CAVEAT LENDER: BANKRUPTCY CONSIDERATIONS FOR SHIPPING LENDERS

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The impact of the COVID-19 pandemic is pushing both US and foreign borrowers to consider US bankruptcy options, including a chapter 11 restructuring or a foreign insolvency proceeding and chapter 15 recognition. Lenders are increasingly asking what they need to know about US Bankruptcy Code to protect their investment. They are right to be concerned, because creditors who are caught unawares by US Bankruptcy Code provisions can find themselves in a much weaker position than they bargained for, even if their borrower successfully reorganizes.

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CHAPTER 11 CONSIDERATIONS FOR LENDERS

Who May File?

Foreign companies utilize chapter 11 to restructure due to the many debtor-friendly rules. The Bankruptcy Code's liberal jurisdiction provisions allow any company that has property in the United States to file a chapter 11 proceeding. There is no requirement that the property has been in the United States for any particular amount of time, so the transfer of funds to a US account prior to filing is sufficient to create jurisdiction.

Automatic Stay

One powerful tool for debtors restructuring under chapter 11 is the imposition of an automatic stay on creditors. Immediately upon filing a bankruptcy petition, the worldwide automatic stay takes effect, staying all actions to enforce or collect pre-petition claims against the debtor and its assets. As a result, creditors are forbidden from (1) terminating existing contracts, (2) commencing or continuing litigation or lien enforcement actions, and (3) taking any other legal actions against the debtor or its assets, without leave of the Bankruptcy Court. The stay is so broad as to not only preclude lenders from foreclosing on their collateral, but also prohibits sending notices of default or acceleration to the debtor.

Most loans contain termination clauses that are triggered by the borrower filing for bankruptcy. These so-called "ipso facto" clauses are generally unenforceable in executory contracts (discussed further below) but may be enforceable in loan agreements.[1] Additionally, lenders cannot be forced to extend financing to a borrower in bankruptcy despite a previous agreement to do so.

SWAPs

The worldwide automatic stay has some limits. For example, the automatic stay does not prevent a financial institution that is party to a swap agreement from exercising its contractual right to offset or net out any termination value, payment amount, or other transfer arising in connection with the swap agreement. As such, swap participants *may* terminate a swap in the event of insolvency or bankruptcy. Additionally, an insolvency event of default entitles a swap counterparty to termination damages, and the counterparty may seize its collateral regardless of the automatic stay.

Credit Enhancements and Preferential Transfers

Lenders who are concerned about their borrower's financial status often request additional security or payments from their borrower. For example, a lender may request that funds held in a blocked or pledge account be transferred to an account held in the lender's name, out of concern that the debtor will use such funds for restructuring. If the debtor files a bankruptcy petition a month or two after such a transfer, that transfer may be challenged and clawed back from the lender into the bankruptcy estate as a "preferential transfer."

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Certain payments and transfers made by a debtor in the months, or even year, prior to filing a bankruptcy petition, are considered "preferential transfers" under the Bankruptcy Code. Preferential transfers include any payment or transfer of an interest of the debtor, including a security interest in additional collateral, to a creditor on account of an existing debt made on or within 90 days (or one year if to an insider) before the filing of the bankruptcy petition.

There are a number of statutory defenses to preferential transfer claims. A transfer cannot be clawed back by the debtor if the transfer, *inter alia*, (1) was made in exchange for *new value* given to the debtor, (2) was made in the ordinary course of business (e.g., timely loan payment), or (3) created a security interest in property acquired by the debtor to the extent the security interest secured new value given by the creditor that was used to acquire the collateral property. For these purposes, "new value" can be money, services, or new credit, but does not include an obligation substituted for an existing obligation. Thus, forbearance likely does not constitute "new value" and any additional security provided to obtain lender's agreement to forbear would likely be considered a preference.[2]

Cash Security

Creditors may be surprised to find that funds accumulated in a blocked account cannot be swept once a borrower declares bankruptcy. Even if the funds are swept into lender's account prior to a bankruptcy, that sweeping might be considered a preference and clawed back. The funds in a pledged or blocked account are known as "cash collateral" because they are owned by the debtor, but the lender has a security interest in the funds. Cash collateral includes cash, negotiable instruments, securities, or deposit accounts in which both the debtor and a non-debtor (i.e., a creditor) have an interest. Usually, the debtor will seek court permission to use this cash collateral during the chapter 11 proceeding to pay bankruptcy and other expenses.

The Bankruptcy Code provides some protections for secured creditors who are, because of the automatic stay, prevented from foreclosing on cash and other collateral. These creditors may seek "adequate protection" of the value of their security if the debtor intends to use the collateral or pledged funds during the bankruptcy. Adequate protection is not specifically defined in the Bankruptcy Code and is often the subject of significant negotiations between the debtor and lenders, and could include a replacement lien on unencumbered property or payments of interest during the bankruptcy proceeding.

Forbearance Agreements

There are additional limitations on forbearance agreements in chapter 11 that should be considered by lenders. While a developing area of law in the United States, forbearance agreements – unlike loan agreements – are generally enforceable against lenders in the borrower's bankruptcy when the parties use the forbearance agreement to afford the borrower the opportunity to avoid foreclosure. In other words, lenders must continue to forbear under the terms of the agreement even if the borrower files for bankruptcy during the forbearance period, because such agreements are considered "executory contracts."

"Executory contracts," although undefined in the Bankruptcy Code, generally include contracts where both parties have material unperformed obligations under the contract. If a debtor elects to assume, or continue, the executory contract, the debtor must first cure any defaults thereunder and assume the entire contract. If a debtor rejects an executory contract, the rejection is treated as a breach of the agreement, and the other party may make a claim against the debtor's estate for damages.

A forbearance agreement may be considered an executory contract because both parties must perform: the borrower must pay some or all of the debt owed to the lender, and the lender has to continue to forbear for some period of time. As such, the debtor may assume or reject the forbearance agreement, and the lender cannot utilize an ipso facto clause to automatically cease forbearance and avoid the risk that borrowers will assume (and thus, continue) the forbearance agreement. However, If the forbearance agreement provides for an extension of additional credit to the debtor that was not advanced pre-petition, the agreement is more likely to be considered a loan agreement and not subject to the restrictions on ipso facto clauses.

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Charter Parties

The bankruptcy courts treat charter party agreements similar to equipment leases, that is as executory contracts that may be assumed or rejected by the debtor charterer at any time before the end of the bankruptcy proceeding. However, if a charter is a finance lease, rather than a true operating lease, the lender is considered to have a security interest in the vessel, while the lessee debtor is treated as the owner of the vessel (and the vessel as part of the debtor's bankruptcy estate). If the lender/owner has not properly perfected its security interest in the finance lease pursuant to the law applied by the Bankruptcy Court, it will have only an unsecured claim against the debtor's estate.

Chapter 15 to Recognize Foreign Insolvency Proceedings

Debtors may commence an action under chapter 15 of the US Bankruptcy Code when conducting a foreign insolvency proceeding. Typically, this requires the administrator of the foreign proceeding, or other authorized representative, acting through counsel, to apply to a US Bankruptcy Court for recognition in the United States of the foreign proceeding. If the Bankruptcy Court recognizes the foreign bankruptcy as a foreign main proceeding, the automatic stay becomes effective with respect to property of the debtor that is located within the United States; it is not worldwide. Although this still prevents creditors from foreclosing on a debtor's US assets, debtors cannot avail themselves of the full panoply of debtor-friendly laws. For example, chapter 15 debtors cannot seek to claw back preferential transfers, which may offer some comfort to lenders.

Lenders to struggling borrowers are best served by considering the possible effect of a US bankruptcy when negotiating any debt restructuring.

Zachary Farley, a former associate in our New York office, also contributed to this article.

[1] *See In re AMR Corp.*, 730 F.3d 88, 107 (2d Cir. 2013).

[2] See *In re Eleva, Inc.*, 235 B.R. 486, 489-90 (10th Cir. 1999) (agreeing "that forbearance of a right does not constitute new value.") (citing cases, including *In re McLean Indus., Inc.*, 132 B.R. 247, 263 (Bankr. S.D.N.Y. 1991), aff'd 162 B.R. 410 (S.D.N.Y. 1993), rev'd on other grounds, 30 F.3d 385 (2d Cir. 1994); and *In re Duffy*, 3 B.R. 263 (Bankr. S.D.N.Y. 1980)). *Compare In re Buffalo Auto Glass*, 187 B.R. 451, 454 (Bankr. W.D.N.Y. 1995) (adopting the view "that where forbearance is alleged to constitute new value, the *actual* value to the debtor of the forbearance in 'money or money's worth' must be established by the defendant.").

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