

## Articles

### Late Is Never Better! Timeline to Protect Your Contract in a Market Downturn

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*Straightline*

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#### Monitoring Your Contracts

Managing financial risk demands close attention to your contracts during a market downturn. Your level of exposure depends upon market conditions, your counterparty's capital structure (and cash cushion), your counterparty's position in its corporate structure and the nature of your contract and remedies. Timing is everything—the value of a contract may be preserved by prompt action before and during a counterparty's bankruptcy.

#### Response to Financial Distress (Before Bankruptcy)

**Right to Demand Adequate Assurance.** Uniform Commercial Code (UCC) §2-609 grants you the right to demand adequate assurance of your counterparty's future performance in connection with the sale of goods.

- What triggers the right to demand adequate assurance? Many contracts identify specific grounds, such as a material drop in stock price, a downward trend or a negative outlook by a rating agency, a restatement of prior financial statements or a default under a debt instrument. Other contracts are silent on the subject. If, for example, your counterparty is giving discounts for cash payment, you hear rumors of covenant defaults, or a "market player" has suspended trading activity, you may have reasonable grounds to demand adequate assurance.
- Contractual terms. A contract may specify when performance may be suspended and define what constitutes "adequate assurance" (i.e., prepayment or issuance of a letter of credit). A pre-bankruptcy demand for adequate assurance is key. "Adequate assurance" of future performance established pre-bankruptcy will be enforced in bankruptcy. For contracts not involving the sale of goods, contractual provisions for adequate assurance are essential because no implied right to adequate assurance would be available under the UCC. Similarly, consider whether you may exercise a right to terminate, as a contract terminated prior to bankruptcy will not be revived.

**Letter of Credit.** A letter of credit offers powerful protection both before and during bankruptcy. Bankruptcy will not prevent a draw on a letter of credit issued by a third party on behalf of your counterparty. However, there is a preferential transfer risk if the letter of credit is received within 90 days (one year for insiders) before your counterparty's bankruptcy filing—another reason to request adequate assurance at the first sign of distress.

**Contractual Obligations.** In bankruptcy, creditors are paid according to priority. A bare contractual obligation is typically an unsecured claim. To increase your likelihood of payment, negotiate holdbacks, third-party escrows, guaranties, bonds, letters of credit and setoff rights. Consider obtaining a valuation or solvency opinion before entering into a transaction with a distressed counterparty. To reduce exposure for future litigation claims, ensure that you make payments to the correct entity and allocate the purchase price to the proper affiliates in a transaction. Be wary of "triangular setoffs" or netting across multiple affiliates or contracts without a master netting agreement.

**Reclamation.** Under the UCC, you have a right to reclaim goods from an insolvent buyer within ten days of receipt. If you suspect that your counterparty is insolvent, act promptly, track your goods and submit a timely demand.

#### Immediate Action After Bankruptcy Filing

**"Automatic Stay."** Most actions against a debtor are immediately and automatically stayed upon the filing of a bankruptcy petition. The automatic stay prevents you from suspending performance under a contract or terminating a contract—and "ipso facto" provisions that allow termination in bankruptcy are generally not enforceable. Creditors are typically barred from creating or enforcing liens against property of the bankruptcy estate. In limited cases, your contract may qualify for an exception to the automatic stay applicable to certain financial contracts (such as forward contracts and swap agreements) and contracts to make loans or financial accommodations to the debtor.

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**“Critical Vendor” Status.** If your service or commodity is critical to your counterparty, it is likely that your contract will be assumed and your claim paid in full, in time (often more than a year). If there is no other practical or legal solution, courts may allow “critical vendor” payments on an emergency basis early in the bankruptcy if a debtor risks losing going concern value that is greater than the payment.

**Reclamation and Administrative Claims for Value of Goods.** If your counterparty files for bankruptcy, your right of reclamation is extended to 45 days. Time is of the essence. Once the goods are resold, used or cannot be identified, your right is inferior to a lender with a lien on the goods. You may also be entitled to an administrative claim for the value of goods received by the debtor within 20 days before a bankruptcy filing, but the claim is usually inferior to a post-petition lender.

**Liens.** You may benefit from contractual or statutory liens on your counterparty's assets. For example, if you are in possession of your counterparty's product, you should hold it and immediately ask the court to allow you to offset or receive adequate protection. Beware, as possessory liens typically secure only amounts currently owing, not damages for rejection of the contract.

### Protecting Your Contract in Bankruptcy

**Assumption or Rejection.** The debtor has two options for treatment of executory contracts—assumption or rejection. Rejection of a contract creates a claim for damages, which are unsecured claims. To assume a contract, the debtor must cure existing defaults. If the debtor seeks to assume and assign your contract to a third party, you may demand proof of that party's ability to perform. Know the status of your contract, catalog the monetary and non-monetary defaults and be prepared to assert your rights.

**Setoff.** Setoff exists under common law and is also allowed in bankruptcy. However, in bankruptcy, setoff applies only to debts owed by the same parties (i.e., legal entities) in the same capacity (both pre-petition/both post-petition). Never turn over funds if you may have a right of setoff against the debtor. But likewise, never offset debtor funds without seeking court approval.

**Protected Financial Contracts.** Financial contracts are protected from the effect of the automatic stay and fraudulent transfer and preference attack (except for actual fraud). A financial contract carries with it a right to liquidate, terminate, accelerate or offset under a master netting agreement.

### Conclusion

Monitor your counterparty's financial outlook and know your rights. Understanding your contractual rights, security and remedies will allow you to move quickly if your counterparty becomes distressed or files for bankruptcy. The Financial Restructuring group at Andrews Kurth provides seasoned advice to a wide array of clients investing in, or facing, distressed situations. We have extensive experience representing clients in complex restructurings and all aspects of corporate reorganizations and distressed investing, including debtors and issuers, official and ad hoc committees of creditors and stockholders, investors, brokers/dealers and traders of debt and equity in both financial and strategic investments, secured lenders, contract counterparties, litigation trustees, and buyers and sellers of businesses and assets.