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DOING BUSINESS WITH BUSINESSES AND FINDING VALUE IN CHALLENGED COMPANIES

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Panel



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Reducing Credit Exposure

- Sell on COD, in whole or part
 - Well-planned partial CODs with new shipments can substantially reduce preference exposure
- Reduce credit terms
 - But, be cognizant of preference risks – doing sooner rather than later helps
- Get deposits or advance payments
 - Reduces preference exposure
 - Can create setoff and recoupment rights
- Get letters of credit
- If selling goods, consider selling with purchase money security interests (“PMSI”)¹¹



- Obtain junior liens
 - on specified assets
 - as a part of second lien group
- Consider getting guarantees, but watch out for fraudulent transfer concerns^[2]
- If selling goods, consider selling on consignment^[3]
- Provide in sale, credit and related agreements that if seller, servicer, party with credit risk becomes “insecure” about creditworthiness of its customer, debt may be accelerated or additional collateral may be sought; *see* U.C.C. §§ 1-208, 1-309, 9-102(a)(19)-(21), 9-319
- Consider “sale on approval” *see* U.C.C. §§ 2-326(1)-(2)

- Carefully prepare default, termination and cure provisions in agreements and enforce them
- If incorporating policies and procedures into invoices or other documentation, make sure other parties know terms and send reminders
- Carefully consider inclusion of “evergreen clauses”
- Obtain credit insurance
- Set-up escrows
 - Payment funding mechanism
 - To hold assets, in particular technology

Technology Escrows

- Most commonly used for source code but can cover schematics, manufacturing packages and chemical formulas
- Escrow agent as the third part in the contract
- “Supplementary Agreement”
- Trigger events defined in the escrow agreement

Involuntary Bankruptcy Filing

- To be successful petitioning creditor claims cannot be subject of *bona fide* dispute as to liability or amount; *see* 11 U.S.C. § 303(a)-(b)
- Petitioning creditors are subject to sanctions if “order for relief” is not entered; *see* 11 U.S.C § 303(i)

Impact of Automatic Stay

- Default and termination notices under a contract sent prior to commencement of a bankruptcy case (“prepetition”) which by its terms expires after case began (“postpetition”) is enforceable
- All efforts to collect on prepetition claims are prohibited, except through filing of proof of claim or setoff/recoupment request
- Postpetition default and termination notices cannot be sent without obtaining relief from stay
- If agreement expires by its own terms postpetition, bankruptcy will not continue effectiveness of agreement, unless agreement contains an “evergreen clause”

Arbitration Provisions

- Bankruptcy courts often will enforce arbitration provisions, but generally not if issue arises under Bankruptcy Code

Prepetition Reclamation

- Seller of goods may reclaim and get back goods, if buyer received goods on credit while it was insolvent, and demand is made within ten days of receipt of goods (but, if written misrepresentation regarding solvency was made within three months of receipt, ten day limit does not apply)
- Return is subject to rights of buyer in ordinary course; *see* U.C.C. § 2-702

Postpetition Reclamation

- A vendor may reclaim goods sold in the ordinary course during the 45 days before a debtor files its petition, if debtor was insolvent when shipment made
- A vendor must demand return in writing, but now has 45 days after the debtor received them to do so, or 20 days after the filing of the petition, if the 45-day period expires postpetition
- Alternatively, claims for goods received by a debtor in the ordinary course of business within 20 days of the petition filing receive administrative expense priority, regardless of whether written demand was made
- Rights subject to security interests in goods at issue
- *See* 11 U.S.C. §§ 503(a)(9), 546(c)

Doing Business with Businesses in Chapter 11 Proceedings

- Cannot change prepetition credit terms, but enhanced credit terms for postpetition sales, services, license fees, other postpetition transactions may be obtainable
- CODs often increase or begin
- Critical vendor status remains selectively available
 - Expect prospective commitment to be required
- Try to get superpriority administrative status
 - Usually limited to lenders and professionals
- Can enter into new agreements postpetition, will require court approval if “out of the ordinary course of business”; *see* 11 U.S.C. § 363(b)

- At a minimum, have administrative expense status for postpetition sales and services and other postpetition transactions, at fair value
- Can seek to compel immediate overdue payments, but might be payable at end of case, and then *pro rata* with other unpaid administrative expense creditors, if any
 - If relying on administrative expense status, keep credit terms short

Assumption and Rejection of Executory Contracts and Unexpired Leases

- Most common definition of executory contract: contracts on which performance remains due to some extent on both sides
- Non-debtor party to executory contract or lease has right to object to assumption or rejection
- Courts rarely deny rejection
- Debtor in possession/trustee is to pay for reasonable use and occupancy pending assumption or rejection, but for tenants in non-residential real property leases, rent and other obligations must be satisfied though court may suspend obligation for first 60 days of case; 11 U.S.C. § 365(d)(3); and must satisfy unexpired personal property lease terms after first 60 days of case, unless otherwise ordered; 11 U.S.C. § 365(d)(5)

- Impact of rejection is that contract or lease is deemed breached, and non-debtor party gets resulting prepetition rejection damage claim for amount due under agreement, subject to certain limits, including for landlords and employees for termination claims; *see* 11 U.S.C. § 502(b)(6)-(7)
- Assumption requires cure of monetary defaults, demonstration of adequate assurance of future performance and satisfaction of “business judgment” standard; 11 U.S.C. § 365(b)
- Unless otherwise ordered, debtor in possession or chapter 11 trustee may seek to assume executory contract (not including real property leases until confirmation of a plan; 11 U.S.C. § 365(d)
- Time for assumption of real property lease is within first 120 days of case, subject to 90-day extension for cause, or longer, but then only with landlord’s consent; 11 U.S.C. § 365(d)(4)

Intellectual Property Licenses

- IP licenses are treated as executory contracts and may be assigned, rejected or assumed and assigned subject to certain limitations; 11 U.S.C. § 365(n)
- Exception: if “applicable law” excuses the non-debtor from accepting or giving further performance under the “hypothetical test” the agreement may not be assumed by the debtor
- Executory: affirmative obligations to pay royalties, keep records, perform ministerial tasks, forbear from licensing other parties, or duty to defend infringement suits
- The licensee may elect to retain certain rights (even when the court approves rejection of the license by the debtor/licensor)
- Licensee rights under exclusivity provisions and rights to retain embodiments of IP will be enforced



- Specific performance of provisions that impose affirmative duties upon debtor – licensors will not be enforced (defending infringement claims or providing support or maintenance)
- Licensees must continue to make royalty payments and waive rights of set-off or administrative claims
- Applies to trade secrets, inventions, processes, designs or plants (under U.S.C., Title 35), patent applications, plant varieties and works of authorship and master works (under U.S.C., Title 17)
- Does not cover executory trademark, trade name or service mark licenses



Enforceability of Anti-Assignment Provisions Generally

- Usually not enforceable; 11 U.S.C. §§ 365(c), (f)
- Not assignable if applicable non-bankruptcy law would excuse party from accepting performance from or rendering performance to entity other than debtor; 11 U.S.C. § 365(c)(1)(A)
- Examples where non-assignability provisions enforced:
 - personal service contracts
 - loan, debt financing, financial accommodation
 - distributorships
 - certain partnerships
 - government contracts, if assignment is prohibited by statute

Enforceability of *Ipsa Facto* Clauses

- Generally not enforceable, except 1) non-assumable contracts, and 2) contracts to make a loan, extend debt financing, or provide a “financial accommodation”, exception does not include ordinary extension of trade credit; 11 U.S.C. § 365(e)

Bankruptcy Remote Entities

- 365(n) does not extend to licenses of IP rights sourced outside the US
- Global economy drives 40% of revenue in most companies
- The BRE serves as the (back-up) licensor and is set up to minimize the likelihood of the BRE becoming a debtor

- Example: Delaware corporation with operational covenants in the charter documents to ensure the separate legal and operational existence between the financially distressed parent AND BRE (avoid substantive consolidation with the debtor associate)
- Use of separate facilities, shareholder rights, independent covenants that restrict the ability to incur guarantee, pledge or indemnification obligations (to avoid nonconsensual bankruptcy petitions)
- Transfer of IP issues
- BREs also used to hold real property and other distinct assets

Acquiring Assets From Companies Doing Business in Chapter 11

- Value of “free and clear order”
- Sales subject to higher and better bids
- Break-up fees commonly approved
- Creditors as ally of prospective buyers
- Post-closing price adjustments

Additional Comments on Avoiding and Defending Preferences and Fraudulent Transfers

- Elements of a preference cause of action are:

With limited exceptions, any transfer of an interest of the debtor in property

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;
- (4) made--
 - (A) on or within 90 days before the date of the filing of the petition; or
 - (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

- (5) that enables such creditor to receive more than such creditor would receive if--

- (A) the case were a case under chapter 7 of this title;
- (B) the transfer had not been made; and
- (C) such creditor received payment of such debt to the extent provided by the provisions of this title; 11 U.S.C. § 547(b)(1)-(5)(C).

- Don't accept presumption of insolvency in all cases
- Not all payments are made on antecedent debt, *e.g.*, CODs, deposits, advances, retainers are not on antecedent debt
- Payments from non-debtors are not avoidable as preferential transfers (but watch for fraudulent transfer concerns)

- Non-debtor guarantees against preference recoveries are not avoidable as preferential transfer (again, watch for fraudulent transfer concerns)
- Stick to terms, don't let payments fall behind
- If payments start to slip or amount outstanding otherwise increases, or otherwise fear financial problems may be ahead, consider changing credit terms fast
- Combination of CODs and credit, with reductions in future shipments can limit exposure
- Most creditors rather get payments and possibly fight over preference later

- Return of goods and grant of collateral can be preferential transfers
- Primary focus in most preference adversary proceedings is on ordinary course and new value affirmative defenses
- Now, to prevail in ordinary course defense need only show ordinary in industry or ordinary between parties; 11 U.S.C. § 547(c)(2)
- Contemporaneous exchange of "new value" means money or monies worth in goods, services or new credit, release of property previously transferred in unavoidable transaction (excluding substitution of obligations); 11 U.S.C. §§ 547(c)(1), (4)
- Other affirmative defenses
 - certain grants of collateral; 11 U.S.C. §§ 547(c)(3), (5)
 - fixing certain statutory liens; 11 U.S.C. § 547(c)(6)
 - earmarking
 - maybe, set-off

Fraudulent Transfers

- Actual fraudulent transfer: to hinder, delay or defraud present or future creditors; 11 U.S.C. § 548, uniform state laws
- See Footnote 2 for elements of “constructive” fraudulent transfer cause of action
 - Reasonably equivalent value is a fact question on which courts have latitude, courts look at entirety of circumstances, can be less than fair market value
- Guarantee issues
 - upstream v. downstream
- Cross-collateralization
- Potential liability of subsequent transfers
- State fraudulent transfer statutes enforceable in bankruptcy case



Footnotes:

- [1] Requirements for a PMSI are:
1. There must be a writing between seller and customer granting a PMSI in specified goods.
 2. A financing statement containing the exact corporate name of the customer and a description of the goods in which a security interest is being granted must be prepared, signed by the customer (unless the writing granting the PMSI authorizes seller to file financing statement), and filed with the Secretary of State of the place of organization of the customer.
 3. A written notice must be sent to all holders of pre-existing security interests in the customer’s inventory or generalized categories of personal property, indicating that seller has or intends to have a PMSI in the goods sold. This notice will only be effective as to products delivered after the notice has been given. *See* U.C.C. § 9-324(b)(3).
- [2] A transfer is avoidable as a “constructive” fraudulent transfer under the Bankruptcy Code if:
- (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or



[2] (continued)

(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligations; and

(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;

(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or
11 U.S.C. § 548(a)(A)-(B)(III).

Most states have substantially similar statutes.

[3] To have an effective consignment, consignor and consignee should agree in writing, among other things, that consignee is agent for consignor, all money collected and held on consigned goods is property of consignor and held for benefit of consignor. *See* U.C.C. § 2-326(4); 9-102, (19)-(21); 9-319.



SARA CHENETZ is involved in complex bankruptcy restructuring, workout, and litigation matters throughout the country.

On behalf of official and unofficial creditor, bondholder, equity and retiree committees, creditors, bondholders, equity holders, lenders, insurers, trustees, vendors, indenture trustees, lessors, asset purchasers, landlords, tenants, shareholders, directors, executive employees, pension plans, and others, Sara has formulated and implemented restructuring and litigation strategies, including those involving out-of-court workouts, the termination of exclusivity, formulation of alternative plans, commencement and defense of fraudulent transfers, equitable subordination, breach of duties, recharacterization of debt as equity, complex preferences, substantive consolidation, relief from stay, dismissal of cases and non-dischargeability of debts, and has contested and championed DIP financing, use of cash collateral, grant of adequate protection, asset sales, disclosure statements, and confirmation of plans. A large majority of these cases ultimately resulted in the confirmation of consensual plans of reorganization in which our clients often received greater value than they had expected early in the case.

Sara has advised individuals and businesses, including potential debtors, their lenders, investors, owners, and potential asset acquirers on the benefits and detriments of the commencement of bankruptcy proceedings and alternatives. Sara has worked with businesses in a myriad of industries.

She has been designated a Southern California Super Lawyer in both 2005 and 2006, as the result of research projects conducted jointly by *Law & Politics* and *Los Angeles* magazines.

Sara is admitted to practice in all state and federal courts in California, New York and New Jersey. She received a B.A., magna cum laude from the University of Massachusetts at Amherst and a J.D. from American University.

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