August 2016

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Business Law Section Annual Meeting
September 8-10, 2016
Boston, MA

Business Bankruptcy Committee Meeting and National Conference of Bankruptcy Judges
October 26-29, 2016
San Francisco, CA

Kay Standridge Kress
Chair, Committee on Business Bankruptcy

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**Business Law Section Annual Meeting**

**COMING UP: 2016 Business Law Section Annual Meeting**

**September 8-10, 2016**

**Boston, MA**

Boston Marriott Copley Place and The Westin Copley Place, Boston

**Thursday, September 8, 2016**

8:30 a.m. - 10:00 a.m.

**Program:** Caught In the Cross-Fire: Recent Litigation Issues Confronting Indenture Trustees in Contentious Distressed Situations

**Presented by:** Business Bankruptcy

**Co-sponsoring Committees:** Business and Corporate Litigation, Trust Indentures and Indenture Trustees

**Program Co-Chairs**

Jeanne Darcey, Partner, Sullivan & Worcester LLP, Boston MA

**Program Co-Chairs and Moderators**

Walter Curchack, Partner, Loeb & Loeb, LLP, NY, NY

**Program Materials Coordinator**

Nathaniel Koslof, Associate, Sullivan & Worcester, LLP, Boston MA

**Speakers**

Kristen Going; Partner; Drinker Biddle & Reath LLP; Washington, DC

Eric Schaffer; Partner; Reed Smith LLP; New York, NY

Robert Schmidt; Partner; Kramer Levin Naftalis & Frankel LLP; New York, NY

Amy Zuccarello; Partner; Sullivan & Worcester LLP; Boston, MA

This panel will discuss issues raised by recent litigations involving public debt, including the use of exit consents to accomplish out-of-court restructurings, the "fair and equitable treatment" doctrine, current proposals to amend the TIA and the Bankruptcy Code, and the related rights, duties and obligations of indenture trustees.

**Thursday, September 8, 2016**

10:30 a.m. - 12:00 p.m.

**Program:** The Life Cycle of Intercreditor Agreements - From Cradle to Grave

**Presented by:** Business Bankruptcy

**Co-sponsoring Committees:** Commercial Finance

**Chair**

Henry Kevane, Partner, Pachulski Stang Ziehl & Jones, LLP, San Francisco CA

**Moderator**

Leon Barson, Partner, Blank Rome LLP, Philadelphia, PA

**Program Co-Chairs**

Henry Kevane, Partner, Pachulski Stang Ziehl & Jones, LLP, San Francisco CA

Matthew Rotenberg, Partner, Blank Rome, LLP, Philadelphia PA

**Program Materials Coordinator**

Adam Sansweet, Associate, Blank Rome, LLP, Philadelphia PA

**Speakers:**

Richard Brown, Partner; Holland & Knight; Charlotte, NC
The panel will: (1) examine the “life cycle” of an inter-creditor agreement, from its “birth” at the time of the initial financing transaction, through interim changes to the financing terms and collateral pool, through its enforcement and application in a bankruptcy case; (2) discuss emerging trends in documentation and key points of contention and negotiation among the participants to the agreement; and (3) survey recent case law in both the non-bankruptcy and bankruptcy context with special emphasis on the ability of junior creditors to exercise rights and remedies in a bankruptcy case.

Friday, September 9, 2016
8:30 a.m. - 10:00 a.m.
Program: Insolvency (Even Bankruptcy) and Your Project- Let's Count the Ways It Spells Trouble
Presented by: Project Finance and Development, Co-Sponsoring Committees: Business Bankruptcy
Program Co-Chairs
Dan McCauley; Member, McCauley Lyman LLC; Framingham, MA
Program Co-Chairs and Moderators
Alison Manzer; Partner; Cassels Brock & Blackwell LLP; Toronto, Ontario, Canada
Program Materials Coordinator
Natalie Levine; Partner; Cassels Brock & Blackwell LLP; Toronto, Ontario, Canada

Speakers
Paul Turner; Partner; Reed Smith; Houston, TX

Lawyers in all areas of business law practice will encounter “projects” and those projects will be adversely affected if there is an insolvency of a key player. This program will look at the key players in project finance, development and operations analyzing the effects of insolvency and the best in class methods of mitigating the damage.

Friday, September 9, 2016
10:30 a.m. - 12:30 p.m.
Program: Industry in Turm-Oil: An Exploration Of Finance, Workout And Bankruptcy Issues Unique to the Oil & Gas Industry
Chair:
Scott A. Lessne
Program Chair and Moderator
Scott Lessne; Senior Counsel; Crowell & Moring LLP; Washington, DC
Program Materials Coordinator
Simon Leefatt; Associate; Crowell & Moring LLP; Washington, DC

Speakers
Ryan Hunsaker; Senior Associate; Vinson & Elkins LLP; Houston, TX
Curtis Miller; Partner; Morris Nichols Arsh & Tunnell LLP; Wilmington, DE
Matt Ochs; Of Counsel; Holland & Hart LLP; Denver, CO
Kyle Parker; Partner; Crowell & Moring LLP; Anchorage, AK

The recent dramatic drop in oil prices has touched all players in the oil & gas industry: producers, explorers, service providers, transporters, wholesalers, retailers, lenders and equity sponsors. This program will familiarize practitioners
with financing requirements and legal structures that are unique to this industry. Panelists will discuss documentation requirements common in loans to oil & gas industry players and will provide insights into challenges that face both lenders and borrowers during the course of a loan restructuring or bankruptcy proceeding.

**Friday, September 9, 2016**
10:30 a.m. - 12:30 p.m.
Program: The Legal Analytics Joint Working Group Presents - The New Paradigms: An Introduction to Legal Informatics for the Business Lawyer
Presented by: Young Lawyer

Moderator
Thomas Morante; Partner; Holland & Knight, LLP; Fort Lauderdale, FL
Program Chair
Warren Agin; Partner; Swiggart & Agin, LLC; Boston, MA

Speakers
Michael Bommarito; CEO; LexPredict; Troy, MI
Dazza Greenwood; Researcher; MIT Media Lab; Cambridge, MA
Eran Kahana; Counsel; Masion, LLP; Minneapolis, MN
Kelly Peters; CEO and Co-Founder; Beworks, Inc; Toronto, Ontario, Canada
Gurinder “Gary” Sangha; CEO; LitiQ, Inc; New York, NY

Big data, math and economics are changing business law. Our panel will examine how this came to pass, explain why lawyers need to understand these new practice methods, and demystify new tools like data analytics, machine learning, computational contracts, and behavioral economics.

**Friday, September 9, 2016**
11:00 a.m. - 12:00 p.m.
Program: An Update on Recent Legal Developments Affecting Indenture Trustees and Investors
Presented by: Trust Indentures and Indenture Trustees
Co-sponsoring Committee: Business Bankruptcy

Chair:
Kesha Tanabe
Meeting Chair
Mark Hebbein; Partner; Foley & Ladner LLP; Chicago, IL
Moderator
Shane Ramsey; Partner; Kilpatrick Townsend & Stockton LLP; New York, NY
Program Materials Coordinator
Zaina Zainal; Legal Assistant; Foley & Lardner LLP; Chicago, IL

Speakers
Beth Brownstein; Associate; Arent Fox LLP; New York, NY
Brian Morgan; Associate; Drinker Biddle & Reath LLP; New York, NY
Lars Peterson; Senior Counsel; Foley & Lardner LLP; Chicago, IL

This panel will discuss legal developments over the past year of interest to indenture trustees and investors, including the ongoing litigation in Caesars regarding TIA section 316(b), payment of indenture trustee fees and expenses in Chapter 11 bankruptcy cases, and other topics of interest.

**Friday, September 9, 2016**
4:00 p.m. - 5:00 p.m.
Program: Governance Issues of Distressed Companies Task Force
Presented by: Corporate Governance & Business Bankruptcy

Co-chairs
Rolin P. Bissell and J. William Boone  
Meeting Co-Chairs  
Brett Amron; Bast Amron, LLP; Miami, FL  
Rolin Bissell; Partner; Young Conaway Stargatt & Taylor, LLP; Wilmington, DE  
J. William Boone; Partner; James Bates Brannon Groover LLP; Atlanta, GA  
K. Tyler O'Connell; Landis Rath & Cobb LLP; Wilmington, DE  

The subcommittee will meet to discuss:

1. Recent developments involving the governance of distressed entities; 2. Progress on the multi-jurisdiction survey; and 3. Future CLE programming.

Saturday, September 10, 2016  
8:30 a.m. - 10:00 a.m.  
Program: The Implications of the Characterization (Or Re-Characterization) of Personal Property Financings Documented As Leases  
Presented by: Uniform Commercial Code  
Co-sponsor Committee: Business and Corporate Litigation and Business Bankruptcy  

Program Chair and Moderator  
Edward Gross; Shareholder; Vedder Price; Washington, DC  

Speakers  
Denise Blau; Shareholder; Vedder Price; New York, NY  
Pamela Martinson; Partner; Sidley Austin; Los Angeles, CA  

Our program will focus on the characterization (or re-characterization) of personal property financings documented as leases. The topics will include, among others: characterizations for accounting/auditing purposes (i.e., balance sheet and financial statement treatment); income tax purposes (i.e., depreciation benefits); and UCC/commercial law/bankruptcy purposes (i.e., UCC/USBC rights and priorities). The accounting characterization discussion will cover the impending changes to the accounting rules and the resulting implications regarding, balance sheet treatment of personal property leases; structural considerations; and analyzing and drafting financial covenants.

Managing Expectations: Contract Termination Rights in Bankruptcy  

By Charles M. Rubio  

Freedom of contract is the principle that individuals and entities may form contracts which incorporate their agreed terms without government interference. This principle is consistent with the parties' expectation that their agreed terms will be enforced by the courts. The Bankruptcy Code includes certain provisions that void the parties' agreed terms related to the right to terminate the contract under certain conditions.

One type of provision that is restricted by bankruptcy law is the "ipso facto" contract provisions. Ipso facto provisions are clauses in contracts that authorize a party to terminate the contract based on conditions related to the insolvency or financial condition of the debtor including the commencement of a bankruptcy case. Section 365(e)(1) of the Bankruptcy Code (11 U.S.C. §§ 101 et seq.) provides that an executory contract may not be terminated or modified, at any time after the commencement of the bankruptcy case because of an ipso facto provision. This means that even if the parties agree that either party may terminate the contract if the other party files for bankruptcy, this term is generally not enforceable under the Bankruptcy Code.

Read more...
Recent Bankruptcy Court Decision Further Constrains Lenders' Ability to Prevent a Borrower's Bankruptcy Filing

By Timothy W. Brink

Lenders sometimes attempt to prevent their borrowers from filing for bankruptcy protection to ensure that they will be able to maintain control during loan workout negotiations or enforcement proceedings. One tool commonly employed for this purpose is a "blocking" director or member - that is, a director or member appointed by the lender whose consent is required for the borrower to take the necessary corporate action to authorize a bankruptcy filing. However, the ability of a lender to utilize a blocking director to prevent a borrower's bankruptcy filing has been further constrained by a recent bankruptcy court decision declining to dismiss a chapter 11 case filed by a limited liability company without the required consent of a blocking member appointed by the company's lender. In re Lake Michigan Beach Pottawattamie Resort LLC, 547 B.R. 899 (Bankr. N.D. Ill. 2016).

Buyer Beware: The Pitfalls of Insider Claims Trading in Bankruptcy

By Eric J. Monzo

Claims trading, the buying and selling of claims of a bankrupt company, has grown greatly in recent years and has become commonplace in large chapter 11 cases. In 2012, for example, even during a slowdown in large chapter 11 filings, distressed investors bought and sold more than $41 billion in bankruptcy claims. The American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (2012-2014), p. 240, citing Dow Jones Daily Bankr. Rev., Jan. 28, 2013. Claims may be purchased for a variety of reasons. Historically, investors who purchased bankruptcy claims often hope to profit in one of three ways: (1) selling their claims within a short period of time for a profit; (2) exchanging claims for debtors' more valuable assets; or (3) effectuating a reorganization plan in which debt is traded for equity in the company. See Andrew Africk, "Trading Claims in Chapter 11: How Much Influence can be Purchased in Good Faith under Section 1126?," 139 U. Pa. L. Rev. 1393, 1394 (1990).

When Worlds Collide: Article 2 of The Uniform Commercial Code and Chapter 11

By David H. Conaway

Picture the scene: You have just received word that your customer has filed Chapter 11. You had followed my advice (see article Reducing a Customer's Accounts Receivable in the Zone of Insolvency), and put the customer on a cash-before-delivery basis and demanded assurances of performance. You were successful in reducing the accounts receivable owed, and avoiding preference liability in doing so.
Kathryn R. Heidt Memorial Award

Nomination Package and Inquiries Nominations for the 2017 Kathryn R. Heidt Memorial Award are now being accepted. The Nomination Package can be downloaded from the American Bar website. We encourage you to nominate a candidate you consider eligible for this award. For further information, or if you have any questions, please contact Sharon Weiss, sharon.weiss@bryancave.com. **The deadline for nominations is September 9, 2016.**

Kate died unexpectedly in May of 2005 at the age of 51. At the time of her death, she was the chair of the ABA Business Law Section's Business Bankruptcy Committee. This memorial award honors Kate's memory. Kate was a tenured member of the faculty at the University of Pittsburgh School of Law. She was an accomplished author, scholar, teacher, lawyer, and administrator. In addition to her leadership roles at the ABA, she served in leadership capacities at the American Association of Law School's Section on Creditors' and Debtors' Rights. She was a counselor in the truest sense of the word -- a wonderful mother, a friend to many, a dedicated mentor to students and young lawyers, and a trusted voice of wisdom. She left us too soon. This Award is designed to serve as a lasting tribute to all she was and all for which she stood and to recognize the importance of bankruptcy education and scholarship to the ABA Business Bankruptcy Committee and the bankruptcy profession.

The annual Kathryn R. Heidt Memorial Award will be conferred during the ABA Business Bankruptcy Committee luncheon at the National Conference of Bankruptcy Judges each year. The recipient will attend the Fall Meeting of the ABA Business Bankruptcy Committee to receive the award.

New Section Books

- Bankruptcy Deadline Checklist, Fifth Edition
- Bankruptcy and Intellectual Property Deskbook

Submit Article for the Business Bankruptcy Newsletter

The Business Bankruptcy Committee invites you to submit articles for possible publication in future issues. The articles do not need to be long or in-depth, and it is a great way to get involved in the Business Bankruptcy Committee. Articles can survey the law nationally or locally, discuss particular business bankruptcy issues, or examine a specific case. If you are interested in submitting an article, please contact Newsletter Co-Editors Brett D. Fallon at bfallon@morrisjames.com or Mariaelena Gayo-Guitian at mguitian@gjb-law.com.
Freedom of contract is the principle that individuals and entities may form contracts which incorporate their agreed terms without government interference. This principle is consistent with the parties’ expectation that their agreed terms will be enforced by the courts. The Bankruptcy Code includes certain provisions that void the parties’ agreed terms related to the right to terminate the contract under certain conditions.

One type of provision that is restricted by bankruptcy law is the “ipso facto” contract provisions. *Ipso facto* provisions are clauses in contracts that authorize a party to terminate the contract based on conditions related to the insolvency or financial condition of the debtor including the commencement of a bankruptcy case. Section 365(e)(1) of the Bankruptcy Code (11 U.S.C. §§ 101 et seq.) provides that an executory contract may not be terminated or modified, at any time after the commencement of the bankruptcy case because of an *ipso facto* provision. This means that even if the parties agree that either party may terminate the contract if the other party files for bankruptcy, this term is generally not enforceable under the Bankruptcy Code.

Section 365(e) is one subsection of the Bankruptcy Code that is part of an overall bankruptcy policy of protecting debtors from contract terminations.

**Bankruptcy Policies That Restrict Contract Termination Rights**

Under the Bankruptcy Code, the automatic stay is an automatic injunction imposed at the commencement of a bankruptcy case that halts a broad range of actions against the debtor (and the debtor’s bankruptcy estate). The purpose of the automatic stay is to give the debtor a breathing spell to stop collection efforts and to permit the debtor an opportunity to attempt repayment or reorganization. Prohibited activities include, among other things, “any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.” 11 U.S.C. § 362(a)(3).

Property of the estate includes a broad range of legal or equitable interests of the debtor. A contract that has not been fully performed is known as an “executory contract” and is considered property of the debtor’s estate. The debtor’s rights under such contract may be a valuable asset that can be sold or the contract may be critical for the debtor’s reorganization.

Prohibition of the exercise of contract termination rights is consistent with the purpose of the automatic stay – protecting the debtor to give it an opportunity for a successfully reorganization in bankruptcy.
Is A Termination At-Will Provision An “Ipso Facto” Provision?

Termination-at-will provisions are provisions that give each party the ability to terminate the contract for any reason, or no reason at all. These provisions are typically structured so the termination takes effect after some specified period of time after giving notice to the other party.

Outside of bankruptcy, the application of a termination-at-will provision is relatively straightforward. Generally, each party has an unfettered right to terminate the contract subject to applicable state law that may include an implied covenant of good faith and fair dealing. So depending on the applicable state law, a party may violate the implied covenant of good faith and fair dealing if it improperly terminates even if there is a termination-at-will provision.

In bankruptcy, exercising the termination-at-will provision as a result of a bankruptcy filing would conflict with bankruptcy principles underlying the automatic stay and the prohibition of *ipso facto* provisions. As a result, bankruptcy courts restrict the exercise of termination-at-will provisions in bankruptcy on the grounds that they violate the policy of Section 365(e) of the Bankruptcy Code.

What this means in practice is that a party cannot rely on a termination-at-will provision to terminate a contract when the counter-party is in bankruptcy. If a party were to terminate a contract based on a termination-at-will provision with the counter-party in bankruptcy, then the terminating party may be found to be in violation of the automatic stay and be liable for damages and sanctions. The party who wishes to terminate should seek permission from the bankruptcy court before taking any action to terminate the contract.

Automatic Stay Prevents Functional Termination

The same policies that prevent exercising a termination-at-will provision also extend to functional termination of contracts. Functional terminations occur when a contract has terms that give one party discretion on whether to proceed with a particular transaction. For example, in the bankruptcy case of *Ernie Haire Ford, Inc.* (Case No. 8:08–bk–18672–MGW, Bankr. M.D. Fla.), Ernie Haire Ford, Inc. (the “Debtor”), and several third-party automobile finance companies (“Auto Finance Companies”) were parties to contracts setting forth the terms under which the Auto Finance Companies could purchase sales contracts originated by the Debtor in connection with the sale of automobiles to the Debtor’s customers (“Contract Purchase Agreements”). Under the Contract Purchase Agreements, the Auto Finance Companies had complete discretion to accept or reject any individual transactions originated by the Debtor. The Auto Finance Companies argued that they could exercise this discretion and refuse all originations from the Debtor.

The Bankruptcy Court reasoned that if the Auto Finance Companies could reject every customer contract originated by the Debtor while accepting similar contracts meeting certain objective standards from other dealers, then the Auto Finance Companies were effectively terminating the Contract Purchase Agreements in violation of the Debtor’s automatic stay. While the Bankruptcy Court acknowledged that the Auto Finance Companies continued to have the right to apply an objective standard in reviewing each individual transaction, the Bankruptcy Court
determined that the Auto Finance Companies could not use the Debtor’s bankruptcy case as the factor in rejecting every transaction submitted by the Debtor.

This is an example of how bankruptcy courts will go beyond express termination rights in a contract to prevent parties from exercising discretion under a contract that would have the practical effect of terminating the contract.

What this means in practice is that parties in contracts with counter-parties in bankruptcy need to be cautious in exercising discretion under the contract as these actions may be considered a functional termination of the contract and a violation of the debtor’s automatic stay and of Section 365(e). The party should seek relief from the bankruptcy court before taking any action that may be a functional termination of the contract.

**Protecting Contract Termination Rights from Bankruptcy**

So how do parties protect themselves from a counter-party bankruptcy? One way is to structure contracts so that they terminate on a date certain. Bankruptcy courts have generally held that if a contract expires by its own terms then the bankruptcy process cannot be used to extend the term of the contract. However, oftentimes parties include an auto-renewal feature in their contracts. Under the auto-renewal feature, a party would have to take an affirmative action, like sending a notice, to stop the contract from auto-renewing. In this situation, if the non-bankrupt party takes such affirmative action to stop the renewal, then this action would likely be considered a violation of the automatic stay. Accordingly, parties need to be careful when drafting their contracts so that the termination provisions meet their expectations if the counter-party files for bankruptcy.

Another way for a contract party to protect itself is to be proactive. Specifically, if a party terminates the contract before the counter-party files for bankruptcy, then the bankruptcy process cannot be used to resurrect a terminated contract. See, e.g., *In re C & S Grain Co.*, 47 F.3d 233, 237 (7th Cir. 1995) (holding that contracts that had terminated prepetition were no longer executory and could not be assumed under Section 365). A proactive counter-party may be able to rely on the termination-at-will provision to cause the termination of the contract prior to the bankruptcy filing thereby avoiding any issues with the automatic stay or Section 365(e) once the counter-party files for bankruptcy.

Finally, the bankruptcy court is a court of equity and a contract party can seek equitable relief from the court related to its executory contract including (i) establishing a deadline to compel the debtor to decide to assume or reject the executory contract, or (ii) lifting the automatic stay to terminate the contract. While bankruptcy courts are generally favorable to debtors, depending on the particular facts of the case, the contract counter-party may be able to demonstrate the need for equitable relief.
Recent Bankruptcy Court Decision Further Constrains Lenders’ Ability to Prevent a Borrower’s Bankruptcy Filing

Timothy W. Brink
Meltzer Purtill & Stelle LLC
Chicago, Illinois

Lenders sometimes attempt to prevent their borrowers from filing for bankruptcy protection to ensure that they will be able to maintain control during loan workout negotiations or enforcement proceedings. One tool commonly employed for this purpose is a “blocking” director or member – that is, a director or member appointed by the lender whose consent is required for the borrower to take the necessary corporate action to authorize a bankruptcy filing. However, the ability of a lender to utilize a blocking director to prevent a borrower’s bankruptcy filing has been further constrained by a recent bankruptcy court decision declining to dismiss a chapter 11 case filed by a limited liability company without the required consent of a blocking member appointed by the company’s lender. In re Lake Michigan Beach Pottawattamie Resort LLC, 547 B.R. 899 (Bankr. N.D. Ill. 2016).

Background

The debtor, Lake Michigan Beach Pottawattamie Resort LLC, owned a vacation resort in southwestern Michigan, which it pledged to secure loans from the lender, BCL-Bridge Funding LLC. After the debtor defaulted on the loans, the parties entered into a forbearance agreement, as part of which the debtor agreed to amend its operating agreement to establish the lender as a “Special Member” of the debtor having the right to approve or disapprove any “Material Action” by the debtor, which included seeking bankruptcy relief. When the debtor defaulted a second time by failing to pay the loans in full by the deadline established in the forbearance agreement, the lender noticed a non-judicial foreclosure sale of the property. One day before the scheduled sale date, the debtor filed a chapter 11 bankruptcy petition. The debtor’s bankruptcy filing was authorized by a written consent signed by the four original members of the debtor; however, the consent was not signed by the Special Member.

The lender immediately filed a motion to dismiss the debtor’s case, arguing that it was filed in bad faith and should be dismissed for cause pursuant to section 1112(b) of the Bankruptcy Code, and that it was not authorized because it was not approved by the Special Member. The debtor opposed the lender’s motion, arguing that while the case was filed on the eve of foreclosure, there was substantial equity in the property and the bankruptcy filing was necessary to preserve that equity, prevent the lender from enjoying a windfall at the expense of other creditors and allow time for a sale or refinancing that

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1 Tim Brink is a partner in the Bankruptcy and Restructuring Practice Group at Meltzer Purtill & Stelle LLC in Chicago, Illinois. He regularly advises clients in all aspects of chapter 11 reorganization and liquidation cases and in out-of-court workouts, creditors’ rights litigation, and distressed transactions.
would pay the lender in full, and that the bankruptcy filing was authorized because the amendment was unenforceable as a matter of public policy.

The Court’s Ruling

Before addressing the unauthorized filing question, the court summarily dispensed with the lender’s argument that the case was filed in bad faith and should be dismissed for cause pursuant to section 1112(b) of the Bankruptcy Code, finding that only two of the so-called Takena factors were satisfied and that the lender’s reliance on Takena was misplaced in any event, and confirmed that the amendment to the debtor’s operating agreement in fact prohibited the debtor’s bankruptcy filing.

The court then turned to the question whether the amendment was enforceable. While noting two potentially conflicting principles - first, that corporations, like individuals, may not contract away their right to seek bankruptcy relief, and second, that state corporate law must be satisfied when a bankruptcy case is commenced - and recognizing that the practical effect of a blocking director structure may be to impair or deny the right to file bankruptcy, the court observed that the structure nevertheless “has built into it a saving grace: the blocking director must always adhere to his or her general fiduciary duties to the debtor in fulfilling the role. This means that, at least theoretically, there will be situations where the blocking director will vote in favor of a bankruptcy filing, even if in so doing he or she acts contrary to the purpose of the secured creditor for whom he or she serves.” Lake Michigan Beach, 547 B.R. at 912.

The court held that the amendment was unenforceable under both Michigan corporate law and federal bankruptcy law because the language of the amendment resulted in the Special Member having no duties to the Debtor: “The prohibition [in the amendment] has no application other than that which is impermissible under Michigan law.” Lake Michigan Beach, 547 B.R. at 914. Therefore, the court concluded, because the amendment was void the debtor’s bankruptcy filing was properly authorized by the written consent signed only by the debtor’s other members.

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2 See In re Takena USA, LLC, 419 B.R. 341, 346 (Bankr. N.D. Ill. 2009) (setting out a non-exhaustive list of factors for courts to consider on a motion to dismiss under section 1112(b) of the Bankruptcy Code).

3 The court concluded that the amendment was effective because the Michigan Limited Liability Company Act (the “Act”) permits the Act’s default “majority of interests” voting requirement to be overridden in a company’s operating agreement.

4 Interestingly, the debtor’s victory was short-lived. Almost immediately after the court’s ruling, the lender filed a second motion to dismiss, arguing that the debtor’s inability to find a replacement lender or a buyer for the property during the nearly five months that the case had been pending made the debtor’s efforts to reorganize futile. When the debtor failed to file a plan by the deadline set by the court on the debtor’s motion to extend the exclusivity periods, the court promptly dismissed the case.
Observations

While some commentators have suggested that the Lake Michigan Beach decision is a response to overreaching by the lender that will have limited application in other cases, it is nevertheless in line with the trend in the case law against enforcement of any mechanism that serves to deny the right to seek bankruptcy relief. This trend became even more pronounced when, only two months after the Lake Michigan Beach decision, a Delaware bankruptcy court denied a creditor’s motion to dismiss a debtor’s allegedly unauthorized chapter 11 filing under similar circumstances. See Intervention Energy Holdings, LLC, Case No. 16-11247, Dkt. No. 69 (Bankr. D. Del. June 3, 2016). In so doing, the court sidestepped the thorny state corporate law question of the scope of limited liability company members’ freedom to contract, and relied solely on the federal public policy of assuring access to the right to seek bankruptcy relief.
Buyer Beware: The Pitfalls of Insider Claims Trading in Bankruptcy.
By Eric J. Monzo

Claims trading, the buying and selling of claims of a bankrupt company, has grown greatly in recent years and has become commonplace in large chapter 11 cases. In 2012, for example, even during a slowdown in large chapter 11 filings, distressed investors bought and sold more than $41 billion in bankruptcy claims. *The American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (2012-2014)*, p. 240, citing Dow Jones Daily Bankr. Rev., Jan. 28, 2013. Claims may be purchased for a variety of reasons. Historically, investors who purchased bankruptcy claims often hope to profit in one of three ways: (1) selling their claims within a short period of time for a profit; (2) exchanging claims for debtors’ more valuable assets; or (3) effectuating a reorganization plan in which debt is traded for equity in the company. *See* Andrew Africk, “Trading Claims in Chapter 11: How Much Influence can be Purchased in Good Faith under Section 1126?,” 139 U. Pa. L. Rev. 1393, 1394 (1990).

The “loan to own” strategy employed by a corporate insider claims purchaser may unwittingly subject the investor to additional risk. Critics contend that such maneuvering may deny the debtor, to the detriment of its creditors, the opportunity to reorganize by favoring a sale of the company and liquidation because the motivation of the investor differs from that of original creditor. *See* Kenneth A. Rosen, Claims Trading Warps the Bankruptcy System, The Wall Street Journal, Jan. 14, 2016 http://blogs.wsj.com/bankruptcy/2016/01/14/claims-trading-warps-the-bankruptcy-system/ (“Claims trading and the allowance of claims at their face value when claims were acquired at a fraction of face value distorts the bankruptcy process.”). Insider investors, may see an opportunity to purchase claims to reduce the claims pool in order to maximize their pecuniary gain and increase control in the company and the chapter 11 process. However, such investors should be cautioned that purchasing claims may increase their risk of
having the acquired claims equitably subordinated, reduced or reclassified, or in certain cases, result in serious allegations of illegal insider trading. Generally, corporate insiders are require to either abstain from trading securities or disclose any material nonpublic information in their possession prior to trading. See e.g. Cady, Roberts & Co., Exchange Act Release No. 6668, 40 S.E.C. Docket 907, 1961 WL 60638 at * 3 (Nov. 8, 1961) (“We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment…If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.”). Courts may reduce the claims with respect to insiders or others fiduciaries. See e.g., In re MC2 Capital Partners, LLC, 2013 WL 772959 at *2 (Feb. 27, 2013), (“the exception to the general rule that transfers are to be taken at face value applies when the transferee has fiduciary duties to the debtor or the transfer is an attempt to circumvent the consequences of those duties.”); In re Papercraft Corp., 211 B.R. 813, 815 (W.D. Pa. 1997), aff’d, 160 F.3d 982 (3d Cir. 1998). A bankruptcy court may also, in its equitable discretion disallow, claims “so that any distributions to which they would be entitled [would be] redistributed to the other creditors and ultimately to the shareholders.” In re Washington Mut., Inc., 461 B.R. 200 (Bankr. D. Del. 2011), vacated in part, 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012).

In Washington Mutual, Judge Mary Walrath, while denying plan confirmation, discussed allegations of “insider trading” by certain claims purchasers. See In re Washington Mut. Inc., 461 B.R. at 255. Judge Walrath’s analysis was tailored to whether the allegations gave rise to a “colorable” claim sufficient to confer standing, in this case, the Equity Committee, to pursue
claims for equitable disallowance. *Id.* The Court, however, did discuss the relevant of trading activity in determining whether it was done based on material nonpublic information. *Id.* at 259. It is important to note that the Court did not reach a final judgment on the merits of the insider trading allegations and was subsequently vacated in part. The decision is relevant should there be a “buying spree” in claims, which may be based on information not readily publically available.

With the potential pitfalls associated with an insider purchasing bankruptcy claims, should practitioners worry more about it occurring in the context of chapter 11? In 2011, Bankruptcy Rule 2019 was amended to increase disclosures by investors that are members of *ad hoc* committees, groups, or investors otherwise acting collectively in the bankruptcy case, so that these investors are required, in these circumstances to disclose, among other things, their names, addresses, and nature and amount of each “disclosable economic interest” they hold against debtors. Further, Bankruptcy Rule 3001(e) governs the mechanics of filing and preserving transferred claims. Despite the increased disclosures and focus on the claim transfer process under the Bankruptcy Code, case law, such as *Washington Mutual*, will continue to dictate the practice of claims trading by insiders.
When Worlds Collide: Article 2 of The Uniform Commercial Code and Chapter 11
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Picture the scene: You have just received word that your customer has filed Chapter 11. You had followed my advice (see article Reducing a Customer’s Accounts Receivable in the Zone of Insolvency), and put the customer on a cash-before-delivery basis and demanded assurances of performance. You were successful in reducing the accounts receivable owed, and avoiding preference liability in doing so.

The customer, now a Chapter 11 debtor, calls and demands that you continue to ship, and resume credit terms.

The customer tells you its lawyers have advised you are required under provisions of the U.S. Bankruptcy Code to continue to ship goods and to extend credit terms set forth in the contract. The problem is there is still a prepetition accounts receivable balance and you are not certain the debtor will survive in Chapter 11. You are certainly aware that in recent years many Chapter 11 debtors don’t successfully restructure their business. Rather, “success” in Chapter 11 often means a Section 363 sale, where the assets are sold as a going concern. Many view Section 363 sales as a tool for lenders to liquidate collateral using the efficiency of the Chapter 11 process. All too often the strike price for the assets is very close to the prepetition secured debt. Understandably, secured lenders’ goals are to recover their loan, and minimize their “transactional” costs in doing so. To lenders, “transactional costs” include Chapter 11 professional fees, post-petition administrative claims and whatever they are compelled to pay on general unsecured claims. The latter may be in the form of critical vendor payments, Section 503(b)(9) claims (so-called “20 day administrative claims”), and a carve-out for dividends on unsecured claims.

Analyzing the risk of extending credit terms outside of Chapter 11 is difficult, but analyzing the credit risk of a Chapter 11 debtor is a complex calculus at best. Is there DIP financing? Is it sufficient? Is the budget realistic? Is the financing short-term, largely discretionary and terminable at will by the lender? Can the debtor pay as it goes in Chapter, or will it become administratively insolvent? Is there a critical vendor order? Will the buyer in the Section 363 sale assume the contract? What “outs” does the buyer have on its proposed purchase? Chapter 11 is the ultimate “fluid” situation requiring the consensus of multiple parties. Without certainty on these issues, it is nearly impossible to gauge the risk of post-petition credit extensions. After all, the debtors’
professionals obtained retainers to secure payment of their post-petition services, rather than accept the risk of administratively insolvency.

Despite this uncertainty, debtors insist you ship goods and extend credit terms ... because there is a prepetition contract that so provides.

**The Basis for the Debtor’s Demand**

Section 365 of the Bankruptcy Code is the basis of the demand. Section 365 provides a debtor the right to assume or reject any executory contract, which is a Bankruptcy Code term meaning simply a contract where both sides owe material performance to the other. A sales or supply contract is clearly an executory contract. Moreover, Section 365 provides:

(e)(1) Notwithstanding a provision in an executory contract ... or in applicable law, an executory contract ... may not be terminated or modified, and any ... obligation under such contract ... may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract ... that is conditioned on –

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;
(B) the commencement of a case under this title ....

(2) Paragraph (1) ... does not apply to an executory contract ..., if –

(A)

(i) applicable law excuses a party, other than the debtor ... from ... rendering performance ... and
(ii) such party does not consent to such assumption or assignment ....

Translated, if a contract contains terms that provide for termination of or cash-before-delivery credit terms, upon the insolvency of the customer or upon the filing of Chapter 11, such terms (referred to as “ipso facto” clauses) are not enforceable. **However, this provision does not abrogate rights that exist under non-bankruptcy law, such as the Uniform Commercial Code, in this instance Article 2 relating to the sale of goods.**

There is no provision in Section 365 that provides the non-debtor party (the vendor) must perform while the debtor decides whether to assume or reject. In addition, there is no provision in Section 365 that actually compels the vendor to perform. Rather, debtors rely on the language above that the contract cannot be terminated or modified after the commencement of the case.
But, this is limited to *contract* provisions that terminate or modify a contract based on insolvency or based on a Chapter 11 filing, not applicable non-bankruptcy law, Article 2 of the Uniform Commercial Code for example.

If the debtor’s position were correct (which it’s not), then any non-bankruptcy law on the subject would be inapplicable.

**The Uniform Commercial Code Article 2 Remedies for Vendors**

Vendors have two powerful tools in Article 2 of the Uniform Commercial Code governing the sale of goods:

**Section 2-609 Anticipatory Breach**

When reasonable grounds for insecurity arise with respect to the performance of either party, the other may in writing demand adequate assurances of due performance and if commercially reasonable, suspend any performance pending such assurances.

**Section 2-702(1) Cash Before Delivery Upon Buyer’s Insolvency**

Where the seller discovers the buyer to be insolvent, the seller may refuse delivery except for cash.

Section 2-609 and 2-702(1) work well together. The seller’s performance obligations, which it may suspend under 2-609, are shipping goods and providing any credit terms agreed on between the parties. If reasonable grounds for insecurity exist, the seller may suspend its obligation to ship or to provide credit terms, or both. Section 2-702(1) likewise allows the seller to sell goods on a cash basis.

If these provisions control, the vendor has the right to suspend its obligation to “perform”, ship goods and extend terms, and demand assurances of future performance by the debtor, namely pay within terms.

In addition, a Chapter 11 filing presumes the customer is insolvent, in which case the vendor may insist on cash-before-delivery payment terms, regardless of what the contract provides.
The Collision of Chapter 11 and the Uniform Commercial Code

Debtors, and their lenders, want credit terms from vendors to reduce pressure on and costs of the DIP working capital facility, and to shift some of the working capital risk to vendors. To this end, Debtors seize on Section 365.

Vendors, already facing an accounts receivable write-off and possibly a preference claim down the road, are reluctant to increase the loss. The vendor may feel some pressure to “work with” the debtor. The same could be true for the debtor, who may need the support of vendors long-term.

This debate normally takes the form of brief, but intense, negotiations over the merits of the positions. Inevitably, debtors roll out the automatic stay violation angle. Specifically, that the refusal to do business is a ruse to obtain payment on the prepetition accounts receivable. Particularly when the vendor inquires about critical vendor status. Fair enough, stay violations can be serious, and should be avoided. There is a difference, however, in seeking payment of the prepetition accounts receivable, and not increasing an already existing loss. The two are not necessarily linked. But expect debtors to up the ante to achieve a result.

When statutes are not clear, legal risk exists, and courts must decide based on cases before them. What have courts ruled?

1. In JW Aluminum Co. (M.D. Florida), the Bankruptcy Court recognized the creditors’ 2-609 demand, and that the Debtor’s response that it would have an administrative claim was not sufficient as adequate assurances of performance.

2. In National Sugar Refining Co. (S.D.N.Y.), the Bankruptcy Court ruled vendors may stop delivery of goods in transit, a UCC Article 2 remedy, without violating the automatic stay, or Section 365.

   It is illogical to suggest a seller could load a truck, commence delivery, then stop that delivery, all allowed under UCC Article 2, but cannot suspend delivery in the first instance, also allowed under UCC Article 2 (Morrison Industries, L.P., W.D.N.Y.).

3. Bankruptcy Courts have enjoined vendors from not providing goods or services, but only if the debtor could prove the debtor would be irreparably harmed, and the vendor was paid in advance.
4. One Bankruptcy Court ruled that a contract termination or modification by a vendor could violate the automatic stay, but only in the situation where the contract was viewed as property of the estate, and the debtor had already filed a motion to assume the contract.

Also, as a practical matter, if a DIP facility extends for only 60 days, extended at the discretion of the lender, it is not reasonable to force a vendor into open-ended credit terms.

**Bottom Line**

The statutes and case law favor vendors’ ability to suspend performance until adequate assurances are provided, and to utilize the UCC remedy of cash-before-delivery terms.

If debtors agree to cash-before-delivery terms, shipping goods poses little risk to the vendor and opens the door for a court to conclude that any refusal to ship on cash-before-delivery terms is designed to obtain payment of prepetition accounts receivable, which is a stay violation.

Vendors should be prepared for the debtor’s position that critical vendor status is not appropriate for vendors with contracts. This is not accurate, and presupposes the correctness of the position that vendors must ship and extend terms post-petition. If so, by definition, the vendor is not “critical”.

The interplay between the Uniform Commercial Code and the Bankruptcy Code can create uncertainty for vendors. To navigate this uncertainty it is important to understand the intricacies of the rules and how they apply to the circumstances of the particular customer, and to also stand firm on the rights of vendors set forth in Article 2 of the UCC.

Given the specter of a stay violation, advice of counsel is prudent.

We hope you found this useful and informative, and feel free to share this with others in your company. Please contact us if you have any questions about this, or any other matter.

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