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Recent developments in Bankruptcy

NOTE: THE FOLLOWING ARTICLE IS FOR INFORMATIONAL PURPOSES ONLY AND IS NOT INTENDED TO CONVEY LEGAL ADVICE. YOU SHOULD ALWAYS CONSULT YOUR LEGAL COUNSEL WITH RESPECT TO YOUR PARTICULAR SITUATION.

A number of prominent manufacturing companies have recently filed for bankruptcy protection. If your company is a supplier to one of these companies, your company is affected. If so, it is important that you understand how the U.S. bankruptcy process works. Also, there are certain actions you may need to take to protect your company if you learn that one of your customers files bankruptcy.

This article will provide a brief summary about how the bankruptcy process starts and how it ends, and the meaning of certain words that you will hear in connection with corporate bankruptcies. Then it will offer a number of suggestions you should consider doing, after discussion with your legal counsel, if you find that one of your customers has filed for bankruptcy.

So let's start with an overview of the bankruptcy process and some definitions. We will be talking only about bankruptcies involving corporations, not individuals.

The bankruptcy process is designed to do two things, under the Court's supervision:

1. Allow a Debtor that is unable to pay its Creditors to develop a plan for the resolution of all debts through reorganization of its business, or
2. Supervise the closure of the Debtor's business and provide a fair distribution of the Debtor's assets to its Creditors.

A company that files bankruptcy is called the "Debtor," and it starts the process by filing a Bankruptcy Petition with the U.S. Bankruptcy Court. Companies that are owed money by a Debtor are called "Creditors."

All U.S. bankruptcy laws are contained in the United States Bankruptcy Code, which is divided into different sections or "Chapters." You are likely to hear about two basic types of proceedings: a "liquidation" and a "reorganization". A filing under Chapter 7 is called a "liquidation" and it results in the permanent closure of a business. Under Chapter 7, the Debtor's property is collected and sold in accordance with a certain procedure.

Creditors are assigned a priority in which they stand to receive a share of the proceeds of that sale. Creditors are generally separated into two groups: “Secured Creditors,” who hold a security interest or a mortgage on specific assets, or who have a lien against the Debtor’s assets, and “Unsecured Creditors,” who are owed money by the Debtor but who do not have a security interest in any specific Debtor assets. The proceeds of that sale are then distributed to the Creditors according to their priority. Secured Creditors have a higher priority than Unsecured Creditors.

A “reorganization” is a bankruptcy proceeding under Chapter 11. The purpose of a Chapter 11 proceeding is to allow the Debtor to restructure its debt while remaining in business. It generally allows for a partial discharge of the Debtor’s debt in exchange for the continued operation of the business under a reorganized structure that is supervised by a Court-appointed trustee. The Debtor in a Chapter 11 case uses future earnings to pay off the balance of its former debt to its Creditors.

At the end of the bankruptcy case, the Debtor receives a “discharge” of all claims that existed against it at the time the bankruptcy proceeding was commenced. Creditors are permanently barred from attempting to enforce their claims after the discharge and the Debtor is given a “fresh start.”

The following are a few of the key terms and steps in the bankruptcy process:

Automatic Stay. As a general rule, once a bankruptcy proceeding has been commenced, a Creditor is prohibited from undertaking any further enforcement actions or collection efforts outside the bankruptcy proceeding. The automatic stay is extremely broad and generally applies to all forms of collection efforts, which means Creditors must stop all lawsuits and cannot make any type of demand for payment on the Debtor (either orally or in writing).

Estate Maximization. Once a bankruptcy petition is filed, the Court’s focus is on maximizing the amount of money and assets that make up the Debtor’s Estate. Debtors are not allowed to transfer assets out of the Debtor’s Estate and Creditors cannot remove assets from the Debtor’s Estate without Court approval.

Once the bankruptcy proceeding has started, all Creditors have a specified period of time to file their claims against the Debtor with the Bankruptcy Court. The Bankruptcy Code establishes the order in which claims are paid from the Debtor Estate. All claims in a higher priority must be paid in full before claims with a lower priority receive anything. All claims with the same priority share equally. Claims are paid in this order: 1) costs of administration (i.e. attorney’s fees, court-appointed trustee compensation, etc.), 2) unsecured post-petition claims in an involuntary case only, 3) wage claims of employees and independent salespersons up to \$4300 per claim, 4) contributions to employee benefit plans up to \$4300 per employee, 5) certain taxes, 6) secured claims, and finally, 7) all general unsecured claims.

Determination of Preferential Payments. The bankruptcy process is intended to result in the fair and equitable treatment of all of the Creditors and to avoid having one Creditor receive preferential treatment at the expense of a different Creditor. It is human nature for a Debtor who knows that he is about to enter bankruptcy to arrange payments from its remaining assets to the Creditors that the Debtor favors most. The bankruptcy code therefore allows the Debtor (or its Trustee) to demand the return or repayment of “Preferential Payments,” which are generally

defined as all payments made by the Debtor to pay off pre-existing debt within ninety days before the date of the bankruptcy filing. Such Preferential Payments must be paid back and become part of the Debtor's estate.

You can imagine that a demand to repay a Preference can be a very unwelcome event for a Creditor, particularly when a customer pays off a large account payable and then files bankruptcy. There are certain defenses that allow a Creditor to defeat the preference claim and keep the payment. For example, a payment that was actually for new value or made in the ordinary course of business and not for payment of a pre-existing debt may not be a Preference. The October 2005 amendments to the Bankruptcy Code improved the ability of Creditors to show that payments were made in the ordinary course of business, which should improve things for trade Creditors who continue to extend credit to financially-troubled customers. The Bankruptcy Code also contains certain standard exceptions to the definition of preferential payments and there is now a threshold of \$5,000 before a payment can be considered a preference.

Classification of Debt. All of the debts of the Debtor are divided into two categories. Debts incurred before the bankruptcy petition was filed are called "Pre-petition Debt," and it is usually either repaid or discharged as part of the overall reorganization. Sometimes Unsecured Creditors receive only pennies for each dollar of Pre-petition Debt. Debts incurred after the petition has been filed are called "Post-petition Debt," and the Debtor must generally pay Post-petition Debt fully and timely as a condition of the Debtor's continued protection from the Bankruptcy Court.

Assumption or Rejection of Executory Contracts. An important feature of Chapter 11 reorganization is that a Debtor is entitled to review all of its current contracts, keep the ones it likes and discard the rest. Debtors are said to have "assumed" the contracts they want to keep and "rejected" the contracts they do not want to keep. Naturally, the Debtor's analysis of these contracts will focus on which business is most profitable for the Debtor. In order for a Debtor to assume a contract, it must do or show three things:

(First) cure any existing defaults under that contract (or provide adequate assurance that it will cure in the future);

(Second) compensate or provide adequate assurance that the other party to that contract will be compensated for any actual economic loss resulting from such default; and

(Third) provide adequate assurance that the Debtor will be able to perform in the future under the contract.

Debtors are likely to assume those contracts that are profitable and that the Debtor can perform. Generally, debtors can reject unprofitable supply agreements or operating contracts (with vendors or customers) and real estate leases, unsecured loans, and union contracts, if canceling them would be financially favorable to the Debtor.

Reorganization Plan and Creditors Committee. All Debtors filing Chapter 11 cases are required to propose a Reorganization Plan. A committee is formed that is made up of the Debtor's Creditors in order to help review the Debtor's plan of reorganization. If the Debtor does not present a viable plan within 120 days, the Creditor's Committee can develop one of its own. Once a plan has been developed that the Debtor and a majority of the Creditors Committee members agree upon, the plan is submitted to the Bankruptcy Court for "confirmation" and a final order. Upon issuance of the Court's final order, the plan of reorganization is implemented

and any distribution of funds is made in accordance with the priority schedule specified in the Bankruptcy Code. Once the reorganization plan has been carried out, the Debtor company is said to have “emerged” from bankruptcy, which may take from a few months to several years, depending on the size and complexity of the bankruptcy. The recent amendment to the Bankruptcy Code has tried to put limits on the duration of a case, but reorganization can still represent a lengthy process.

Liquidation. If the Court does not approve a plan of reorganization, the Court may either convert the case to a liquidation under Chapter 7 or the Court may simply dismiss the case, which returns the Debtor to the same position that it was in prior to filing the bankruptcy petition (except without the Court’s protection against creditor collection actions). The recent amendment to the Bankruptcy Code changed the rules here a bit by limiting the judge’s discretion to postpone a conversion or dismissal.

Now, many of these things are happening at the same time. Let’s step back a minute and look at the typical process. The Debtor files a petition that either initiates liquidation or requests approval to reorganize. The court issues an order that prohibits Creditors from collecting their debts, while the court figures out who is owed what and what the Debtor actually owns. The court’s objective is to maximize the Debtor’s estate, and the court may require that recent payments made by the Debtor before filing be paid back into the Debtor’s estate. The Creditors’ claims are divided into groups according to the priority of their claims. In a liquidation, the Debtor’s assets are sold and the proceeds are divided up among the Creditors. In a reorganization, the Debtor and the Creditors work toward a plan under which the Debtor can pay some debts and avoid others, continue some contracts and reject others, and emerge from the bankruptcy as a going concern.

What to do if your Supplier files for bankruptcy

Keep in mind that the signs that your supplier is about to file for bankruptcy are generally more difficult to see in advance than a situation where your customer is about to file. You may not be aware of the fact that your supplier is in bankruptcy until you see it in the newspaper. The practical reality is that when faced with your supplier's bankruptcy, your rights and the obligations of your supplier change in a number of important respects. The following discussion relates to the sale of goods or the provision of services under a contract. Special rules apply to contracts involving the lease or sale of real estate.

Once in bankruptcy, your supplier will have the right to assume your contract if the supplier finds it to be beneficial, or to reject it if the supplier finds it to be burdensome. Whether or not the contract is profitable and the amount of profit that the supplier makes on the contract is the most important consideration. Your supplier will have this right because your contract will be “executory”, meaning there are material ongoing performance obligations under the contract as of the bankruptcy filing.

Under the U.S. Bankruptcy Code, if your supplier does not want to make a quick decision on assumption or rejection of the contract, it probably will be allowed to delay the decision until the end of the case, which can take anywhere from a few months to several years. During this time, you will be automatically prohibited from unilaterally terminating your contract or otherwise enforcing remedies under it.

You will have to continue obtaining the goods or services and paying the supplier under the terms of your contract. It is possible to ask the court to set a specific date by which the supplier must make the decision to assume or reject the contract, but there is no assurance that the court will grant such a request. Obtaining court approval allowing you to terminate requires that you convince the court that the supplier is currently not performing and is likely to be unable to do so in the future. Even when your contract gives you the right to terminate at any time and without cause, many courts still require prior court approval before you can exercise that right. In addition, you should be aware that even if you include a provision in your contract that gives you the right to terminate the contract if the supplier becomes insolvent or declares bankruptcy, such a provision is unenforceable under the U.S. Bankruptcy Code.

A supplier that wants to assume a contract must first cure all defaults and perform the contract on a going forward basis. If the supplier had been in default prior to bankruptcy, you can insist on receiving "adequate assurance" of the supplier's ability to perform. If the supplier breaches the contract after it is assumed, your claim against the supplier for your damages will have priority over pre-bankruptcy unsecured claims.

Your supplier will also have the right to "assume and assign" your contract to another supplier. This has happened in a number of bankruptcies in the telecommunications industry where the supplier sells its business as a going concern to an asset purchaser. Their purchase order from you can be assigned to this new supplier - even if the contract includes language that prohibits assignment - as long as the defaults are cured and the new supplier provides adequate assurance of its future performance.

Your supplier has the right, with the court's approval, to reject and terminate your contract if it determines that your contract is burdensome. This is most likely to arise where the supplier is required to make additional investments in order to continue performing, as compared with using its existing installed capacity representing sunk costs that cannot be avoided. Though rejection is treated as a contract breach, giving you a claim for damages, your claim will be unsecured and without priority, so any recovery you receive could be only a few cents on the dollar. The rejection can occur with relatively little notice - 20 days or less. You will have no legal certainty that you will have sufficient time to secure a replacement supplier. Also, if the supplier rejects, you will not be entitled to enforce your contractual right to transition services. As a consequence, it is not uncommon for debtor suppliers to use the threat of rejection as leverage to renegotiate a contract. Many times the debtor's financing source will condition their continued extension of credit to the debtor upon the debtor's using this tactic to renegotiate their contracts.

There may be self-help available to you if the supplier owes you money. While the automatic stay prohibits you from exercising your right of set-off (at least when the amounts are owed back and forth under separate contracts), you are entitled to put a temporary freeze on what you owe to the supplier to assure that you will receive full payment of amounts owed to you. You should investigate the existence of set-off rights immediately upon your supplier's bankruptcy, so that your rights of set-off can be preserved.

In the current economic environment, there are more financially challenged suppliers than in recent memory, including many of a scale not previously encountered. Understanding the risks you face with a supplier's bankruptcy and implementing the appropriate protective measures can make the difference between being in control of your sourcing options - and being a victim of them.

While it is impossible to avoid the limitations you will face once your supplier is in bankruptcy, there are some contractual protections you can employ to help limit your exposure to a supplier bankruptcy. They include the following:

- If possible, when negotiating major purchase agreements, obtain financial covenants and current financial information that will provide an early warning of deteriorating supplier financial health and permit you to act before a bankruptcy filing.
- Limit your exposure to the extent possible in the event the supplier defaults under its arrangements with subcontractors and other third parties. Pay particular attention to any notices of lien that you may receive from a supplier's subcontractors and take immediate steps with the supplier to have those liens discharged.
- Retain ownership and control of software, equipment, data, deliverables and work in progress, as well as the right to continue using supplier-owned items that are critical to your business.
- Include language in your contracts that prohibits the assignment of the contract or delegation of the supplier's responsibilities without your approval, so that you can assess the financial strength of prospective assignees. This may not prevent the contract from being assigned, but it does allow you the right to have the court listen to your arguments against assignment if the prospective assignee is a greater credit risk than the existing supplier was prior to bankruptcy.
- Make sure that your supplier has the corresponding protections with respect to its subcontractors.

In summary, here are some key lessons to keep in mind

- If your supplier declares bankruptcy, you lose the right to terminate the agreement unilaterally, which will interfere with your ability to find another supplier, and your supplier can terminate the agreement on little notice without providing you any termination assistance.
- Take precautions at the start of the relationship to limit your exposure. Then monitor the supplier's financial health to take action before the bankruptcy filing.
- For critical goods, always have a second source or a resourcing strategy that can be implemented quickly.