

KENTUCKY BAR ASSOCIATION LAW UPDATE 2009
“Déjà vu: Bankruptcy and Debtor/Creditor Issues in Today’s Troubled Economy”¹

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I. Introduction

The over-arching goal of all debtor/creditor situations is to attempt to extricate both sides from a potential (or existing) mess, to maximize recoveries for the benefit of all involved, and to avoid a meltdown situation. Today’s economic woes present the latest cycle of debtor/creditor disputes. During the economic good times, many poor operational issues were covered up and “fixed” by attaining another layer of debt. Now that the cash has dried up, debtor/creditor workouts, litigation, liquidations, and bankruptcy have returned to the forefront, and what’s old is new again. It’s not rocket science – distressed companies and financially strapped individuals, as well as their creditors, have only a limited number of financial solutions and a short window of opportunity during which to attempt to choose the best one. Help your clients to choose wisely based on their particular facts and circumstances.

II. Knowledge Is Power

From the initial phone call through the final case closure, working through debtor/creditor issues is often an evolution and not necessarily a static right or wrong answer. Both debtor counsel and creditor counsel need access to as much accurate data and information as is humanly possible in order to properly analyze options and consequences which will flow from various actions as well as inactions. Obtaining accurate and complete data is key – an incomplete, or worse, an inaccurate analysis may doom the work-out from the outset and produce less-than-optimal results for the client.

A. Several key questions to analyze and answer

1. Review of all relevant documentation, including perfection
2. Status of each current credit: default; how long past due; maturity date; litigation pending; judgment; collection efforts

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3. Priority among competing creditors

B. Document Review

1. Perfection defects?
2. “Course of Dealing” outside documents

C. “Default” or not – “deemed insecurity” clauses

D. Collateral and Value of Collateral

1. Costs and amount of time to liquidate
2. Carrying costs
3. Valuation estimates

E. Financial Reporting

1. Cash is King – the 13-week rolling cash-flow projection
2. Adequate internal controls
3. Where is bank account? “Freeze” and set off concerns.

F. Lender Liability Concerns/Strategies

1. Same common theories still exist: breach of contract; breach of commitment to lend; breach of duty of good faith and fair dealing; control; breach of fiduciary duties/aiding and abetting; negligent misrepresentation; duress; promissory estoppel; fraudulent misrepresentation
2. New life:

- “Loan to own” and excessive control/ “Creditors in Possession”
- “Zone of insolvency”
- “Deepening insolvency”
- “Improvident lending”

3. Kentucky cases

- *DeJong v. Leitchfield Deposit Bank*, Ky. App., 254 S.W.3d 817 (2008)
- *Taylor v. First Sec. Trust Bank, Inc.*, Ky. App., 2008 WL 4267847 (2008) (unpublished) (“Unpublished opinions shall never be cited or used as authority in any other case in any court of this state. See KY ST RCP Rule 76.28(4).”)
- *Associated Warehousing, Inc. v. Banterra Corp.*, 2008 WL 4180260 (W.D. Ky. 2008)
- *Durbin v. Bank of the Bluegrass & Trust Co.*, Ky. App., 2006 WL 1510479 (2006) (unpublished)
- *Farmers Bank and Trust Co. of Georgetown, Kentucky v. Willmott Hardwoods, Inc.*, Ky., 171 S.W.3d 4 (2005)
- *Sallee v. Fort Knox Nat’l Bank, N.A.*, 286 F.3d 878 (6th Cir. 2002)
- *Ranier v. Mount Sterling Nat’l Bank*, Ky., 812 S.W.2d 154 (1991)
- *Steevest, Inc. v. Scansteel Service Center, Inc.*, Ky., 807 S.W.2d 476 (1991)
- *Bale v. Mammoth Cave Production Credit Ass’n*, Ky., 652 S.W.2d 851 (1983)
- *Henkin, Inc. v. Berea Bank and Trust Co.*, Ky. App., 566 S.W.2d 420 (1978)

G. What is The Ultimate End-Game?

1. If you can envision yourself after this is all over, what does it look like?

III. Communication Skills, the Lifestyle Factor and Attempts at Client Control

- Trustworthy, “honest but unfortunate” forthcoming debtor
vs.
- Arrogant, controlling, evasive, head-in-the-sand debtor
- Dinner and golf at the country club – bankers and borrowers
- “Deer in the Headlights” borrowers who cannot move
- Email precautions

IV. **Professional Assistance and Cost Factor**

A. Counsel

1. Credibility is what professionals are selling
2. “Reconstructing reality” is what we do as lawyers, weaving the story
3. “...the first thing we do, let’s kill all the lawyers.” *Henry VI, Part II, (Act IV), Scene 2, William Shakespeare*

B. Accountant/Financial Advisor

C. Crisis Management/Turn Around Consultant

1. “Control” is THE key issue

V. **Workouts**

A. Documentation concerns

1. Pre-negotiation Letter
 - a. No binding agreement until fully reduced to writing
 - b. Negotiations do not waive existing or future defaults
 - c. Negotiations are not a binding commitment to lend
 - d. “Settlement” discussions – FRE 408
2. Forbearance Agreements
 - a. To sign or not to sign, that is the question?

- b. Why? “Negotiating” a forbearance becomes the be all, end all, rather than addressing the ultimate exit strategies – “forbearing” to do what, exactly? Prolonging the situation or addressing a solution?

3. Objectives

- a. Acknowledgment of debt and status (balance, interest, default interest, fees, charges)
- b. Validity and perfection of liens
- c. Information sharing
- d. Release of claims – controversial

- B. Multiple Creditors and Rights

1. Secured – usually still traditional banks in Kentucky, but seeing more “private equity” lenders and other non-traditional lenders
2. Administrative and priority – taxes, landlords & others
3. Trade and other unsecured
4. Equity

- C. Finding the Decision-Maker – Oh where, oh where can he be?

1. Loan “servicers”
2. Banks – “work-out” departments?
3. Proper party in interest – “bundling” / slicing & dicing
4. Loan Participations / Lender Intercreditor Agreements
 - a. Duties of “Lead” Bank to Participants

- b. Who has contractual relationship with whom?
Who controls decision-making?
 - (i) Co-lenders to borrower?
 - (ii) Lender to lead lender?
 - (iii) Buyer of piece of a credit?

5. The Omnipresent “Regulators”

D. Options

“Workouts” generally have only so many possible outcomes. There is no “magic bullet” where all troubles magically disappear. Both sides must remain focused on the ultimate end-of-the-day exit strategy. This may include:

1. Refinancing existing debt with a new lender
2. Restructuring existing debt with current lender
3. Sale of the business as a going concern
4. Joint venture, merger, or other new capital investors
5. Selling off excess assets or non-core parts of the business, as going concern or individually
6. Complete liquidation and wind-down of the entire business and its assets
7. Consensual reorganization or liquidation through bankruptcy
8. Cram-down reorganization or liquidation through bankruptcy

VI. Bankruptcy

A. End of the Road – or the Yellow Brick Road?

1. “Work-Out” implies a process that results in a consensual, non-court-involved resolution among various parties in interest

2. “Bankruptcy” is the dirty word – a threat, an ultimatum, a last-ditch effort **OR** merely the last stage of the consensual workout with someone
 3. Filing of involuntary petition by creditors is always a possibility
- B. Chapter 11 – Are you on the bus (front or back seat?)
– Or Thrown Under the Bus?
1. Has the train left the station without you, and can you ever run fast enough to get on?
 2. Cash flow
 3. Speed of the case – “emergency” hearings every week
 4. Committee
 5. Who is the ant at the picnic?
- C. Is Chapter 11 still a viable tool for a debtor after BAPCPA?
1. Scarcity of debtor in possession financing
 2. Additional administrative burdens
 3. Shortened time limits
 4. Heightened utility protections
- D. Chapter 11 for the sole benefit of the secured lender - “Creditor in Possession”
- E. Increased use of CROs

VII. Bankruptcy– Pro’s and Con’s – (depends on where you sit)

- Debtor’s home court “advantage”
- Fiduciary duties

- Automatic Stay
- Post-petition cash use or DIP financing
 1. Beware, the case is already over on the first day
- Section 363 – “golden” sales
- Out of control litigating UCC – where is the Deep Pocket?
- Claims analysis
- Creation of central forum
- First Day Orders
- Operating Consequences

VIII. Other Options

A. Receiverships

1. KRS Chapter 31A.080 – persons who may serve as receivers
2. KRS 425.600 – powers of receivers
3. KRS 451.200 – liabilities of receiver
4. KRS 378.080 – property to be surrendered to receiver
5. KRS 381.420 – receiver if waste occurs in pending action

B. ABCs

1. KRS Chapter 379
2. *In the Matter of ODC Holdings, Inc., et al.*, Jefferson D. Ct., No. 06-CI-012275
3. *In the Matter of Pediamed Pharmaceuticals, Inc.*, Boone D. Ct.,

No. 07-C-00862

4. *In the Matter of West Irving Die Castings of Kentucky LLC, et al.*,
Jeff. D. Ct. No. 08-C-016773
5. *In re Appalachian Holding Co.*, Fayette D. Ct., No. 09-C-4320

C. Mediation/Arbitration