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Bankruptcy Bargaining

Negotiating with Businesses in Financial Distress

Almost everyone—buyers, sellers, lenders and borrowers—knows the risks of doing business with companies and individuals experiencing financial distress. But, given that experiencing financial distress has become the new normal, avoiding distressed situations and involvement in bankruptcies may not be realistic. And most businesses cannot afford to turn away customers or lose strategic relationships even in the face of some risk.

When entering a distressed situation, consider the following ways to protect yourself from risk and potentially turn these situations into golden opportunities:

POSITION YOURSELF PROPERLY

By the time a debtor files for bankruptcy, most creditors' recoveries are set in stone. Claims have priority based on pre-petition state-law rights, meaning secured is better than unsecured, and first priority is better than second priority. However, these rights cannot be changed after the bankruptcy has been filed. Move up the feeding chain by securing your obligations, making your contracts "bankruptcy smart," and maximizing your defenses to "claw-back" actions.

Smart lenders secure debtors' obligations or bargain for inter-creditor priorities from the beginning. Security interests, statutory liens and other state laws can protect sellers and service providers. Diligently attaching and perfecting liens can—and usually does—make the difference between being paid in full with interest and attorney's fees and recovering nothing.

Smart contractual language can improve recovery for even unsecured creditors. The Supreme Court, in *Travelers Cas. & Surety Co. of Am. v. Pacific Gas & Elect. Co.*, ruled that unsecured creditors can have an allowed claim for attorney's fees in bankruptcy if provided for in the parties' agreement. Similarly, post-petition interest, inter-creditor subordination, default interest and other valuable rights often depend on well-drafted contractual language. However, many creditors fail to have bankruptcy counsel update their documentation.

Finally, be aware that transfers received from a debtor pre-petition may be avoided and recovered, or "clawed back," by trustees as preferences or fraudulent transfers. The pre-petition course of dealing, however, can provide a defense or limit the amount the trustee can recover.

Diligence, bankruptcy-smart contracts and prudent dealing with debtors prior to bankruptcy can make the difference between sitting pretty and having no seat at all when the music stops.

PLAY BY THE RULES

Bankruptcy courts can seem complex, unfair and rule-driven to the uninitiated. Learning and observing the rules can prevent trouble and protect your interests. The most common errors are not complying with the automatic stay and not meeting deadlines.

Filing a bankruptcy petition operates as an automatic stay of almost all actions to collect debts or enforce obligations. Violations of the stay are punishable by actual and punitive money damages. If you are unsure whether an action will violate the automatic stay, consult with your counsel before acting.

Bankruptcy is also full of important mandatory deadlines. Missing deadlines can cause forfeiture of hard-fought pre-petition rights. Key deadlines include deadlines for filing proofs of claim, objecting to motions, the debtor's plan or discharge and assuming leases. Protect your rights by getting on the notice list and reviewing all of the pleadings.

BANKRUPTCY CODE BENEFITS

Within the dusty recesses of the Bankruptcy Code are hidden opportunities for savvy businesses. Two examples are post-petition debtor-in-possession lending and "free and clear" asset sales.

Earlier I mentioned parties' rights are largely set in stone pre-petition. There is one glaring exception that allows a post-petition lender to leap frog into first position. The Bankruptcy Code (section 364(d)) does allow a lender, with court approval, to obtain a so-called "super priority" priming lien ahead of a pre-petition first-position secured lender. If the value of the collateral is not at risk, this virtually assures repayment.

Post-petition lenders, sometimes called debtor-in-possession (DIP) lenders, command high interest rates, generous loan fees, payment of attorney's fees and repayment over the short or medium term.

Bankruptcy can deliver better title to assets than almost any other legal process, including foreclosure. Under the Bankruptcy Code (section 363(f)), a debtor may sell assets "free and clear" of all liens, claims, interests and encumbrances. Debtors in possession sell real estate, businesses, equipment, intellectual property and other assets often at fire-sale prices but with the code's superior protections. These protections can insulate a buyer from many of the common headaches of buying assets outside of bankruptcy, including successor liability, contractual liabilities, clouded title, lawsuits, fraudulent transfer liability, prior security interests and tort liabilities. **UB**

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