CLIENT ALERT

Credit Risks and Bankruptcy Exposure: The Importance of Implementing Mitigation Strategies and Understanding Your Rights in Bankruptcy

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The recent Chapter 11 bankruptcy filing by James River Coal was the latest reminder that mining companies continue to face unique and myriad challenges. Several factors, including the depressed global economy, tougher environmental rules and enforcement, funding and liquidity challenges, and market volatility, are causing industry-wide stress, particularly for coal companies. Trade press and pundits suggest that more mining company bankruptcies may be on the horizon. Mining industry participants should manage this distress by exploring and implementing credit and bankruptcy risk mitigation strategies. This article offers a few pre-petition mitigation measures and provides an overview of some key bankruptcy concepts and issues.

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Shore Up Credit Risks Before Bankruptcy

In these challenging times, all industry participants should assess and try to mitigate counterparty risks. It is prudent for every business to know the financial status of its counterparties, customers, and vendors. A sudden or growing trend toward late or partial payments may be an indication of potential financial troubles.

A coordinated program of business diligence and legal counseling may result in the implementation of a few steps to take (among others):

Analyze aging accounts receivable. Understanding and monitoring aging receivables is important for beginning to understand the potential magnitude of counterparty risk. There may be time to manage receivables and to react quickly to avert slippage if receivables are growing. An active receivables management program also can help reduce one's exposure in the event of a bankruptcy filing. Having aging receivables reports and account histories on hand also can be useful when negotiating for preferred vendor or critical/essential supplier treatment in a bankruptcy scenario.

Protect against preference exposure. In bankruptcy, creditors often can be made to return funds received within 90 days before a bankruptcy filing. An analysis of aged receivables, payment history, and business terms is necessary to determine whether and how a company can reduce this risk and what defenses may be available. Again, implementing a receivables management program now may help mitigate future clawback risks.

Analyze and amend current business terms. When dealing with a stressed or distressed company, it becomes increasingly important to reduce credit exposure, ensure timely payment, and protect against writing off receivables. The worst case, of

course, is to be directed to return funds already received. Delivery and payment terms, other commitments, collateral or other security, and a variety of other situation-specific terms can be amended (or enforced if they already exist) to mitigate exposure.

Consider whether an expiring contract should be renewed or allowed to lapse. When contracts are up for renewal, a company should consider whether or not to operate without a contract in place (so as not to be locked into a long-term contract) if operating on an invoice-only, month-to-month basis is a viable business option. In bankruptcy, the arrearages due on contracts are treated as unsecured claims. Generally, pre-petition receivables are only paid in full if and when a contract is assumed by a debtor. Usually, contracts are assumed late in the case in connection with confirmation of a plan of reorganization. Thus, counterparties can be required to perform under contracts while being forced to carry receivables. If the contract is rejected (*i.e.*, breached, not terminated) in the bankruptcy, then the pre-petition receivables and any breach damages will be paid in bankruptcy dollars – usually pennies on the dollar. If a contract expires according to its terms (either prior to or during the bankruptcy), then there are no performance obligations and there may be an opportunity to negotiate more favorable terms with the debtor.

Analyze and improve available rights and remedies. Depending upon the nature of the goods or services being provided and the specifics of the contractual relationship, a variety of rights and remedies may exist or be available. For example, there may be statutory lien rights, rights and remedies under the Uniform Commercial Code, common law rights, and contract-based rights and remedies, such as cross default provisions, available if the parties modify or amend their agreements. Additionally, creditors should explore and exercise any available rights and remedies under the Uniform Commercial Code, such as security interests and liens and rights of stoppage and reclamation relating to the sale of goods.

Consider other potential mitigation strategies. Any mitigation program should include a wide-ranging review of business and operational issues. In dealing with liquidity challenges, for example, it may be necessary to consider capital-raising alternatives such as joint ventures or mergers. Sales of non-core or low-margin assets and low-yield projects also may be appropriate. It also is prudent to closely monitor regulatory/compliance programs and tax creep.

Understand and Protect Your Rights in Bankruptcy

When a business suffers financial distress, most often the company needs to raise cash and restructure its debt obligations. For a variety of reasons, not the least of which may be creditor dissent, distressed companies often seek bankruptcy protection. The two basic options available under the U.S. Bankruptcy Code are liquidation in Chapter 7 and reorganization in Chapter 11. It is not uncommon for a company in Chapter 11 to effectuate a controlled liquidation of some or all of the business. For purposes of this article, we will consider a Chapter 11 bankruptcy filing in which the company is known as a "debtor in possession" because existing management usually continues to run the debtor's business operations.

Overview of Chapter 11. The Bankruptcy Code is designed to achieve two objectives. The first goal is to ensure a fair and orderly distribution of the debtor's assets (the "estate") for the benefit of creditors. The second goal is to provide an honest debtor with the ability to start over financially (*i.e.*, to obtain a "fresh start"). Chapter 11 allows a financially troubled entity to first stabilize and then reorganize its business. Certain key Bankruptcy Code sections assist in this goal and are discussed below.

Administration of the estate includes running the debtor's business during bankruptcy and necessarily involves various expenses. Administrative expenses are paid out of the assets of the estate and are given priority over other claims. This priority goes some way to protecting a vendor who supplies goods or services to a debtor during its bankruptcy.

If the debtor is able to stabilize its business operations, it will seek to negotiate a "plan of reorganization" with its creditors and shareholders. The plan will provide how "claims" of creditors or "interests" of shareholders will be treated. Either the proceeds of the estate (in a liquidation) or a portion of the property of the estate (in a reorganization) will be distributed to creditors in accordance with their respective rights and priorities. As a general rule, similarly situated creditors (*e.g.*, two unsecured vendors) will receive equal treatment, or the same percentage recovery. The claim of a secured lender may not be placed in the same class as the claim of an unsecured vendor. In return, a plan of reorganization may provide the reorganized debtor with a "discharge" of certain claims against it other than those exempted by statute or order of the court.

Before a debtor can seek acceptance of its plan from creditors and confirmation by the bankruptcy court, a disclosure statement must be sent to all holders of claims or interests. The disclosure statement must contain "adequate information," which is generally enough information to allow a reasonable investor to make an informed judgment about the plan. Creditors who will not receive payment in full, with interest, are known as "impaired creditors" and are entitled to vote to accept or reject the proposed plan. Although voting rights provide larger creditors with some leverage in negotiating the terms of a plan, a bankruptcy court may confirm a plan over the objections of dissenting creditors if the plan does not discriminate unfairly, is fair and equitable, at least one impaired class of claims accepts the plan, and the plan meets the other requirements for confirmation. Confirmation over the objection of a class is called a "cramdown." The ability to cramdown a plan allows a debtor to negotiate a plan that is acceptable to some but not all creditors.

***Important Bankruptcy Concepts*. For those uninitiated, the rights, responsibilities, and results in bankruptcy proceedings may seem as foreign as the bankruptcy jargon (*e.g.*, the automatic stay, executor contracts, core bankruptcy proceedings, Chapter 11 plans, proofs of claim, etc.) used by practitioners. Below is a brief introduction to a few important bankruptcy concepts. The following discussion is not exhaustive, as even these few concepts have intricacies that are beyond the scope of this overview.**

- ***The Automatic Stay*. Section 362 of the Bankruptcy Code – the "automatic stay" – is one of the most important provisions of the Bankruptcy Code. The stay goes into effect automatically upon the filing of a bankruptcy petition. It places an immediate stay on all actions by creditors to collect debts owed by the debtor. By doing so, the automatic stay grants the financially troubled entity breathing space and an opportunity to first stabilize and then reorganize its business without litigating numerous claims contemporaneously. For example, once a party files its bankruptcy petition, a vendor is prevented from suing the debtor to recover on an unpaid pre-petition invoice. The automatic stay also prevents a creditor from taking unilateral action to terminate a contract.**

  The scope of protection afforded by the automatic stay is broad and is applicable to all entities, which are deemed to have notice of the bankruptcy filing. There are severe consequences for violating the automatic stay. The Bankruptcy Code provides that a party injured by a willful violation of the automatic stay shall recover its damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages.

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- ***Treatment of Executory Contracts*. "Executory contracts" are contracts where the obligations of the debtor and the other party are not fully performed so that the failure of either to perform would constitute a material breach. The debtor's estate is comprised of all legal and equitable interests of the debtor in property as of the commencement of the bankruptcy case. This includes the debtor's interests in any unexpired contracts (*i.e.*, executory contracts). As a Chapter 11 debtor develops its reorganization strategy, it often seeks to shed (*i.e.*, reject) burdensome contractual obligations and preserve (*i.e.*, assume) beneficial contracts. Further, Section 363(1) of the Bankruptcy Code gives the debtor the authority to use its property, including its contracts. There are several issues and requirements in bankruptcy relating to assumption, rejection, or performance of executory contracts, a few of which are discussed here.**

  Pursuant to Section 365 of the Bankruptcy Code, the debtor can pick and choose which "executory contracts" it wishes to assume or reject, applying its business judgment. The debtor can only assume, and otherwise require performance of, contracts that are "executory" at the time the bankruptcy case is commenced. Thus, if a contract has expired by its own terms or has been terminated, there is nothing for the debtor to assume. The termination process, however, must be complete and not subject to reversal (*i.e.*, any cure period must have expired).

  Generally, the debtor will assume beneficial contracts or unexpired leases for personal and real property, and reject those that are burdensome to the estate. Importantly, a contract must be assumed or rejected in its entirety. This can be an important issue in structuring contractual relationships, whereby avoiding a scenario where a debtor retains the beneficial aspects of the relationship and sheds out of the market or otherwise burdensome obligations. It is also important to understand that rejection is simply treated as a breach – not a termination – giving the creditor a claim for damages arising immediately prior to the petition date. If a contract is rejected, the creditor is left with a claim for its pre-petition damages and an administrative expenses claim for its post-petition damages, if any.

  A court order is required for a debtor to assume or reject an executory contract. Generally, a debtor must file a motion seeking the bankruptcy court's approval. However, an executory contract also can be assumed in a Chapter 11 plan. The debtor can wait until just before confirmation of its plan to identify which executory contracts it will assume or reject. In complex cases, the time period from commencement of a case until confirmation of a plan can be a matter of years. During that period, a creditor can be required to provide services to the debtor without any firm assurance that it will be paid in full for those services, unless such party obtains a Bankruptcy Court order requiring timely payment. The creditor may move the Bankruptcy Court for the debtor to assume or reject the contract in a shorter time frame. However, such motions are seldom successful in the early stages of a bankruptcy.

  If, before assumption or rejection, the debtor elects post-petition to receive benefits under a contract from another party before assuming or rejecting that contract, the debtor must pay for those post-petition benefits. On occasion, a question arises as to whether the debtor must pay the contract price for those benefits. The Bankruptcy Code is silent and the case law is not clear about whether the debtor should pay the market value for those benefits to the estate or pay the actual price under the contract. If the estate is administratively solvent and there are sufficient assets and cash flow to pay on-going business expenses, a vendor or service provider is generally paid in the ordinary course after the initial period of the bankruptcy. Further, for a Chapter 11 plan to be confirmed, administrative expense

claims for post-petition goods and services must be paid in full. Many debtors, however, are unable to reorganize, become administratively insolvent, and are forced into liquidation under Chapter 7. If this occurs, the vendor or provider is unlikely to receive full payment for its post-petition goods or services.

As mentioned above, the automatic stay prevents a creditor from unilaterally terminating a contract. Thus, the creditor cannot terminate a contract post-petition because of a pre-petition default. Contracts often include provisions, known as *ipso facto* clauses, that seek to terminate a debtor's interest in a contract because of the debtor's bankruptcy or financial condition. Although special exceptions apply to commodity, swap, and other similar contracts, the Bankruptcy Code generally provides that such clauses have no force and effect. It is not clear if a creditor can terminate a contract post-petition because of post-petition default. However, in any event, it would be prudent to seek court approval before taking such action.

Like *ipso facto* clauses, anti-assignment provisions in contracts generally are not enforceable under Section 365(f) of the Bankruptcy Code. There are exceptions for certain contracts, such as those involving non-delegable duties and debt accommodation contracts. But generally, a debtor can assign a contract without the consent of the other party. The debtor can only assign a contract if it has been assumed and the assignee provides adequate assurance of future performance.

- *Recovering amounts due*. To participate in any recovery in a Chapter 11 proceeding, a creditor may need to file a "proof of claim," which is a form required to describe the nature and basis of the amount(s) due. The proof of claim is the mechanism for asserting pre-petition claims. Section 502 of the Bankruptcy Code precludes each unsecured, pre-petition creditor, including an undersecured lender, from accruing interest on its claims after the petition date. This allows a business in Chapter 11 to increase its cash flow by deferring (or in some cases eliminating) the accrual and payment of interest after a bankruptcy filing. If other amounts become due after a bankruptcy is filed, then a creditor may file a request for payment of an administrative claim.

  The bankruptcy court will set a bar date or deadline by which all proofs of claims must be filed. A creditor should automatically receive notice of the bar date, which generally occurs some months into the bankruptcy. It is always worthwhile, however, to check with debtor's counsel or the bankruptcy court to see if the bar date has been set. In certain circumstances, when a Chapter 11 debtor properly lists a creditor's claim in its bankruptcy schedules and the claim is not disputed, contingent, or unliquidated, a creditor may rely on the debtor's schedules. However, a proof of claim for the pre-petition amount(s) owed should be filed as a matter of course.

  If the debtor's plan of reorganization is successful it will provide for the treatment of pre-petition claims. The percentage of recovery will depend on the case: it could be 100 percent; it could be nothing, or a few pennies on the dollar. The creditor is only paid upon the completion of the bankruptcy, which could be a matter of months or years. Furthermore, there is a priority scheme for distributions in bankruptcy and unsecured creditors may not be paid before certain other creditors, such as holders of administrative claims and secured claims. If the debtor is forced into Chapter 7, an unsecured creditor may not receive any distribution on account of its claim.

- *Clawback risks – preferential and fraudulent transfers*. Under the Bankruptcy Code a Chapter 11 debtor has certain "avoidance powers" that allow the debtor to recover certain transactions made by the debtor prior to the filing of the bankruptcy petition, which are known as preferential transfers and fraudulent transfers. Once recovered, these transfers will be included in the debtor's estate for the benefit of all creditors.

  Technically speaking, a preferential transfer is a transfer by the debtor to a creditor made within 90 days of the petition date on account of an "antecedent debt" that enables the creditor to receive more than the creditor would have received if the debtor's estate had been liquidated. In other words, if a creditor receives a payment on a debt within 90 days of the bankruptcy that is received outside of the ordinary business terms of the parties, such payment may be recoverable by the debtor.

  A creditor may assert certain defenses to a preferential transfer, such as that the payments were in fact made in the "ordinary course of business" or that the bankruptcy estate received an equal benefit in return for the transfer. For example, a payment to a supplier will not be recoverable by the debtor, if, after the payment is made, the creditor transfers new supplies to the debtor equal in value to the payment received.

  The avoidance of preferential transfers serves to deter creditors from taking action on the eve of bankruptcy that improves their position with regard to other creditors. From a creditor's perspective, it may be prudent to collect as much as possible from a debtor before any bankruptcy. If and when a debtor later files for bankruptcy protection, a creditor may litigate or settle the matter of how much, if any, of the pre-petition amounts collected must be returned to the debtor's estate.

  In addition to preferential transfers, a Chapter 11 debtor may seek to avoid fraudulent transfers. A fraudulent transfer is a transfer of property that has the effect of improperly placing assets outside the reach of creditors. Fraudulent transfers are generally recoverable from the party causing the fraudulent transfer or the recipient of the transfer. And the period of time in which a Chapter 11 debtor may look back to avoid transfers is two years under the Bankruptcy Code and can be longer under applicable state law.

  Absent actual fraud, in the context of commercial parties dealing with each other at arms' length, one may believe that fraudulent transfers should not occur. However, a one-sided or really good deal made by an insolvent debtor may be unwound as being constructively fraudulent where, for example, assets of the debtor are sold to a third party for no consideration or substantially less than market value. Some transfers may appear to be legitimate transfers, but are in reality fraudulent transfers recoverable by the debtor. For example, if a creditor receives a payment from an insolvent debtor for a debt owed by another entity (such as a solvent affiliate), the transfer may be fraudulent. In that situation, the debtor has diverted assets of the insolvent debtor without the debtor receiving any benefit in return for the payment. Therefore, it may be prudent for a creditor to only accept payment from the party with whom the creditor has contracted to do business.

- *Other issues*. When a counterparty files for bankruptcy protection, it is important to promptly gather all related documentation and information related to the relationship and to obtain a prompt assessment of the situation,

including each party's rights and responsibilities. There may be a variety of rights, remedies, defenses, and potential pitfalls to consider. For example, a party may request "adequate protection" of its rights when a debtor is using, selling or leasing property, borrowing against property, or when a creditor is otherwise stayed from enforcing its rights or interests. Adequate protection may be in the form of periodic payments, additional or replacement liens, or other relief depending on the circumstances. A creditor also may seek to exercise certain rights such as recoupment, setoff, or reclamation.

Conclusion

Although financial distress and bankruptcy are nothing new to the mining industry, the current economic environment is a reminder to creditors to remain vigilant about credit risks. Planning for and dealing with a party suffering financial distress can be complex and nuanced. Now is the time for mining companies to have wide-ranging discussions to develop and implement mitigation strategies.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.