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# Strategies for Protecting Suppliers and Customers of Insolvent or Bankrupt Companies

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# Questions When Dealing with Insolvent or Bankrupt Companies

- Keep doing business with a financially troubled company?
- Prospects for being paid by company in financial distress?
- Risks in accepting payment from financially trouble company?
- How to deal with goods in transit to an insolvent company?
- Can I terminate or stop performing under a contract when either party files for bankruptcy?
- What happens with executory contracts (substantial performance outstanding by both sides) in bankruptcy?



# Ensuring Payment For Goods and Services Provided to Financially Troubled Counterparties

- Seek a security interest in goods sold to financially troubled company
- Seek guaranty from parent company or letter of credit support
- Seek payment for goods/services in advance or on COD basis
- Seek adequate assurance of performance (i.e., ability to pay) from financially distressed customer pursuant to UCC provisions allowing suspension of performance until assurance provided



# Stopping Goods in Transit

- Consider stopping delivery of goods sold on credit to financially troubled customer that are either:
  - not yet shipped, as permitted under UCC §§ 2-702(1) & 2-703; or
  - while in transit, as permitted UCC § 2-705, if buyer has not taken actual or constructive possession or control of the goods
- After delivery is stopped, convert credit sale into COD sale or arrange for return of the goods from the carrier or warehouse



# Reclaiming Goods Sold to an Insolvent or Bankrupt Party

- UCC § 2-702 allows reclaiming goods from insolvent buyer within 10 days after delivery
- 10-day limitation inapplicable if buyer misrepresents solvency in writing to seller within three months before delivery of goods
- Seller's right to reclaim is subject to rights of buyer in ordinary course or other good faith purchaser under UCC § 2-403

# Initial Steps to Take When Customer Files for Bankruptcy

- Review documents filed in bankruptcy court and file a notice of appearance to receive future documents filed in case
- Different analysis for Chapter 11 (debtor's operations continue) or Chapter 7 bankruptcy (debtor's operations terminate)
- Note any important upcoming hearing dates & deadlines
- Consider attending the Section 341 "meeting of creditors" to learn about debtor's finances, intentions regarding bankruptcy exit strategy and ask questions of representative under oath
- File proof of claim



# Impact of Bankruptcy Automatic Stay On Collection Contract Rights

- Automatic stay effective upon bankruptcy filing prohibits collection activities for pre-petition debts (even invoicing)
- Common contract provisions allowing termination if a party files for bankruptcy is generally unenforceable in bankruptcy
- Non-debtor also violates stay by ceasing performance under contract with debtor in bankruptcy
- But, non-debtor party can suspend performance while seeking relief from bankruptcy court
- Relief can include debtor's required payment or other performance or other "adequate protection" or relief from automatic stay to allow termination of contract



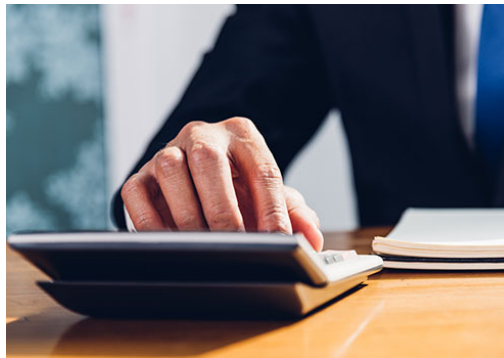
# Reclaiming Goods After Bankruptcy

- Seller can make written demand to reclaim goods sold in ordinary course of business and received by insolvent debtor w/i 45 days or w/i 20 days after petition date, if bankruptcy filed within 45 day period.
- But reclamation rights subject to prior security interest in goods (e.g., lender with blanket liens on debtor's assets)
- Consider also filing an “adversary proceeding” in bankruptcy court, including request for TRO preventing debtor from selling goods pending determination of reclamation claim
- Check if the bankruptcy court has entered an order approving universal procedures for resolving reclamation claims



# Evaluating a Customer's Creditworthiness Post-Bankruptcy

- Important to assess debtor's financial condition after filing for bankruptcy before extending additional credit
- Consider impact of debtor-in-possession ("DIP") financing, generally secured by blanket lien on debtor's assets, with DIP lenders paid typically paid before all other creditors
- Ensure there is a order authorizing debtor's use of secured creditors' "cash collateral" before accepting a cash payment
- Review debtor's monthly operating (financial) reports, bankruptcy schedules and statement of financial affairs



# Administrative Expense Treatment For Goods/Services Provided to Debtor in Bankruptcy

- After a debtor files Chapter 11 bankruptcy, it is legally permitted to pay for goods and services received in the ordinary course of business (but generally not prebankruptcy debt)
- These debts generally give rise to administrative expense claims, with priority over unsecured prebankruptcy debt
- Such expenses must be reasonable & necessary to receive administrative expense treatment
- Debts arising prior to bankruptcy filing can only be paid through confirmed Chapter 11 reorganization plan or other approval of bankruptcy court



# Strategies for Preferential Treatment of Prebankruptcy Claims in Bankruptcy

- Priority (administrative expense) claim for party who delivered goods (but not services) to debtor in ordinary course of business within 20 days prior to bankruptcy
- Alternative to reclamation demand
- “Critical vendor” status for certain suppliers of goods and services in some Chapter 11 cases allows payment of prebankruptcy debt if vendor continues extending credit



# Executory Contract Considerations in Bankruptcy

- Special rules for executory contracts (i.e., material performance remains on both sides) in bankruptcy under Bankruptcy Code § 365
- Debtor has following options for its executory contracts (subject to bankruptcy court approval):
  - “Assume” (ratify), which requires cure of all pre- and post-bankruptcy defaults and adequate assurance of future performance;
  - Reject (repudiate), and stop performing, with non-debtor party entitled to claim for damages resulting from contract rejection; or
  - Assume and assign--does not require counterparty consent despite contract provisions (but assignee must provide adequate assurance of performance)
- Counterparty cannot stop performing unless debtor rejects contract
- Counterparty can file motion to compel debtor to assume or reject contract, or seek “adequate protection” payments pending that decision

# Preferential Transfers and Reducing Risk of Claw Backs in Bankruptcy Case

- Payments received by creditors within 90 days prior to bankruptcy filing can be clawed back as preferential transfers
- Creditor can file claim for amounts clawed back as if payment had not been paid; treated as general unsecured claim
- Defenses to preference claims - “ordinary course of business,” “subsequent new value” and contemporaneous new value
- When dealing with party approaching bankruptcy, try to have payments consistent with parties’ history if possible
- Deliveries after preferential payments can reduce clawback liability as subsequent new value
- Contemporaneous new value if payment COD or received within few days of delivery & intended to be contemporaneous

# Treatment of IP Licensing Rights in Bankruptcy

- Different treatment for license agreements of patents and copyrights vs. trademarks, where debtor is licensor under Bankruptcy Code § 365(n)
- For patents and copyrights, even if debtor rejects license agreement, licensee can continue using technology if they pay license fees, but debtor not obligated to update technology
- Because trademarks are not included in definition of IP under Bankruptcy Code, licensee not entitled to same protections if debtor rejects license agreement
  - But recent SCOTUS decision allows licensee to keep using trademark anyway. *Mission Product Holdings, Inc. v. Tempnology, LLC*, 139 S. Ct. 1652 (2019)



## Questions + Contact Information



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