

FINANCIAL DISASTERS

Risks and Rights When Insolvency Strikes



Gregory R. Fox

Shareholder, Creditors' Rights and Bankruptcy

Lane Powell PC

Seattle, WA



James B. Zack

Attorney, Creditors' Rights and Bankruptcy

Lane Powell PC

Seattle, WA

Potential Insolvency Triggers

- Increased procurement and materials costs – fuel, lumber, plastics, etc.
- Supply chain delays
- COVID-19 industry disruption: hospitality, retail, office
- Inflation and future interest rate increases
- Labor shortages and increased labor costs
- Decreased local tax revenues
- Unstable commercial real estate market
- The next COVID-19-esque event??

Insolvency Scenarios

Bankruptcy or default by:

- Owner
- General Contractor/Prime Designer
- Subcontractor/Subconsultant
- Municipality

Bankruptcy Risks to Consultants and Engineers

- Surrender of pre-petition payments
- Non-payment for pre-petition services
- Ongoing liability to subconsultants and suppliers
- Obligation to perform post-petition
- Bankruptcy stay and potential violation of federal bankruptcy law
- Creditors' Committee and Trustee activity and claims
- Fees and costs

Pre-Bankruptcy Planning and Protections

Security interests

Security deposit/retainer

Letter of credit

Guaranty

Statutory lien rights

Work product ownership and copyright protections

Notice to Lender (RCW 60.04.221)

Strong contract terms

Forbearance agreements, deferral agreements (and releases)

“Petition Date” & Bankruptcy Chapters

Petition Date: The date the debtor files its bankruptcy petition

Pre-Petition: Before the Petition Date

Post-Petition: After the Petition Date, during bankruptcy

Common commercial bankruptcy chapters:

Chapter 7: liquidation by trustee

Chapter 11: reorganization plan or sale by debtor

Subchapter V: expedited small business reorganization

Chapter 9: reorganization plan by municipality

Claim Priorities & “Proof of Claim” Form

Section 506, 507: Claim priorities

Secured > Administrative > Priority Unsecured > General Unsecured

Form 410: national proof of claim form

Rule 3001: prima facie evidence of claim validity, subject to objection

Amount: all amounts owed as of the Petition Date

Deadlines: Ch. 7 (Petition Date + 70 days); Ch. 11 (TBD by court during case)

“Automatic Stay” & “Relief from Stay”

Section 541(a): bankruptcy estate includes debtor’s property “wherever located”

Section 362(a): “automatic stay”

Immediate injunction broadly protecting debtor and estate property

362(d)(3): single asset real estate (90 days)

105(a): court authority to extend stay to non-debtors

Section 362(d): “Relief from Stay” for specific/general actions

362(d)(1): for “cause,” including lack of “adequate protection”

362(d)(2): debtor lacks equity in collateral, and not necessary for reorg.

Contracts in Bankruptcy

- Section 365: Executory contracts & unexpired leases
- Post-petition performance obligations
- Assumption, rejection, assignment
- Post-petition claims
- Work product, copyright protections

“Preference” Avoidance of Pre-Petition Payments

Section 547(b): preference elements

- 1) Transfer of an interest, to or for creditor’s benefit
- 2) On account of “antecedent debt”
- 3) While debtor insolvent (presumed)
- 4) Within 90-day Pre-Petition period (1-year for insiders)
- 5) Creditor received more than it would have received in Ch. 7 liquidation

Section 547(c): affirmative defenses

Ordinary course, new value, perfection within 30 days

Common Scenarios:

Payments to unsecured and under-secured creditor

Grants of collateral or other transfers (antecedent debt and new value)

“Fraudulent Transfer” Avoidance

Section 548(a)(1)(A): actual fraud, RCW 19.40.041(1)(a)

Actual intent to hinder, delay, defraud

Section 548(a)(1)(B): constructive fraud, RCW 19.40.041(1)(b)

Debtor received less than “reasonably equivalent value”

While debtor was insolvent

Common Scenarios:

Payments from third parties

Subsidiary guaranty or pledge of collateral

Third-party pledges of collateral

Enforcing Rights in Bankruptcy

- Relief from Stay:
 - (1) for “cause,” or
 - (2) for lack of equity in property, and not necessary to effective reorganization
- Notable Exceptions:
 - Mechanics’ Liens: lien recording/filing ok if (i) timely under applicable state law and (ii) relate back to a date before the Petition Date; but lien enforcement requires relief from stay (enforcement deadline tolled during bankruptcy, 11 U.S.C. 108(c))
 - Trust Funds: Debtor’s funds held in trust for third party are not property of the bankruptcy estate
 - Surety Bonds: Debtor’s surety bond is not property of the bankruptcy estate

Obligations to Third-Parties

- No automatic stay for non-debtor third parties or non-estate property
- Contractual rights (and payment obligations) among third parties unaffected by bankruptcy

Conclusion: Planning for Financial Disasters

- Demand security deposit, letter of credit, guaranty, etc.
- Require periodic financial reporting, audits, appraisals, milestones, etc.
- Issue timely notices for statutory liens
- Terminate delinquent contracts or leases pre-bankruptcy
- Be aware of potential preferences and claw-back exposure

THANK YOU