Managing Risk With Counterparties Facing Financial Difficulties: Practical Strategies for Nonprofits

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MARNI CENTOR: Hello everyone. The Association of Corporate Counsel and SmartPros Legal and Ethics welcome you to today's webcast: Managing Risks with Counterparties Facing Financial Difficulties: Practical Strategies for Nonprofits.

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Our presentation today will be moderated by Scott Drumheller, general counsel and secretary for Lions Clubs International. Now, I'll turn it over to Scott.

SCOTT DRUMHELLER: Thank you. Welcome to the Association of Corporate Counsel Nonprofit Organizations Committee webinar entitled "Managing Risk With Counterparties Facing Financial Difficulties: Practical Strategies for Nonprofits." My name is Scott Drumheller, and I will be the moderator for today's presentation. I'm the general counsel and secretary of Lions Clubs International and I serve as the chair of the Webcast Subcommittee for the Nonprofit Organizations Committee of ACC.

Today's presenters are Jeffrey Tenenbaum, Larry Katz, and Moxi Upadhyaya, all of the nonprofit organizations practice at the law firm of Venable LLP. The Venable law firm is the 2009 sponsor of the ACC Nonprofit Organizations Committee. Venable's nonprofit organizations practice group is the largest of its kind in the country. It assists clients with a broad array of legal issues affecting trade and professional associations, charities, foundations, advocacy groups, and other nonprofit organizations.

Mr. Tenenbaum, our first presenter, is a partner in Venable's Washington, D.C. office, and he's the chair of Venable's nonprofit organizations practice group. Mr. Tenenbaum will further introduce our other two panelists for today's presentation a little bit later on.

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If you any have questions that occur to you after the close of the presentation, you may send it to Jeffrey Tenenbaum at jstenenbaum@venable.com.

This webcast is being recorded and will be available through a link on [the] ACC Web site. During the course of the webcast, there will be an opportunity for you to complete a satisfaction survey on your screen when you leave the webcast. Please take a moment to respond to this survey; it's a very useful tool so that we can present webcasts that are interesting and informative to ACC members.

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Now, let me turn over the presentation to Mr. Tenenbaum, who will introduce our other two panelists. Jeff?

JEFFREY TENENBAUM: Thank you, Scott. Good afternoon, everyone. We have a very interesting webinar for you today that I think you're going to really enjoy and get a lot out of. And we're very fortunate to have two of my colleagues, who are real stars at Venable, who are real experts in this area and are going to bring a very interesting perspective to our topic.

Our two speakers today: Moxi is a senior associate in Venable's Commercial Litigation Group, where she handles complex business litigation with a focus on partnership disputes. Over the last few years, Moxi [has] been extensively involved in a billion-dollar bankruptcy litigation on behalf of the client against many Wall Street investment banks and institutional investors. She's also handled a number of smaller cases, including [those] for many of our nonprofit organization clients, who were dealing with counterparties facing financial difficulties.

Larry Katz is a senior partner in Venable's Bankruptcy and Creditor's Rights Group, where he concentrates his practice on complex Chapter 11 proceedings, workouts, business restructuring, and commercial litigation. For the past 31 years, Larry has represented business entrepreneurs, real estate developers, creditors' committees, bankruptcy trustees, and others in a wide range of bankruptcy and commercial matters. He has served as a Chapter 11 bankruptcy trustee and has participated in numerous bankruptcy sales on behalf of purchasers and sellers. And we frequently—all of us in our nonprofit group—frequently turn to both Moxi and Larry to assist in situations where our nonprofit clients get into difficulties or face challenges when they are working with vendors and others who are facing financial difficulties.

Through those experiences, Larry and Moxi have a lot of insights and tips to offer to you today; both to help give you guidance on what your organizations can do when you are facing the challenges of counterparties, such as vendors, contractors [and] others, who are facing financial difficulties, as well as what you can proactively do to limit your risk at the outset when you're negotiating contracts and otherwise structuring transactions.

Nonprofit organizations frequently rely on third-party vendors to provide a wide range of services to the organization, to the organization's members, to the organization's constituents and others. And unfortunately, in our difficult economic times, it is becoming increasingly more common that those counterparties face financial difficulties, which then poses real challenges to the nonprofit organization.

Today's program is going to delve into those issues, and give you some very helpful, practical tips and suggestions. With that, I'm going to turn it over to Moxi to get us started. Moxi?

MOXILA UPADHYAYA: Thanks, Jeff. What Larry and I would like to do is give all the attendees some real-world, practical scenarios and tips for handling counterparties that are facing financial difficulties. As Jeff mentioned, the nonprofit associations often deal with third-party

vendors. At least in my experience, we have been contacted at the point where our client is either trying to collect against their counterparty for payments due and also to—unfortunately, at some points—figure out [how to] navigate the world of bankruptcy once they have not been paid and once the counterparty has filed for bankruptcy.

I'm going to let Larry speak very briefly about choosing the right vendor or third party, and we'd like to start from the beginning of your relationship with your counterparty and set it up so that if, unfortunately, you do face or are in the position where you fear that your counterparty is about to file for bankruptcy, you've at least set up and created the right structure from the beginning to make the process go efficiently and most advantageously for you.

LARRY KATZ: Thank you, Moxi. And good afternoon, everybody. We have set up this program on a timeline that I think makes sense, and it certainly is consistent with the various issues that we, as attorneys, deal with on behalf of our clients.

There are really three periods of time that are essential to our clients in trying to build in protections for them against the possibility of the other party to a transaction not performing or going into bankruptcy. The first of those periods is, obviously, the initial agreement between the parties. And so, the first area of focus is how one puts themselves in as good a position as possible for purposes of protection at the time that the contract is first being entered into.

What we'll get to after that is the second period of time. You've got a contract. There's some performance taking place on one side or the other side, and there are warning signs that appear that suggest that things are not going quite the way the parties had anticipated, and there's reason to believe that things are going to get worse and not better, and what can be done at that point in time to try and patch up the situation and provide some additional protection that may not have been put in place when the contract was first entered into.

Finally, on this timeline, there is the third period of time. Unfortunately, the other party to the transaction, either through a voluntary bankruptcy petition or an involuntary petition—and we'll talk about both of those—has ended up in a bankruptcy proceeding. That could be a Chapter 7 proceeding. It could be a Chapter 11 proceeding—and we'll talk briefly about the differences between those two. But either way, the other party to the transaction is now in bankruptcy, and you—whether you like it or not—are now getting sucked into those proceedings if you have not already, prior to the bankruptcy filing, severed your relationship with the party. Sometimes, even if you have severed your relationship, there may be things that take place in the bankruptcy that pull you back in, whether you like it or not.

So, those are the three points in time that we're going to focus on.

Now, the first of them is the contract itself. I guess probably the most fundamental part of entering into a contract is simply deciding who you're willing to enter into a contract with. There is no way that anybody can ever know with absolute certainty that they are entering into a contract with the right party—a party that will perform all of its obligations in a timely fashion, do everything that it was supposed to do, and the relationship goes perfectly from start to finish.

There's always the possibility of something going wrong, and you can never be 100 percent certain that you will not run into problems. Just doing business means taking risks. And they are inherent in the process, and you cannot eliminate them entirely. But you can, in many ways and at many points in time, you can minimize your risks. The first, and maybe the most important, opportunity to minimize risks is choosing the party that you're going to enter into a business transaction with and memorializing that relationship in a written document.

Let me take the first of those: choosing who you are willing to enter into a business deal with. Again, you're never going to know for sure if they're going to have problems down the road, but a little bit of homework really does go a long way.

Assuming that the party on the other side of the transaction is not the only party in the world that can offer you the specific services or goods that you're looking for, you have choice and you can choose a party that is more likely to perform, as opposed to one that is not as likely to perform. Doing some research before you enter into that transaction can really help you significantly. This is not something that you need a lawyer necessarily to help you with; this is something that common sense and a high-speed Internet line will give you just about everything you need in order to give you some information before the relationship is established.

If you're dealing with a publicly traded company, you go onto EDGAR; you go onto Hoover's. You do any sort of search online. Get financial information about the company that you're thinking about doing business with. It seems just common sense, but it's surprising how many times people don't just get onto their computer and do some due diligence to investigate the financial stability of the company that they are about to enter into a transaction with.

If it's a small transaction, maybe that's not so important, but anything that is involving a significant amount of money and a significant commitment, you owe it to yourselves to go online and do some financial research about the company that you are entering into a transaction with. It costs nothing but time and a little bit of effort.

Publicly traded: As I said, that's very easy. There's a wealth of information out there that is very, very helpful to [learning] whether the company is having financial problems or not.

If it's a privately held company, there are still a number of services, both free and for a fee, that will provide you with that information. You can just do a Google search. Go onto Yahoo!. If you have an account, do a Lexis search; do a Westlaw business search. Just try and get a sense of whether this is a company that's on shaky ground or solid ground. It's not going to necessarily be 100 percent insurance against a future failure, but it will help you steer clear of companies that may be heading in the wrong direction.

You can see if the companies have been sued. You can go on to a program called PACER, which is provided by the government. All you need is an account—give them a credit card to charge for downloads—and you can find out whether or not in any federal court in the country the party that you are thinking of doing business with has been sued. And, if they have been sued, you can pull up documents regarding that suit and see: Are they being accused of breaching contracts? Are they being accused of fraud? Are there warning signs there that you should know about,

because of what problems other people have run into in dealing with the same company? If you want to, just check with your local Better Business Bureau and see whether or not others have complained about the company. These are all very easy ways to get some good intelligence on whether or not this is a company [that] you want to do business with.

In addition to that, there's just word of mouth. If you are in a business where others have dealt with this same company and you know those other folks, pick up the phone. Talk to them. See whether or not they have had a good experience or a bad experience with these folks. Then, when you are satisfied that this is a risk worth taking, then you go to the next step, and you enter into an agreement with them.

Moxi and I will both talk about the agreement itself. The agreement is critical. There are lots of provisions that will make a huge difference over time in a relationship that doesn't go as the parties expect. Once there is a problem, those provisions in the contract will control—and this is something—people sign agreements all the time. There's small print in every document. Often we sign agreements; we don't even read the small print; we think we know what it says. But in a business relationship it is really essential that you read the fine print and that you understand what you are agreeing to, and you negotiate for better terms if you don't like what the agreement says, particularly if the agreement is a preprinted agreement from the other side with five pages of boilerplate that no one has looked at in the last several years, and everybody just blindly signs it. We all do it. But it is important that we sort of resist the temptation to just sign on the dotted line without reading and without negotiating and without asking questions about those provisions, because, as you'll hear throughout the rest of the presentation, some of those provisions are going to be critical as things start to go off track and people's expectations are not met.

Moxi, do you want to maybe identify a few of the more important provisions that could play a key role?

MOXILA UPADHYAYA: Sure. As Larry said, I just can't underscore how important it is to, at the get-go, have vetted and really understood what the terms of your agreement with your third party or counterparty [are], especially where you are contracting with a counterparty who, for example, is going to run your annual conference, or someone who's going to be collecting money from attendees for membership—something to that effect; something that's going to involve a substantial flow of funds and a substantial relationship. You must look at the agreement that they are proposing. And, oftentimes, having your counsel look at it at the beginning will end up saving you a lot of money at the end if, for example, there are some terms that you didn't necessarily intend or if there are terms of the agreement that you didn't quite understand how they would play out.

Let me talk to you about what happens when I get a case where a client—especially a nonprofit client—is concerned that their counterparty isn't paying and that they might be facing bankruptcy. There are a number of provisions I look at in the contract or the service agreement, and I'm going to talk to you about some terms that you should definitely consider when entering into a substantial relationship with a counterparty.

The first one that I'd like to talk about is choice of venue and choice of law provision. You want to make sure that you understand what happens if there is to be a lawsuit or a dispute based on that contract. You want to try to make it, of course, venue-wise, the most advantageous for you, and you also want to consider, with input from your counsel, what choice of law would govern any dispute that arises out of that contract. For certain types of relationships, you may want Delaware law to apply. Delaware courts are known to [have] expertise in business law. You really need to think about where a lawsuit would be brought and what state's laws would apply, and you have to be comfortable that that provision in the service agreement or the contract is one that you can live with and, ideally, one that works to your advantage.

Another provision in that same category is an arbitration provision. You could ask 100 attorneys—and Larry and I were just talking about this—whether to include a mandatory arbitration provision in your contract. Fifty will tell you yes and 50 will probably tell you no. Some of the advantages to arbitration, of course, are that, generally, it will go faster. Just for those of you who aren't familiar with mandatory arbitration provisions, it's a provision in the contract or service agreement that says any dispute arising out of that service agreement has to first be arbitrated through one of the recognized arbitration groups—the American Arbitration Association [AAA], for example. And it will also say what rules will apply. The AAA has their own arbitration rules, kind of like the Federal Rules of Civil Procedure.

That arbitration provision requires you to first go through the arbitration process before you can go to the courts. So one of the benefits is that you can go straight to arbitration, [and] hopefully get a quick result, hopefully get a result that costs you less to go through that process than going through the courts, instituting a lawsuit, and being in litigation for a couple of years. There is certainty, in that sense, in arbitration.

The disadvantages of arbitration are that in arbitration, an arbitrator's decision is binding. And so, if you have a mandatory arbitration provision and you get a binding decision from an arbitrator that you don't like, you have very limited recourse with the courts. You can go to the courts, and most states and the Federal Arbitration Act give great deference to an arbitrator's decision. So your audience with your local, state or federal court is very limited once there is an arbitral ruling. Arbitration provisions really cut both ways, and you have to consider, based on the circumstances of your agreement, who your counterparty is, and what you have a preference for, whether or not to include an arbitration provision. Be careful—a lot of service agreements do have mandatory arbitration provisions, and once you're facing a dispute, they're very, very powerful provisions that really bind you.

Another set of provisions that really must be very clear in the contract to protect you are default provisions. These are provisions that say exactly what constitutes a default under the agreement. For example: If they are 30 days late in paying you [or] if your counterparty files for bankruptcy, you should definitely consider that to be an immediate event of a default.

There should be delineated and very clear terms in the contract [as to] what is considered a default under the contract. Depending on the unique contract that you're dealing with, you can have a number of different events be considered a default. When you sit down to think about it, you can be creative and say, "What can I really not live with? In a business sense, I'm going to

be a partner with this counterparty. What are things that can happen that I can't live with?" You can consider putting into the contract some events which both parties agree will be considered a default under the contract.

You should also have clear notice provisions with respect to default. What are the two parties' rights and obligations with respect to both giving and getting notice? You should have a period of time, usually a written notice and a period of time for the other side to cure. You should really have a roadmap in your agreement as to what happens next. So my counterparty hasn't paid the fees that they're owing me for 60 days. Well, if my contract says that 30 days late is a default and I just have to give them five days' notice to cure, and then after that I can immediately institute a lawsuit—if all those things are set forth in your contract, it's very easy for you to go to court and say, "Look, Judge, here's what we agreed on. I followed the procedure; I'm in court and they can't complain that they weren't given adequate notice or that the contract is ambiguous."

I would say that one of the biggest concerns I have when I am called by clients who need help is that oftentimes you look at the contract, [and] you have no idea what's exactly clearly a notice and what the notice provisions are. You protect yourself in setting forth a procedure that you can live with at the outset, in terms of getting notice.

Another thing about default that you want to consider is including a provision in which you are entitled to attorney's fees from the other side in pursuing a default. You should definitely look for any provisions in the agreement that entitle either side to attorney's fees. If the counterparty gives you one of their boilerplate or their *pro forma* agreements that says they're entitled to attorney's fees arising out of any lawsuit, you really want to negotiate the terms of that. Does that mean that the prevailing party of any dispute gets their fees? Does it mean that any time any lawsuit is instituted or arbitration is instituted they're entitled to fees? That can, at the end, really, really work against you. And you could take a huge hit if there is an attorney's fees provision that you are not aware of in your contract or one that isn't fair and balanced. So, you want to consider [the] attorney's fees provision.

I don't believe I talked about a jury demand. You'll want to consider whether or not to waive the party's rights to a jury trial. Again, this is one of those things, like the arbitration provision, [about which] half of the litigators will tell you, "Yes, those are good for certain circumstances," [and] half of them will tell you, "No". It just depends on who your counterparty is and what the service agreement is. I'm happy to let Larry chime in. I know that he has more thoughts about this.

LARRY KATZ: Thank you, Moxi. Two quick points; one with respect to attorney's fees. The American policy on attorney's fees is that when you go to court to enforce rights that you have, you do not have the right, if you are the prevailing party, to be reimbursed your attorney's fees unless you have a contract that gives you that right or there's a statute that gives you that right. So, if you don't have a provision in your contract that says that if you have to sue them for breach by them and that you're entitled to your attorney's fees if you prevail, then you're not going to be entitled to recover those attorney's fees in litigation or in bankruptcy, if you have a claim in a bankruptcy case without that provision. It's very important to have that in there.

Moxi talked about the termination provision. Let me put it again in the context of a breach and a potential bankruptcy to explain why that is so important. By the time the party to the contract has ended up in bankruptcy, it's too late for you to do certain things under your contract, because bankruptcy changes contractual rights and obligations. You're not in Kansas anymore once the party is in bankruptcy. A lot of the rules change. Those changes are designed to protect the debtor now in bankruptcy, to give them an opportunity to catch their breath, get a fresh start, [and] hopefully reorganize.

Among the changes that occur once a party files for bankruptcy is that a lot of provisions in contracts that are fully enforceable out of bankruptcy are no longer enforceable. That's what a lot of what we are talking about is all about, because when you enter into the contract and when you take certain actions down the road when things are not going as expected, the name of the game is to try and get out before bankruptcy.

Once the other side has filed for bankruptcy, your remedies are going to be limited. For example: You have a provision that says that if the other party files for bankruptcy, that's a default and that will terminate the agreement. That's not enforceable in bankruptcy. There's a specific provision in the bankruptcy code that invalidates the types of provisions that say that the filing of bankruptcy is an event of default and can result in termination of the contract.

For example: If you have a contract that is designed to go on for a year, and three months into that contract, the other side goes into bankruptcy, the fact that you have a provision in the contract that says if you file for bankruptcy the contract's over is not going to give you any protection whatsoever. You are still tied to that contract and you cannot stop performing under that contract merely because the other party has filed for bankruptcy. That provision is not enforceable.

There are other things that will ameliorate that harm to you, but the point is: If you're in a position to take action to terminate the contract and get away from the other party before they file for bankruptcy, you're going to be in much better shape, because you will not then be sort of a captive party once they're in bankruptcy. A lot of what we're talking about is designed to give you the ability to protect yourself and get away from the other side before they end up in bankruptcy and you get pulled into those proceedings.

Now, let's assume you have a contract where the other side is either going to get payments from you in exchange for performance—and maybe that performance will take place and maybe it won't take place, but you're paying for it. Or, looking at it from a different point of view, the other side is collecting money on your behalf. That's your money, and they're performing some sort of a service where they're collecting the money for you, and the idea is that they're supposed to turn it over to you.

Whenever the other party to a contract has something of value of yours that they are holding onto, you have to consider ways that you can protect your interests in those assets, because if they file for bankruptcy and they're still holding onto what we would say is your money, unless it's clear that it's your money, that property may end up being part of their bankruptcy estate. How the transaction is structured as between you and them is critical to determining whether or

not the money they're holding onto—either because they collected it for you or because you gave it to them—whether or not that's going to be part of their estate and subject to the bankruptcy court's jurisdiction or your assets that you can retrieve in one way or another.

For example: If you are paying for goods and services in advance of your receipt of those goods or services, number one, you can keep it as short-term as possible. The less you pay in advance the better, obviously. Number two, there may be circumstances where you can have the payment escrowed in the name of a third party, so that it doesn't actually get into the hands of the counterparty to the agreement until the counterparty has fully performed. Then, and only then, is the money released to them, so that if they go into bankruptcy and the escrow agent is holding onto the property, you will be able to go against the escrow agent [and] retrieve your money without violating the rules of the bankruptcy proceedings that say that you can't take action against the debtor and the debtor's assets once the bankruptcy is filed. Again, you're avoiding getting pulled into the bankruptcy proceedings, and you can have access to what is rightfully your property and not have it treated as property of the estate.

As far as the contract termination provisions, as Moxi says, you want to have strong, clear language that allows you, upon a default by the other party, to act quickly and decisively to terminate the agreement, because if the agreement isn't terminated before bankruptcy, as I said earlier, you may end up having to continue to perform under the agreement in bankruptcy, even though the other party is now in bankruptcy and they may not be performing in all respects.

During the period of time when things are starting to look like they are going off track, you really want to act decisively. You don't want to waste any time whatsoever declaring a default, if there has been a default, putting the party on notice, looking at the agreement, and seeing exactly what's required. There's nothing worse than having the other side default and then finding out that there are very specific ways that that default needs to be noticed to be effective and that type of notice was not given, because after the fact they can challenge the action that you have taken. And it may turn out that your termination or attempted termination of the agreement was not effective, because they were not given the proper notice in terms of whether it has to be in writing, who it needs to go to, how many copies, and what period of time, and so on and so forth. So, you really need to know what your contract calls for, and you need to follow the contract to the letter of its provisions in terms of giving notice of a default and of termination.

If you can terminate before a bankruptcy filing, you're going to be in much better shape than if you have to deal with the issues once a bankruptcy is filed. If there are warning signs and the counterparty is not performing as they should, or you're having problems communicating with them or bounced checks—the telltale signs are usually pretty obvious; sometimes they're a little subtle; sometimes they're not—but you will sense when there is a potential problem with the other side, and you may have reason to believe that they are heading towards bankruptcy. The odds are in favor of somebody that you deal with these days going that route, because of what is happening generally in the economy and how many companies are in trouble. One of the things that you need to do is: You obviously need to gather up information, figure out whether or not this is heading in the wrong direction, look at your agreement, as I said, and figure out whether or not it's time to pull the plug and terminate and cut your losses.

If you are in a position to restructure the obligation, there's a right way and a wrong way to restructure it and to change your relationship with the other party. Every situation is unique in some respects, so it's a little hard in a program like this to go into all of the dos and don'ts, but there are certainly right ways and wrong ways to restructure the transaction to give you additional protection if you want to go forward.

Some of the things that you would want to think about [are], number one: If the counterparty is not performing correctly, and you haven't already gotten another party to guarantee performance, this is the time to start thinking about getting a guarantor. Get the principal of the other side to guarantee performance or to guarantee payment, because if the company goes into bankruptcy, that doesn't prevent you from taking an action against the guarantor. Unless the guarantor also goes into bankruptcy, you are free to pursue your remedies against the guarantor. The guarantor knows that—knows that you have an opportunity to go against them. That's going to affect their conduct, and they may be less inclined to put the company into bankruptcy if they are personally on the hook. If they do, you still have remedies against them in addition.

Second: Now's the time to think about whether you can get some security for performance, if you haven't already in your original contract negotiations. There is a pecking order in bankruptcy, and it starts at the top with the secured creditor—some creditor that has a valid lien on assets of the debtor.

As you go down that pecking order, you have certain administrative claimants, and then you have certain unsecured creditors who are entitled to priority, and then you have the general unsecured creditors. The only people below them are the owners of the business—the equity holders. In bankruptcy, the name of the game is to get as high up on that pecking order as you can, because typically there's not enough money for everyone, and as that money flows down, there's less and less available for the folks at the bottom. You don't want to be an unsecured creditor if there's any opportunity for you to become a secured creditor. You have to do it before the bankruptcy, because by the time the bankruptcy is filed, it's too late.

If there are problems with the counterparty, and you haven't already gotten some security for their ongoing performance, that's the time to say, "If you want us to continue in this relationship, you're going to have to put up some collateral. Give us a lien on something to secure your continued performance, because we don't want to keep paying you" or "we don't want to keep providing goods or services to you," depending on the relationship, "without some additional protection."

It may end up turning out that that restructuring of the relationship may be challenged if there's a bankruptcy filing within 90 days or within a year of that occurring. There are bankruptcy rules that look back and undo certain transactions that occur prior to the bankruptcy filing, and you've probably heard about preference actions and fraudulent transfer actions. My rule of thumb, and I don't think I've ever deviated from this in advice I've given to a client: You're always better off getting the protection and worrying about losing it afterwards if there's a bankruptcy filing than never getting it at all. So, anything that you can do to improve your protection as the counterparty starts to struggle financially, you should do it, and worry about whether or not that's going to be undone at some future date. You don't know if it's going to be undone. They

may never file for bankruptcy. Or they may file for bankruptcy outside of the period of time when you can look back at these transactions. Or you may have all sorts of defenses to a challenge to the restructuring. So, it's important to do it the right way, but it's important to do it. You're better off doing it than not doing it.

If all else fails, and despite your efforts to avoid choosing a counterparty to a contract that is on sound business and financial foundation, and you end up fronting a bankruptcy, there are a number of things that you need to be aware of. Because bankruptcy, as I said earlier, really is a different world than the normal business world. The rules change. Things happen in a way that can be very confusing. If nothing else, things happen quickly, and people who sit on their rights often find themselves sort of left behind and are much worse off as a result.

If there's a bankruptcy filing, you will get notice. If you don't get notice, you're not going to be subject to what happens in the bankruptcy proceedings, so presumably the debtor is going to fulfill its obligations of giving notice to everybody that it has a contract with, everybody that it owes money to, and you will get notice of the bankruptcy filing. It is very important that you come up to speed quickly on what is happening in the case when you get that notice, because bankruptcy proceedings tend to happen very, very quickly. In a Chapter 7 case, which is just a liquidation of the assets of the debtor by a trustee, it is not unusual for the case to be over in 60 or 90 days, so you need to be proactive in the case. You need to have counsel go into the case and advise you as to what's happening, or the case could be over before you even get started.

In a Chapter 11 case, where it is the norm for the company to stay in control, they're referred to as the debtor-in-possession, because they continue to operate in the normal course of business without a trustee. In those cases, which could go on for months or years, a lot of what happens in the case that is important happens within the first couple of days or maybe weeks. Even on the first day of the case, there are significant events that occur, so it is extremely important there too to jump in right away, because that sets the stage for things that happen later on in the case.

Among the things you have to be prepared to do in any bankruptcy case to protect yourself, number one: You'll want to file a proof of claim. In a Chapter 7 case, if you don't file a proof of claim saying, "This is what I am owed by the debtor," you're out of luck. If there are assets to be distributed, and you have not filed a proof of claim, you're just going to be ignored in a Chapter 7 proceeding.

If you're in a Chapter 11 proceeding and the debtor schedules your claim in an amount that you agree with, technically you don't need to file a proof of claim, but for a variety of reasons, it's a good idea to do it, and, nine out of 10 times, what you think you may be owed is more than what the debtor thinks it owes you. So, it's always a good idea to file a proof of claim, and there's going to be a date set by the court within which you must file a proof of claim in order for your claim to be recognized and for you to share in any distribution. So, you're going to need to do that.

Second, if your claim is large enough, you may be asked to be a member of a creditors' committee. Time is not going to allow us to discuss the pros and cons of whether or not you want to participate in the creditors' committee, but it is something to consider. It gives you much more

of a participation in the bankruptcy proceedings, which is often a very good thing. With it go certain obligations, because you're a fiduciary for all of the unsecured creditors. But if you get such a notice, you want to talk to somebody about whether or not it would be a good idea for you to participate as a member of the creditors' committee.

There is always a first meeting of creditors that takes place, usually within the first 30 or 40 days of a case, where the debtor is required to show up and, under oath, answer questions about the case and about its assets and about its liabilities, and you have a right to participate in that. You can show up, with or without counsel, and you can ask the debtor questions. There is a lot of very useful information that you might be able to obtain from attending that first meeting of creditors, and that date, time and the place for the meeting is all set forth on the initial notice that you get of the bankruptcy filing.

You will have, in a Chapter 11 case, an opportunity to vote on a plan if there is a reorganization. That's a very important right. There are a lot of very complicated documents that will be circulated to creditors in anticipation of the vote that will lay out how each creditor is to be treated under the plan. The plan is basically a new agreement between you and the debtor on a going-forward basis—what you're going to be paid, how you're going to be paid, if you're going to be paid, over what time period you will be paid. This is the debtor's proposal for restructuring its relationship with all of its creditors. You have a right to vote on whether you are in favor of that plan or against the plan. There are very complicated rules on how all that works in bankruptcy, but the important point for today's presentation is: You need to be aware of what's being proposed by the debtor. You need to understand it, and you need to exercise your right to vote for or against it, depending on whether or not it does make sense from your perspective.

Finally, there is an opportunity, if your contract still exists with the debtor, for the debtor to assume that contract; meaning that the debtor will say, "This is a contract that I want to continue on with, with this party," or reject the contract. The debtor says, "This is a contract that is not going to help me on a going forward basis, so I'm going to breach this contract. I'm going to reject the contract and not perform under it anymore."

That's a decision that the debtor will make based upon its business judgment. But you will have an opportunity to do several things that are very important in terms of your rights under the terms of your contract when the debtor decides to assume or reject.

If the debtor decides to assume the contract, one of the things the debtor has to do is [to] cure a default, if there is a default under the contract. And that's an important time for you to step forward and say that you agree or disagree with the debtor's view of what the cure is. If the debtor owes you $100,000, and goes to court and says, "We want to assume this contract and we want the other party to continue to perform, and we think we owe the other party $10,000," that's the time when you have to run into court and say, "Judge, we're happy to continue this contract, but guess what? We're not owed $10,000, we're owed $100,000, and we're not going to keep performing unless we get $100,000 to cure this default." It's up to you to run into court and say what is needed to cure the default before the debtor can force you to continue to perform under the contract.

If the debtor rejects the contract, you'll have a right to seek damages from that rejection. The rejection is: Essentially, they're breaching the contract with the court's blessing. That breach of the contract will give you the right to have a damage claim. Maybe that damage claim isn't worth all that much, but it depends on the particular facts of each case as to whether or not that claim will have value. The important thing is: You want that claim to be as great as possible, so if there is a distribution, you will share in that distribution based upon the size of your claim.

That almost gets us back full circle to where we started our discussion, in terms of the contract provisions. It's another reason why you want the contract, on day one, to have certain protections for you, such as the attorney's fees that Moxi talked about.

You may want to consider a liquidated damage provision, so that if there is a rejection of the contract in bankruptcy or there is a breach of the contract before bankruptcy, you don't spend forever in court fighting over what your damages are. A properly drafted liquidated damage provision will give you the ability to establish immediately what your damage claim is. If it's properly drafted and it's fully enforceable, it will eliminate much of the delay and the cost of litigating over what your claim is. That is something that is extremely valuable outside of bankruptcy. It is also extremely valuable in bankruptcy, because if there isn't a clear understanding of what your claim is, you could end up having a very costly dispute in bankruptcy over the amount of your claim. Again, that's something that you can hopefully avoid through proper drafting of the [contract] at the beginning of the relationship.

I think we are getting close to running out of time, but there are certainly other things that we can address, both in terms of the contract terms that can be added to protect parties starting a new relationship, as well as the things that can be done along the timeline that we identified at the beginning of our presentation. Jeff, Moxi, does anyone else have any other thoughts on ways that folks who are starting relationships with a counterparty can protect themselves from potential problems down the road?

MOXILA UPADHYAYA: I would just add, Larry—I can't remember if you said it specifically— but the time to act is immediately after you start to see the telltale signs. Larry talked about what the telltale signs are, but oftentimes, as litigators, Larry and I don't get contacted until the client's counterparty is months and months in arrears or unless our client has waited to hand the case over to us. Of course, that hinders our ability to try to get these protections and take action quickly to protect our clients. I would just emphasize Larry's comment that as soon as you have a breach, even though it may not be a major breach, but when you think it's going to lead to a material breach of contract, get your counsel involved and start to look very closely at the contract.

LARRY KATZ: Just to add to what Moxi said: One of the most difficult questions that you may confront when you've got a default by the counterparty is: Do you want to file suit? There is a cost associated with it. It is never a quick process, and it's a difficult question to weigh the pros and cons of filing suit. There's no one right answer to that question, but sometimes the worst thing you can do is to procrastinate and not file suit—not immediately declare a default and figure out how you can quickly get a judgment in your local jurisdiction.

If you're having problems with the counterparty, you can often assume that others are as well, and it could be a race to the courthouse. There is tremendous value in having a liquidated, fully adjudicated claim against the other party. That eliminates all sorts of issues in the future with or without a bankruptcy. If you don't have that judgment and that liquidated amount that you're owed by law that can no longer be challenged, then those issues are going to remain if there is a bankruptcy and you're going to end up fighting about that in the bankruptcy court anyway. The sooner you can get over those hurdles and have your claim reduced to a liquidated amount, and you have the ability to enforce that claim, the better off you're going to be. I don't want to make it a black-and-white rule, but I would say that most of the time you are better off going forward with enforcing your rights under the contract than in sitting back and doing nothing.

Now, is there a middle ground where you simply can negotiate with the parties? Yes, and we talked about that, and we talked about ways you can get additional protection. But if you can't get that protection and there is a breach, the longer you wait, the more likely it is that the other parties, who are in a similar situation, are running to the courthouse, and they're getting their judgments and they're putting additional pressure on the debtor and they may be getting a head start over you, and the closer you're getting to a bankruptcy filing when it's too late to do anything. You really want to take a very close look immediately at whether or not to go and file suit and get your judgment. If you do get a judgment, that gives you additional rights, even in the event of a bankruptcy, so it's something that you want to give very serious consideration to.

Jeff, I'm looking at my watch, and it looks like we may be just a couple of minutes shy of the end of our presentation, and we may or may not have some questions pending.

JEFFREY TENENBAUM: Let's open it up. Right now, we don't have any questions in the queue, but let me ask: Does anyone have any questions before we wrap up the webinar that you would like to send into us via the online function? We'll give it a minute or so to see if anyone has any questions.

SCOTT DRUMHELLER: In the meantime, Marni, would you like to give the CLE information at this time?

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SCOTT DRUMHELLER: Jeff, any questions coming into the queue?

JEFFREY TENENBAUM: No, it appears not. So I guess what that means is that Larry and Moxi did a terrific job, and I certainly think they did, in covering a wide range of material in a very efficient time. The PowerPoint presentation, as well as the audio recording, will be available afterward to all of you folks and your colleagues who might be interested, if you would like to share it with others who might like to listen to it. With that, I'm going to thank Larry and Moxi for their work and a terrific job today and turn it back to Scott to close things off.

SCOTT DRUMHELLER: OK, thank you, Jeff. That concludes today's webinar. I'd like to thank our panelists, Jeff, Larry and Moxi, for their time and the excellent presentation. I would also

like to thank the Venable law firm for sponsoring our webinar today. Remember, if you have any questions that you did not get to submit, please feel free to send an e-mail to Jeff Tenenbaum at jstenenbaum@venable.com. I would like to thank our audience for attending today's webcast. Please don't forget to complete the survey that will appear on your screen when you leave the webinar. Marni?

MARNI CENTOR: Thanks, Scott. On behalf of the Association of Corporate Counsel and SmartPros Legal and Ethics, thank you again for listening to today's program.

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Thank you again and have a great day.