party establishes that relief is justified because (1) a debtor has no equity and does not require an asset to reorganize effectively or (2) for cause, including the debtor's failure to adequately protect the interest of the non-debtor in estate assets.

Avoidance of Transfers

The ongoing saga of Bernie Madoff is a reminder that pre-petition transfers can be targeted using the so-called avoiding powers under the Bankruptcy Code. The bankruptcy system is based on, among other things, the principle of equality of distribution so that creditors of the same class receive generally equivalent treatment. The Bankruptcy Code includes a number of provisions specifically aimed at avoiding and recapturing pre-bankruptcy transfers that in effect favor one creditor over the general creditor body. Section 544, the so-called strong arm section, gives a bankruptcy trustee (or debtor-in-possession) the status of a hypothetical lien creditor.

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This permits a trustee to avoid liens and other interests that have not been properly perfected before a bankruptcy filing. Another provision, section 547, is directed at preferential transfers. That section permits a trustee to recover debt payments made during the ninety days before bankruptcy (one year in the case of transfers to insiders). It applies even if (a) the payments were on valid obligations of the debtor and (b) the creditor receiving the payment continued to have a claim even after the preference. Section 548 permits avoidance of fraudulent transfers. Generally, it mirrors state fraudulent transfer laws that are also applicable in bankruptcy under the “strong arm” section. Under section 548, a trustee may challenge transfers intended to hinder, delay, or defraud creditors. That language has been interpreted to include payments made in connection with Ponzi schemes. The section also covers transfers made by an insolvent debtor for less than reasonably equivalent value. In that regard, section 548 has been used to challenge pre-bankruptcy asset sales deemed to have been for an inadequate price.

Rejection of Contracts and Leases

Bankruptcy contradicts the adage that “a deal is a deal.” One of the more important bankruptcy powers is the ability to break contracts. In recent years, numerous well-publicized cases of airlines, large retailers, and even automotive manufacturers, have been filed to deal with “burdensome” real estate and personal property leases, employment agreements, dealership agreements, and benefit packages. In bankruptcy, contract and lease rejection turns on reasonable exercise of business judgment. Courts have shown a definite inclination to sustain a debtor’s exercise of judgment when rejection is deemed crucial to the outcome of a reorganization. Although damage claims arise from lease and contract rejection, that is often of hollow comfort to the non-debtor party both because of statutory caps on some claims (one year’s rent under real estate leases) and because reorganization plans often pay such claims at substantial discount.

Under section 365, a debtor may also assume a lease or contract if the debtor cures any monetary defaults and agrees to perform according to contractual terms. If there is equity in a lease (a rarity in these difficult times), some debtors will assume a lease and then assign it to a third party.

Modification of Loan Agreements

Most bankruptcies have their roots in a debtor’s inability to pay debt, particularly secured debt, according to terms. Bankruptcy not only offers a reprieve from enforcement by imposition of an automatic stay, it also permits modification of fundamental loan terms including the debt amount, interest rate, and repayment term. Many times the changes are a matter of post-filing negotiation and agreement between debtor and lender. In some cases, the changes

are imposed by “cramdown” under section 1129(b)(2)(A).

The bankruptcy power to bind dissenters also applies to unsecured debt. Under section 1126(c), if a majority in number and two-thirds in amount of claims of an unsecured creditor class vote to accept a treatment, those in the class who vote against the plan are bound.

Discovery of Pre-Bankruptcy Misconduct

A hallmark of bankruptcy is transparency. A debtor’s actions, both before and during a case, are scrutinized by a combination of lenders, bondholders, committees, the United States Trustee, and a cadre of lawyers. In bankruptcy, the free flow of information is assured by the requirement of detailed bankruptcy schedules and statements, detailed operating reports, liberal discovery rules, and court-supervised status conferences. In this environment, any pre-bankruptcy misdeeds, let alone post-filing improprieties, cannot be concealed for long.

Management’s Loss of Control

Chapter 11 and other reorganization chapters of the Bankruptcy Code presume management’s retention of control of a business as a debtor-in-possession. Nonetheless, debtors can lose control of their reorganizations in a number of ways. Pre-bankruptcy misconduct (such as improper transfers in a Ponzi scheme) can lead either to conversion of a case to a chapter 7 liquidation under section 1112(b) or to appointment of a trustee under section 1104. In addition, timing is crucial in bankruptcy cases. The failure to heed statutory deadlines can result in stay relief under section 362(d), forfeiture of real estate leases under section 365, and even loss of a debtor’s exclusive right to propose and confirm a reorganization plan under section 1121(b).

Because bankruptcy can have such significant impact on pre-filing activities, I will conclude with several practical implications. Whatever the transaction, simple prudence dictates that careful attorneys always consider financial circumstances and the potential for bankruptcy. There are times that the financial risk is so pronounced that it alone may be a deterrent to an intended transaction. Even if the risk is considered manageable, a few precautions may still be worthwhile. For example:

- Management, aware of their fiduciary duty to protect assets, may wish to reconsider transfers to insiders or distressed sales of assets at bargain prices;
- Because of the fraudulent transfer risk, prospective purchasers of assets of a distressed business may press for a bankruptcy filing so that a transaction can be pursued under supervision of the bankruptcy court;
- Suppliers, mindful of the preference risk associated with deferred

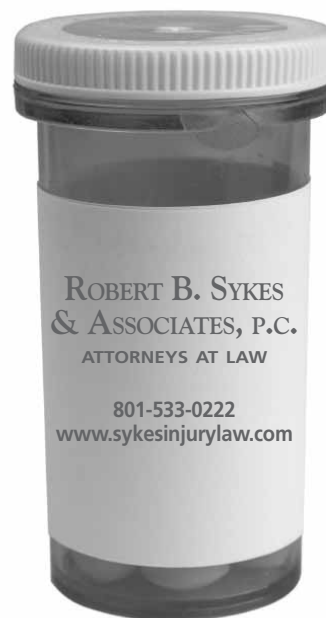
payments, may condition deliveries upon COD terms or require timely payment for all new product. Then again, the mere risk of a future avoidance action usually would not warrant rejecting a preferential payment. Even if a bankruptcy should follow, statutory and factual defenses leave substantial latitude for a recipient to negotiate a less-than-full return of a pre-bankruptcy transfer;

- With insolvent clients, lawyers and other professionals usually should request and work against retainers to minimize the preference risk; and
- After assessing the risk, lessors and parties to contracts may conclude that they are better off postponing transactions until they can be approved by a bankruptcy court.

The preceding list makes no mention of lenders. As a group, lenders tend to be the most sensitive to the delays, added costs, and other potential downsides of a borrower's bankruptcy. Because of that, even if the possibility of bankruptcy is remote, lenders will include loan provisions geared both to complicate a voluntary bankruptcy filing and to expedite loan enforcement if one does ensue. Of course, contractual proscriptions on the filing of a bankruptcy are contrary to public policy and unenforceable as a matter of law. However, some lenders require their borrowers to include in corporate charters provisions that condition bankruptcy filing on unanimous board approval. In such cases, the lenders require the inclusion of independent board members who may be more favorably disposed to the lender. Because of the duty owed by directors of a distressed company to creditors, however, this device ultimately may not stymie a bankruptcy filing.

Lenders commonly include other loan provisions aimed at "bankruptcy proofing" a transaction. For example, real estate lenders make their loans to entities whose sole function is to hold legal title to the real estate collateral, with all project-related costs born by a separate development entity. That structure is driven by the view that without debt (other than to the lender) an entity should not qualify for bankruptcy relief because of a dearth of debt to reorganize. Other lenders include loan provisions intended to expedite relief from the section 362 stay. Secured lenders, as previously noted, are entitled to adequate protection of their lien interests during a bankruptcy. A debtor's failure to provide adequate protection is a ground for lifting the stay. Recognizing this, some loan documents contractually define the protection to which a lender would be entitled in the event of bankruptcy, and couple this with an agreement that, failing such protection, the court should lift the stay. Provisions of this type may at least be probative in a court's ruling on a stay relief motion. Such provisions may at least be probative in a court's determination of a motion for stay relief under section 362.

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