SAFELY NAVIGATING TROUBLED WATERS: RESTRUCTURING AND BANKRUPTCY

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I. The Market has Fallen—Tips for Survival

A. Conserve Cash. This is simple to say but hard to do. Reducing cash expenditures requires rethinking every aspect of business. In a down market, the goal is for the business to survive long enough to ride through the down cycle -- operating twice as long on half the cash. In the good old days you were not required to operate so efficiently, but now you must. Common expenses that can be cut:

1. Staff—Most businesses operate just as effectively, and perhaps more effectively, with far fewer people. Experts often reduce payrolls by about half within the first 60 days. Work toward a skeleton team. Take care to comply with WARN Act requirements, but eliminate dead weight.

2. Office space. Do you really need all that square footage? Couldn’t you really operate out of much smaller facilities? Renegotiate the lease. Sublease. Sell the building.

3. Outside services coming in—Instead of contracting out for service, can you perform work more cheaply in house with your existing staff?

4. Inside services going out—Would it be less expensive to hire an accounting firm than to maintain a staff of accountants?

5. Non-critical expense. That lawsuit that you once thought was essential may not be critical to everyday operations. Neither is marketing or advertising in a down market. Reduce or eliminate these expenses.

B. Protect Against Personal Liability. Desperation often leads to principals deciding to increase their own personal exposure rather than permit the business to fail. DON’T.

1. Pay the payroll taxes. This is a must. You are better missing the payroll than not paying the taxes. The payroll tax liability is often viewed by employers as the “bank of last resort.” The problem is that you can never, ever escape the resulting personal liability.

2. Do not guarantee trade debt. If the business cannot pay it, and suit is threatened, let them sue the business. Do not agree to sign personally. Collection lawsuits take time. Use the time. If you still cannot pay by the time they obtain judgment then the business was likely doomed anyway. Do not expose personal assets to business liabilities.
3. Carefully consider your existing liability to the bank or lender. If they are asking you to increase your exposure—what are you getting in return? This downturn is expected to last another 2 years—if the business cannot survive that long then a temporary extension won’t help.

4. Do not use your retirement assets to pay company debt. Your retirement assets have legal protection from creditors already. In the event you have to consider a personal bankruptcy filing, these assets are generally exempt and you would keep them. Do not use protected money to pay company debt.

5. Do not cross collateralize. If you have more than one business or entity with assets, your lender may ask you to “cross collateralize” or pledge assets from another entity to protect the loan. Remember, the assets were set up in separate entities for a reason—to protect them in the event one of the entities failed. Cross collateralizing destroys this protection.

C. Communicate with Your Lienholders—They will sometimes work with you. Today’s market is an interesting place. Most lenders are willing to work jointly with borrowers.

1. The Lenders really do not want to own your project or property. They would rather try to jointly market than foreclose.

2. Operating businesses are a unique problem. Almost always, the whole is worth more than the sum of the parts.

3. The issue is trust. Does your lender trust you? If yes, they will almost always work with you. If no, then they will ask you to turn over operations to a trustworthy operator.

II. Bankruptcy Opportunities. Asset Sales -- Look for the Bargains.

In Chapter 7 bankruptcy cases, an appointed trustee, who is not related to the company, sets about selling all of the assets that have any apparent equity. Even if the case is a Chapter 11 reorganization, the facts are that most businesses cannot successfully reorganize without selling assets. Most bankruptcy cases are simply a forum to sell assets.

A. Private Sales. Usually, these sales are conducted as auctions, but not always. If there is a particular asset or piece of equipment that you are interested in purchasing then do not hesitate to make an offer.
Even if the Trustee does not accept your first offer, a dialogue usually starts. “Haggling” is normal and bargains are the order of the day.

B. Bankruptcy Trustees. Most of them are actually quite helpful. You do not need a lawyer to do a simple asset purchase in most bankruptcy cases. Trustees are only interested in the best combination of price and terms. If you are aware of a bankruptcy case that has assets, and you are interested in buying, call the trustee directly. Always keep in mind that it is all about the money. If it is a significant asset, consider building into your offer a “break up fee” or cost reimbursement provision to cover your costs in case you are not the winning bidder. (No harm in asking.)

C. Show Up and Bring Your Money. If a sale is advertised as an auction, you should show up. Many times the sales are not well attended. Even if the sale is in the court—the judge will almost always ask if there are any other interested parties in the courtroom that want to bid. As a buyer, so long as you have authority to act for your company or enterprise, and the court is satisfied, you can bid without a lawyer. There may be time limits on closing the purchase, but the court or trustee will explain these and ask if you or your company agree to the deadlines.

D. WATCH THE PAPERS and trade publications in your area. Most sales of any size are advertised. The word “bankruptcy” is almost always prominent.

YOU CAN GET A LIST OF THE LOCAL TRUSTEES AND ASK TO BE PUT ON THEIR MAILING LISTS FOR ANY FUTURE SALES.

III. Restructuring Help – The Partially Complete Project.

Imagine that residential development was booming in your area. A developer has 40 acres planned. It is divided into roughly four equal phases. Roads and utilities are complete in Phases 1 and 2. Houses have been built and sold in Phase 1. Contracts and deposits have been accepted for Phase 2. Twenty houses are in various phases of construction. The market has changed. Funding stops. Work stops. Frustrated, the bank commences foreclosure. The developer, convinced that the project is worth far more than what is owed to the bank, files Chapter 11. The president of the developer has personally guaranteed the bank’s loan. The development sits abandoned. Half completed construction is exposed to the elements.

If the developer has no funding to finish, the Court will either permit the Bank to foreclose, or the Court will appoint a trustee to explore options to complete with the bank’s cooperation. Why would the bank agree to leave the development in Chapter 11?

Mid-completion construction and development projects have attracted a new kind of player in bankruptcy cases. The terms “white knight,” “restructuring officers and agents,” “turnaround management”, and similar phrases describe a variety of individuals attracted to trying to find ways to rescue and profit from projects in a financial stalemate. Essentially, the business of becoming and
remaining a restructuring expert is all about trust, imagination, and avoiding your own liability.

A. Restructuring Experts—Who are They?

There are generally two kinds of restructuring specialists: 1) Those that are hired or appointed to manage projects on a purely contract basis, and 2) those that agree to provide funding along with taking over control. Under number 2, the funding is sometimes in the form of bridge financing, and is sometimes in the form of a purchase of some or all of debtor’s assets or equity.

Construction warranty issues are one of the many successor’s headaches. The best chance for getting the project completed may be to leave ownership in the debtor entity. Whether it stays in Chapter 11 or the bank forecloses, a new builder will have to be involved. Neither the bank nor the new builder want responsibility for the failed builder’s work.

The bank has lost all trust in the debtor and its president. As a result, despite knowing that stranding the project has placed collateral at risk, the bank and debtor have been unable to negotiate terms for funding to complete the project. The bank has made it clear that they will litigate and resist any effort to bring in financing ahead of their lien without their consent.

Enter the restructuring expert. He is new to this deal. Usually, he is contacted by a lawyer, banker or accountant involved in the project. Generally, he is experienced, respected and trusted by the banks and the contractors involved.

B. How Does a Restructuring Specialist Enter the Picture?

Parties have been creative and there are many possible structures. Most tend to be variations of these forms:

1) Straight Contract—Hired on an hourly or monthly basis to provide expertise. This is similar to a customary receiver.

2) Contract Percentage Fee—Offered a percentage of all money generated from the project in sales. This kind of fee is paid ahead of the bank.

3) Priming Lender—The restructurer loans the debtor enough money to bridge the completion of the project with the bank’s consent. Sometimes all of the loan is ahead of the bank’s lien. More unique and appealing to the bank are the deals where the lender is willing to loan some funds ahead of the bank, and some funds junior to the bank so that the restructuring expert has a financial incentive to succeed. This arrangement almost always will involve the priming lender dictating who the new builder is going to be and disclosing all arrangements to the court.

4) Buyer—The restructurer agrees to “purchase” a significant portion of either the primary asset, or the equity of the
debtor. The “purchase” funds are used to bridge completion of the project. The restructuring specialist takes over complete management control of the debtor entity—with terms to assure that the president of the debtor cannot wrestle control away before the agreed upon time. Usually, the pre-existing equity holders must agree to deposit their equity into trust.

5) Combinations—there are arrangements which can involve combinations of all of the above.

IV. How to Get Paid in a Bankruptcy Case

A. Purchase Money Security Interests and Mechanics’ Liens — Record those Lien Notices

Section 546(b) states that the rights and powers of a bankruptcy trustee under sections 544 (strong arm powers), 545 (avoidance of statutory liens), and 549 (avoidance of post-petition transfers) of the bankruptcy code are subject to any generally applicable law that:

(1) permits perfection of an interest in property to be effective against an entity that acquires rights in the property before the date of perfection (Section 546(b)(1)(A)), or

(2) provides for the maintenance of continuation of perfection of an interest in property to be effective against an entity that acquires rights in the property before the date on which action is taken to effect maintenance or continuation. (Section 546(b)(1)(B)).

Further exploring (1). Let’s suppose that you sell goods or inventory to the debtor, and the debtor has agreed to grant you a security interest in the goods you sold and/ or the proceeds thereof. Further assume that the debtor surprises you and the rest of its creditors by filing a bankruptcy within days of getting your delivery, and you had not recorded your lien notice yet. Did you lose your lien? No. If the time for perfection of your security interest under state law (usually within 20 days of delivery under Section 9-317(e) of the Uniform Commercial Code) has not expired by the time debtor files the bankruptcy, you may record your lien notice within the 20 days and you have perfected your lien—even if another creditor filed an intervening lien notice on the same goods—your lien relates back in time to the date the debtor took delivery if your lien notice is recorded timely under generally applicable law. Timely recording your lien notice is not a violation of the automatic stay.

Further exploring (2). The Bankruptcy Code similarly protects your ability under applicable state law to perform such acts post-bankruptcy as are necessary to maintain or continue a mechanics lien if the generally applicable (usually state) law provides that the rights of the contractor or supplier will “relate back” in time and be superior to the rights of intervening lien creditors acquiring an interest in property prior to the acts necessary to maintain or perfect. Suppose you commence work on a site. The debtor files a bankruptcy within weeks of your work and materials arriving. Can you still record your lien? Yes. Provided that a
preliminary lien notice is timely filed under generally applicable (non-bankruptcy) law in relation to when services or goods are provided to the debtor, such mechanics’ lien could, and often does, relate back to the original date of commencement of work or delivery of material. Again, timely recording your notice(s) is not a violation of the automatic stay.

B. Reclamation Rights are Expanded—Make Your Demand

Section 546(c) protects a seller of goods’ right to reclamation under state law, if such right exists in your state. Prior to the amendment of the bankruptcy law, a seller of goods that the debtor received while it was insolvent could seek to reclaim such good if the seller made a written reclamation demand “[b]efore 10 days after receipt of such goods by the debtor; or…if such 10 day period expires after commencement of the case, before 20 days after receipt of such goods by the debtor…” 11 U.S.C. §546(c)(1).

In 2005, the Bankruptcy Code Section 546(c) was changed to provide that a seller has a right to reclaim its actual goods sold if: (1) the debtor received the goods while it was insolvent and within 45 days before the bankruptcy filing; and (2) the seller makes a written demand for reclamation on the debtor (a) not later than 45 days after the debtor received the goods, or (b) not later than 20 days after the commencement of the case if the 45 day period expires after the commencement of the case. 11 U.S.C. §546(c)(as amended).

Further, the prior law, which permitted the court to deny reclamation of goods to a seller that has made a timely demand in exchange for granting the seller either a priority claim under Section 503(b) or a claim secured by a lien has been stricken from the statute. As a result, it appears that a seller that has made a timely demand, and whose actual goods are still in possession of the debtor, has an absolute right to reclaim such goods.

Caution: 1) The automatic stay under Section 362(a)(3) has not been changed to permit reclamation without the court granting relief from the stay so an emergency motion will still be required. 2) Sellers’ reclamation rights are still subject to the rights of holders of security interests in goods, inventory and the proceeds thereof under Section 507.

C. Warehouseman’s Liens are Newly Protected

Section 546(i)(l) now limits a bankruptcy trustee’s ability to avoid a warehouseman’s line for storage, transportation, or other costs incidental to the storage and handling of goods, notwithstanding the provisions of Section 545 governing a trustee’s ability to avoid statutory liens.

D. File Your Proof of Claim

If you are owed money by a debtor in a bankruptcy case you should file a proof of claim immediately. It is very common for judges to set claims bar dates in chapter 11 cases. There are exceptions, but in general, if you received notice of the bar date, and if you do not file your proof of claim timely, your claim could be disallowed.
It is even more vital in a chapter 7 case. Bankruptcy Rule 3002(c) generally requires the filing of a claim within 90 days of the first date set for a Section 341 meeting of creditors. All creditors should get notice of this date, and most times (depending on the practice in your area) this same notice will contain the claim filing deadline. If you miss the claim filing deadline, chances are high that the court will disallow the claim if filed untimely.

A good business practice is to prepare and file your proof of claim immediately (within 10 days) upon receiving your very first notice in the case.

**Caution:** If you have pending litigation or a material risk of litigation, and your company is located in a different geographic area than the debtor—always consult counsel before you file a proof of claim. The filing of a proof of claim will be deemed your agreement to the jurisdiction of the bankruptcy court where the debtor’s case is pending.

**E. Is the Money Owed to You “Outside” of the Bankruptcy?**

There are at least two instances where you (or your attorney) should inquire about getting paid when the source of the funds to pay you may be “outside” (not an asset controlled by the debtor) of the bankruptcy case: 1) The job is bonded, and 2) Funding comes from a bank line of credit or construction financing designated for the job you are working on.

If the job is bonded (generally a “performance” or “completion” bond) then you should immediately submit your claim to the bonding company for payment. Upon payment, the bonding company subrogates (a legal term for “stepping into your shoes”) to your claim against the debtor. That gets you paid and leaves the bonding company to try to collect against the debtor. The bond is not an asset of the bankruptcy estate and the bankruptcy has no effect on the bonding company’s obligation to pay you.

If the job is financed through a construction loan or line of credit that is keyed to that particular job, there are recent cases that have determined that the financing proceeds are “held in trust” for the benefit of the contractors on that job. That means that the debtor cannot draw the line and then use the proceeds for any unauthorized purpose. As funds “in trust” the financing might be considered outside of the bankruptcy estate and not available to pay items not related to the job (like the debtor’s attorneys fees).

**V. What is a “Preference”? What do I do?**

Almost everyone in the construction industry that has done any significant business in up and down markets has, at one time or another, been told in a bankruptcy case that your company has received a “preference” and been asked, demanded or even sued to return the money or asset. Usually, it has taken a long time to get the “dead beat” debtor to pay on the debt owed and it is very frustrating to be asked to give the money back. Some understanding of “preference” might be useful to guide business practices in the future.

**A. Preference Defined.**
Assuming you simply have a normal commercial relationship with the debtor, a “preference” is generally any payment of, or taking of a lien to secure, an unsecured debt that occurs within 90 days prior to the filing of a bankruptcy. This is the shorthand way to think of it.

If you or your business entity could be considered an “insider” with respect to the Debtor, then any payment of, or taking of a lien to secure, an unsecured debt that occurs within one year prior to the filing of a bankruptcy is a preference. An insider is generally a person or entity in a position to control or assert material influence over a debtor’s decision-making. It is certainly an officer, director, partner, member or entity owning 10% or more of the debtor, but the definition of insider is very broad. If you have any relationship with the debtor, or its officers and directors, partners or members you should consult counsel as to whether you could be considered an “insider.”

B. To Take a Preference? or Not to Take a Preference?

TAKE THE MONEY. Taking a preference usually means getting paid, or getting a lien to secure a previously unsecured debt. If you are a creditor, there is nothing wrong or criminal about taking a payment or lien that you strongly suspect might become a preference. A preference merely violates the bankruptcy goal of equal distribution among creditors. Preferences are not automatically void—the trustee has to pursue legal action in court to request the return of a preference. Your risk is that the trustee might ask you to return the preference and sue you if you decline. If you get sued, the bad news is that you cannot recover your attorneys fees if you win (unless the trustee brought an entirely bogus suit). If the trustee wins, he cannot get his fees either (unless you put up an entirely bogus defense). It is very common that preference suits are settled and that the party that got the preference will retain something.

The Answer: So, in general, take the preference. Get the money, put it away, see if anybody comes knocking later.

C. What are the Defenses to a Preference?

Now you have done exactly what we’ve told you to do. You took the preference. You got paid the $25,000. Now you’ve been sued—the trustee wants it back. (Great. Thanks a lot.) First, the trustee has to prove that the payment you received meets all of the requirements for a preference. Even if he can prove it was preference, there are defenses. The defenses are in Bankruptcy Code Section 547(c).

For the sake of brevity we will only discuss the defenses that you are more likely to encounter.

1) Contemporaneous Exchange—If you sold goods to, or did work for, the debtor at or very near the time of the $25,000 payment, at the value of the goods or services was also $25,000 or more, then the trustee may not avoid the transfer and you keep the money. If the debtor paid you more than the goods or services were worth, the excess amount paid is not defendable. So, if the goods or services were worth $10,000, and you got
$25,000, the extra $15,000 is vulnerable. The parties must intend that the transaction be contemporaneous, and the transaction must, in fact, have been contemporaneous.

2) Payment in the Ordinary Course of Business—If the payment you received was for a debt incurred in the ordinary course of business for both your company and the debtor, and either 1) the payment or transfer was made in the ordinary course of business of both parties, or 2) the payment of transfer was made according to ordinary business terms, the trustee may not avoid the transfer. This defense protects the recurring, customary credit transactions. The 2005 Amendments make it easier to invoke this defense as the requirements summarized in 1 and 2 used to be conjunctive, but are now disjunctive. Requirement 1 looks at the pattern between your company and the debtor and whether this payment was “ordinary” in that context. Requirement 2 looks at the payment pattern for the industry as a whole so that if the company and debtor had no prior relationship, or if their relationship was atypical, then so long as the payment is within industry standard terms, it is protected.

3) Purchase Money Security Interests (Enabling Loans)—If a sale of goods requires a purchase money security interest in order to enable the debtor to acquire the goods, a trustee may not avoid a securitization transfer so long as the lien is perfected within 30 days after the debtor receives possession of the goods. An important tip for lenders: The defense is only available to the extent that the funds are actually used by the debtor to acquire the goods. Tracing is a potential problem if funds are commingled so a joint check to the seller and debtor may be advisable. Do not miss the 30 day window. Many courts have considered, and almost all have rejected, efforts to defend perfection outside of the statutory deadline under a contemporaneous exchange defense.

4) Transfer for Subsequent New Value—Even if you have received a preference, you may still offset against a trustee’s preference claim any subsequent unsecured credit that you extend to the debtor. The intent is to encourage the extension of new credit to the debtor. For instance, if you received a $25,000 preference (long overdue payment) for goods, but then sold $30,000 of new goods to the debtor on credit, that credit extension is a defense to and prevents avoidance of your preference.

5) Transfers Aggregating Less Than $5000 in Cases Involving Non-Consumer Debts—This is new under the 2005 amendments, and is exactly what it says. If you received transfers aggregating less than $5000 in a business case within the 90 days, this payment or payments are exempt and not avoidable.
VI. Conclusion.

Riding through a “down” market is all about conserving and protecting money. The goal is to be able to bear the expense of holding the assets until the market improves. Hopefully, this outline assists you in understanding the need to reduce overhead for your own business, while protecting your ability to collect from others.

TEN GOLDEN RULES OF BANKRUPTCY IN A DOWN MARKET

1. YOUR BUSINESS CAN SURVIVE IF YOU CUT COSTS
2. KEEP YOUR PERSONAL ASSETS OUT OF IT
3. BARGAINS ARE STILL THERE -- KEEP YOUR EYES OPEN
4. IF YOU DON’T ASK, YOU DON’T GET
5. IT REALLY IS ALL ABOUT THE MONEY
6. KNOWLEDGE IS THE MOST IMPORTANT ASSET YOU HAVE NEXT TO MONEY
7. ALWAYS TAKE THE MONEY-- EVEN IF YOU HAVE TO DEFEND IT LATER
8. ARRANGE FOR AS MANY SOURCES OF PAYMENT AS POSSIBLE
9. FILE EARLY AND OFTEN –LIENS, MECHANICS’ LIENS, AND CLAIMS
10. THE ONLY ONE IN AS MUCH TROUBLE AS YOU IS YOUR LENDER