

Presented at:

*University of Texas School of Law
34th Annual Corporate Counsel Institute*

April 19-20, 2012
Dallas, Texas

May 3-4, 2012
Houston, Texas

**Lessons Learned from the Economic Downturn:
Critical Guidance for In-House Counsel**

Submitted By:

Melanie Gray
Angela C. Zambrano
Candice Carson

Martin A. Sosland
Sylvia A. Mayer
Regina Merson

Melanie Gray
Weil, Gotshal & Manges LLP
700 Louisiana, Suite 1600
Houston, TX 77002

Melanie.Gray@Weil.com
(713) 546-5045

Sylvia Mayer
Weil, Gotshal & Manges LLP
700 Louisiana, Suite 1600
Houston, TX 77002

Sylvia.Mayer@Weil.com
(713) 546-5087

Martin Sosland
Weil, Gotshal & Manges LLP
200 Crescent Court, Suite 300
Dallas, Texas 75201

Martin.Sosland@Weil.com
(214) 746-7730

Angela Zambrano
Weil, Gotshal & Manges LLP
200 Crescent Court, Suite 300
Dallas, Texas 75201

Angela.Zambrano@Weil.com
(214) 746-7704

Regina Merson
Weil, Gotshal & Manges LLP
200 Crescent Court, Suite 300
Dallas, Texas 75201

Regina.Merson@Weil.com
(214) 746-7795

Candice Carson
Weil, Gotshal & Manges LLP
200 Crescent Court, Suite 300
Dallas, Texas 75201

Candice.Carson@Weil.com
(214) 746-7757

TABLE OF CONTENTS

	Page
I. Introduction.....	1
II. Advice for Dealing with a Counterparty in Distress.....	1
A. Recognize Early Signs of Distress	1
B. Determine the Source of the Distress.....	1
C. Conduct a Legal Document Review	2
D. Avoidance Actions.....	3
1. Preferential Transfers.....	3
2. Fraudulent Transfers	4
E. Claims	4
F. Special Vendor Claims	5
G. The Automatic Stay	6
1. Safe Harbor Protections for Derivatives, Swaps, Securities Contracts, and Forward Contracts.....	6
2. Set Offs	7
H. Bankruptcy Litigation	7
1. Know Your Adversary	8
2. Understanding Bankruptcy Discovery: Use and Abuse of Rule 2004.....	8
3. Settle Strategically	8
III. Advice for a Company in Distress	9
A. Act Sooner Rather than Later	9
B. Prepare for a Crisis.....	9
1. Practice Good Corporate Governance	10
2. Establish Contingency Plans.....	10
C. Take Practical Steps to Avoid Chapter 11	10
1. Review Debt and Contract Compliance.....	11
2. Develop Exit Options.....	11
D. Prepare for Bankruptcy	12
1. Recognize that Cash is King	12
2. Know Yourself.....	14

TABLE OF CONTENTS
(continued)

	Page
E. Chapter 11	15
1. Chapter 11: The Participants.....	15
2. Chapter 11: The Processes	15
3. Chapter 11: The Plan	18
IV. Conclusion	18

I. INTRODUCTION

While it may be debatable whether the economy has stabilized or is improving, in today's economic climate, most companies can answer "yes" to one or both of these questions:

1. Is your company doing business with others who are undergoing financial distress?
2. Is your company undergoing financial distress?

As a result, during this time of continuing economic uncertainty, there are a number of ways in which in-house counsel can help their clients maximize strategic options. From reassessing business functions - to strengthening risk management and corporate governance - to capitalizing on opportunities in litigation, counsel can and should be a vital part of any company's efforts to survive and thrive. Below is some practical advice to assist in-house counsel in anticipating and preparing for a counterparty's financial distress and/or their company's own internal financial distress.

II. ADVICE FOR DEALING WITH A COUNTERPARTY IN DISTRESS

A. Recognize Early Signs of Distress

Just as it is easier to prevent a fire than it is to put one out, so too is it easier to prevent loss or disruption due to a counterparty's distress than it is to repair any damage caused by it. As a result, corporate counsel should work with the client to ensure that early warning systems are in place. For example, depending on industry practices, a customer who fails to pay timely may be "yellow-flagged" and then more closely monitored for the next several months. If the customer fails to pay timely twice in the monitoring period, then they may be "red-flagged" and the account subjected to review to determine whether to place the customer on C.O.D., terminate the relationship, or develop an alternative payment plan.

Similar monitoring of a customer, vendor, or other counterparty's compliance with its legal agreements, trade terms, or loan documents, may enable the company to identify a concern before it develops into a crisis. While it may be impractical to monitor all counterparties, at a minimum, counterparties critical to the company's operations or financial performance could be monitored. In addition to a formal internal monitoring process, relationships can be key. An open line of communication with critical customers, vendors, and other counterparties may also provide an informal avenue for assessing early indicators of distress.

B. Determine the Source of the Distress

In-house counsel should advise its client that different types of distress merit different responses to a counterparty. A counterparty's financial problems may stem from any number of causes, including, but not limited to, a downturn in the overall economy, a downturn in the particular industry, a sharp increase in commodity prices that have not been properly hedged, or a problem with the counterparty's capital structure. *See generally* REORGANIZING FAILING BUSINESSES REVISED EDITION A COMPREHENSIVE REVIEW AND ANALYSIS OF FINANCIAL

RESTRUCTURING AND BUSINESS REORGANIZATION VOL. I 2-10—2-12 (Weil, Gotshal & Manges LLP eds., 2006). The type of financial distress suffered by a counterparty is a key part of a company's decision whether to continue or terminate the relationship with that counterparty. Thus, to the extent possible, a company should attempt to understand the source of a counterparty's distress before taking any action.

For instance, if an economic downturn is the culprit, one counterparty may not be more adversely affected than its competitors. *Id.* at 2-11. As a result, a company's attempts to seek more advantageous relationships with its counterparty's competitors would prove futile. In this situation, in-house counsel should ensure that a monitoring system is in place to limit exposure and, so long as all proactive steps have been taken, then suffer through the downturn awaiting recovery. *Id.* at 2-11.

If the counterparty's industry is experiencing a decline, then the company should analyze its counterparty's position relative to the counterparty's competitors. *Id.* at 2-11. By engaging in such analysis, a company should evaluate the long-term prospects of the entire industry before determining whether to continue the relationship with the counterparty. *Id.* at 2-11. In this situation, it may be wise for the company to seek relationships with the counterparty's competitors if those competitors are faring better than the counterparty within the industry.

Finally, if a counterparty's problems are a result of, or aggravated by, the counterparty's capital structure, the counterparty may undergo a recapitalization and deleveraging process, which could involve a bankruptcy filing. Monitoring the counterparty is a critical means to limit the company's exposure. Concerns include pre-bankruptcy claims (which may go unpaid), litigation with respect to avoidable transfers, and the demise of the counterparty.

C. Conduct a Legal Document Review

Once it has been determined that a counterparty may be in distress, corporate counsel should initiate a legal review of the company's contracts and legal obligations with the counterparty. This review should focus on determining the company's rights against and exposure to its counterparty, including any consequences of breaching or terminating the relationship. However, in-house counsel should note that provisions that provide for termination in the event of a counterparty's bankruptcy (*ipso facto* provisions) are unenforceable under the Bankruptcy Code unless the contract qualifies for a safe harbor exception. For a discussion of this issue refer to the sections entitled "Safe Harbor Protections for Derivatives, Swaps, Securities Contracts, and Forward Contracts" and "Property of the Estate" below. *See infra* Part II.G. p. 6, Part III.E.2.c. p. 16.

In-house counsel should carefully consider whether its client company would be better served by terminating the relationship with the distressed counterparty. Calculated breach of an agreement may be to the company's benefit if the cost of the breach is less than the cost of continuing the relationship with the distressed counterparty. Such a breach may enable a company to pursue more advantageous relationships with other parties, such as the counterparty's competitors, as discussed above.

Find the full text of this and thousands of other resources from leading experts in dozens of legal practice areas in the [UT Law CLE eLibrary \(utcle.org/elibrary\)](http://utcle.org/elibrary)

Title search: Lessons Learned from the Economic Downturn: Critical Guidance for In-House Counsel

Also available as part of the eCourse

[Critical Guidance for In-House Counsel: Lessons Learned from the Economic Downturn; Responding to Hostile IP Overtures; Best Practices during Times of Corporate Crisis; plus The Role of In-House Counsel in Arbitration](#)

First appeared as part of the conference materials for the
34th Annual Corporate Counsel Institute session

"Lessons Learned from the Economic Downturn: Critical Guidance for In-House Counsel"