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PIECES OF THE PUZZLE

A Newsletter from Arnold & Porter's Private Client Services Team

December 2014

Bankruptcy 101 for Investors

First in a Series of Articles on Bankruptcy Issues

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For many investors, business bankruptcy is a mysterious black box that chews up investor and creditor value and then spits out assets or, occasionally, a reorganized operating company. In this series of articles, we are going to open up that box and shed some light on the processes of bankruptcy. After all, you never know what business will file next. It is best to have some understanding of the nature of the game – and to be as well-armed as possible.

This first article addresses the situation where your Monday starts with the news of the chapter 11 bankruptcy filing by that nifty biotech start-up TechCo for which you contributed capital, provided a secured loan, and then got talked into providing a guarantee for some additional funding. First things first:

- What are the fundamental principles governing the "bankruptcy world"?
- What are the immediate effects of the filing for you as an investor and creditor?
- What steps should you take to protect your interests at the early stages of the case?

Subsequent articles in this series will discuss (i) the restructuring process in chapter 11 cases; (ii) advance planning and risk assessment for creditors and investors; (iii) early warning signs of financial stress for a business and steps for an investor or creditor to consider before a bankruptcy filing happens; (iv) affirmatively using bankruptcy to restructure portfolio companies; (v) tax consequences in the event of business failure; and (vi) alternatives to bankruptcy.

First principles of bankruptcy: A business bankruptcy case can best be characterized as a class action by the debtor against all of its creditors, compelling them to stand still, while the debtor's management (or, in some cases, a court-appointed trustee) determines whether the business should be salvaged, sold, or shut down. Bankruptcy court decisions are generally guided by the following fundamental principles:

- Goal of a consensual plan: "Success" in a chapter 11 case under the Bankruptcy Code is defined as confirmation of a consensual plan of reorganization. This means bankruptcy is all about "let's make a deal."
- Maximizing value of the bankruptcy estate: The process is intended to maximize the value of the assets and the business, and thus to repay creditors as fully as possible.
- Parity of treatment: Similarly situated creditors should receive comparable recoveries, after taking into account any payments they received before the bankruptcy filing while the debtor was arguably insolvent.

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These principles sometimes clash with creditor or other interested parties' legal rights under state or federal law, even where the bankruptcy process is supposed to give effect to those rights.

Thus you can expect to face resistance in bankruptcy court if you are either fighting to carve out certain assets (such as intellectual property licenses or collateral for your loan), or to achieve a much higher recovery than other apparently similar creditors, or to exercise or keep control of the debtor entity. The key to an effective bankruptcy strategy will likely be to leverage your legal and equitable arguments to block or facilitate the process, thereby obtaining the best outcome possible in a difficult situation. In your original transaction documents, you should try to arm yourself with the most and best tools and weapons that you can, against the possibility that the other side's financial wheels fall off at some point in the future.

Who can file bankruptcy: Almost any person or entity – including corporations, partnerships, LLCs and LLPs – can file a bankruptcy petition in the blink of an (electronic) eye, because the federal bankruptcy courts are available on a 24/7 basis. These courts have exclusive jurisdiction over bankruptcy cases under the U.S. Constitution; states are prohibited from impairing contracts. The debtor does not even have to be insolvent; just in financial crisis with a purported good faith intention to restructure or discharge debts.

Who is most likely to file: Most business bankruptcy filings result from one or more of the following circumstances: (i) undercapitalization, especially for start-ups or development stage companies; (ii) adverse litigation judgments that may threaten seizure of cash or disruption of business operations; (iii) inability to refinance loans, especially common in a recession; (iv) a general decline in the particular industry sector; or (v) overexpansion. Usually contributing to the problems are mismanagement or an inability of management to transition to a new business model in a changing environment. The key initial question: is the core business still viable, provided it receives debt relief – or is the business truly terminal?

Different types of business bankruptcy cases: Businesses can file a bankruptcy petition under either chapter 11 or 7. In a chapter 11 case, existing management retains control and usually continues to operate the business during the case. The goal is usually a plan of reorganization or sale of all or substantially all of the business as a going concern. In contrast, in a chapter 7 case, a trustee is immediately appointed to shut down the business, and liquidate any assets. Most chapter 7 cases result in no distributions to unsecured creditors. Usually businesses are already quite dead by the time of a chapter 7 filing.

Immediate impact -- the automatic stay: The Bankruptcy Code's automatic stay takes effect *automatically* when a debtor files bankruptcy. The automatic stay is designed to give the debtor a "breathing spell" from its creditors. It prevents creditors from exercising remedies against a debtor or its property. Subject to some exceptions, this bar also applies to giving notice of default or termination of contracts. Willful violations of the automatic stay can result in the imposition of damages and/or sanctions. Even an inadvertent violation may undermine a creditor's position with the court.

What to do if you are notified of a bankruptcy filing: If the debtor lists you as a creditor, contract counterparty, equity holder or other interested party, you should receive notice of the bankruptcy filing. However, sometimes the entity named as the debtor may not match your records. Be sure to investigate; don't assume you received the notice by mistake. The name may have changed, or assets may have been transferred to another entity.

Upon receiving any notice of a bankruptcy filing, stop any enforcement actions against that debtor. Don't send any default notices. Don't terminate any contract. However, you can stop making any further cash or credit advances under lines of credit. And you don't have to sell on credit terms; you can insist on COD sales if you are selling goods or services on a one-off invoice basis. Beware that, if you have an ongoing contractual relationship with the debtor, you should consult with counsel before taking any steps to modify terms.

Should you get involved in the case?: If your interest in the debtor is relatively minimal or you view it as a lost cause, then you may simply want to monitor developments and file a timely proof of claim. But if you could be significantly impacted, then you or your counsel should review the "first day filings" that usually describe why the debtor filed and what it intends to do in the case. You may need to retain counsel and appear promptly to object to proposed actions that could adversely affect your collateral, position, or other interests and rights. Bankruptcy cases often proceed extremely quickly and your relative rights could be determined within the first month or two. Don't delay.

What you can expect in the TechCo case: If TechCo follows the typical path of a start-up company's chapter 11 case, you are probably looking at the following effects:

- *Definite bad news*: Your capital contributions are likely a complete loss; equity holders are almost always entirely out of the money.
- *Almost as bad news*: You will probably obtain very limited recovery on any unsecured loan – usually just pennies on the dollar, also known as "bankruptcy dollars."
- *Good news*: On the other hand, if you had the foresight to insist that your loan was properly secured by TechCo's patents, you may succeed in obtaining substantial (or even complete) repayment, either upon sale of TechCo's assets or over time, if TechCo finds funding to enable it to reorganize.
- *Bad news*: On a emergency basis, as the secured lender, you find yourself pressured to provide initial funding for the business operations, for example, to pay for electricity and other utilities to keep the laboratory mice alive and preserve TechCo's value. The tough question: is it worth throwing "good money after bad"?
- *More bad news*: As TechCo's guarantor, you can expect to be sued by the creditor holding the guarantee. The automatic stay does not protect nondebtor guarantors of a debtor's debt.
- *Possible bad news*: A fight may develop over rights in TechCo's patents. If your loan is secured by the patents, you may have a direct stake in that fight.
- *Even more (possible) bad news*: Depending upon TechCo's organizational structure, you may face tax consequences from cancellation of debt or other side effects.

Next in the series: Chapter 11 outcomes: what happens to the business vs. what happens to creditors