Bankruptcy and Economic Development – How to Protect your City and Pursue the Insolvent

International Municipal Lawyers Association

- IMLA 2018 – 83rd Annual Conference
- October 17-21, 2018
- Houston, Texas

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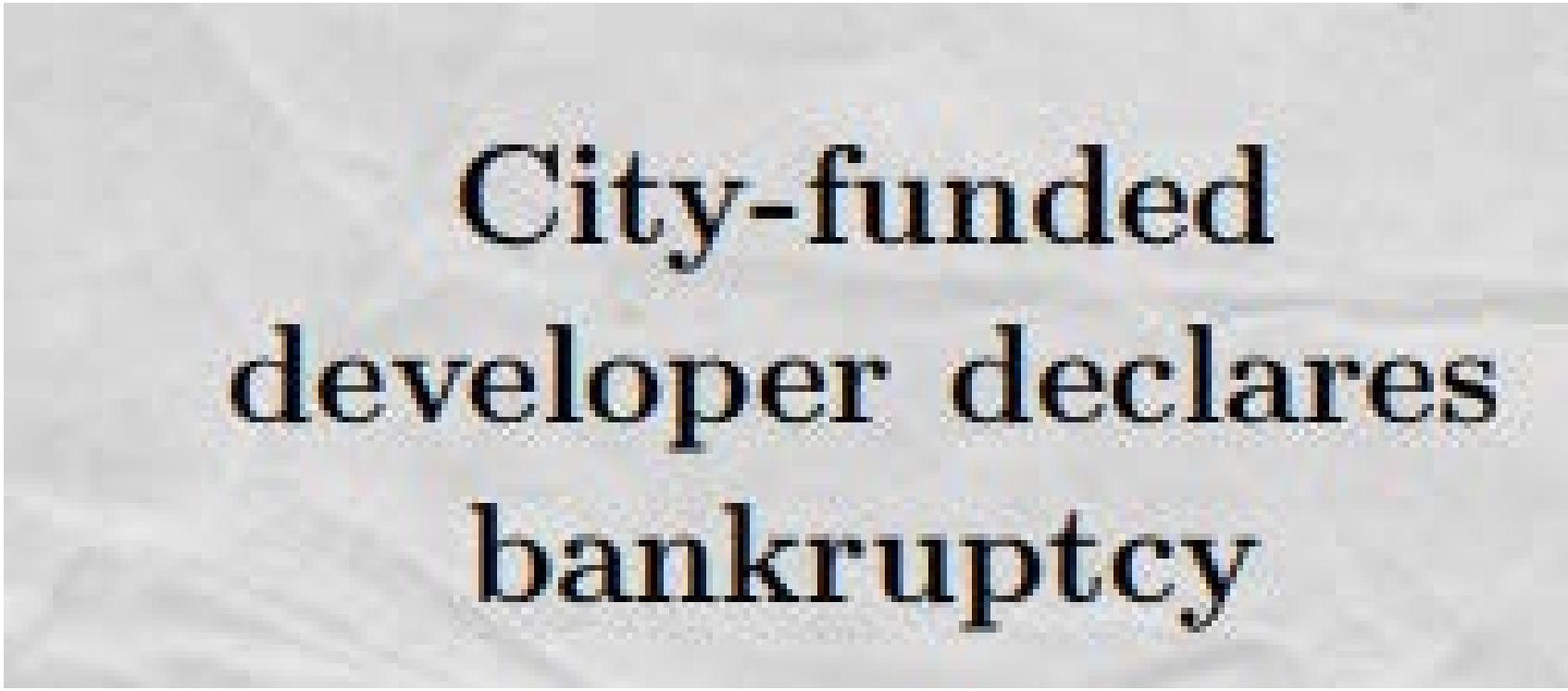
Headlines you do not want to see in Morning

Developer files for Bankruptcy City unlikely to see Funds or Project


Daily News
RECIPIENT OF CITY FUNDS CLOSES DOORS
Headlines on Natural Forest Reserve
News Report Released


City-funded
developer declares
bankruptcy

City Council to go into to Executive Session to consider Employment of City Attorney

How to Protect your Client from Loss of Economic Development Funds

1. Use Formal Application for Economic Development---Demand information up front in thorough economic development application

a. Developer will adjust the deal with each Council member, showing them the parts of the proposal they are interested in and make different promises to different people

b. Written application pins the proposal down early

c. Written application allows the entity to be vetted

2. Get a personal guarantee from as many principals of the assisted entity as possible

a. Personal guarantee maximizes chance that your client will be paid back first

b. Personal guarantee may lead to preferred payments that could lead to later preference actions – but at least your client was paid in a preferential manner


Before we go bankrupt lets sell this business.
WHAT Business?

3. Use deed restrictions, reversionary clauses, covenants and other nonconventional security mechanisms to "secure" economic development obligations

Often, economic development obligations can be "secured" with a real property covenant, a reversionary clause, or a deed restriction, especially if a 1st lien will need to be held by a different entity

4. Backup a guarantee with security

a. Security puts your client into a class of secured creditors in bankruptcy

b. Security, even if inadequate, allows the economic development entity to be “doing something” to obtain repayment

5. Include an “Ipso Facto” Bankruptcy/Insolvency Clause, but assume it will not assist you because it will be invalid in bankruptcy

a. Ipso Facto clauses are valuable in limited situations, such as insolvency where bankruptcy is not filed

b. If your directors/councilmen review the clause, you will need to explain the bankruptcy code's invalidation of ipso facto clauses

6. Execute economic development contracts with parent-companies, not special purpose local companies

A bankruptcy-remote entity will typically be:
(a) a parent-company with extensive assets that reduce its chance of bankruptcy;
(b) contain provisions in its formation documents that limit or eliminate the ability of the entity from incurring liabilities other than the debt to be included as part of the concerned transaction;
(c) insulate the entity from liabilities of affiliates and third parties; or
(d) be subject to contractual limits on dissolution

It is not unusual for the initial application to be filed by the parent-company, which touts its own experience, assets, and team, then that parent-company to attempt to execute local economic development contracts with special purpose entities with a same or similar name to the parent company----Preventing this tactic requires vigilance.

7. Perfect your Liens and Security Interests and establish procedures for follow up

The most import bankruptcy insulation vehicle is to properly and repeatedly perfect your liens and security interests in the applicable collateral. The basics include: (a) if real estate, filing applicable real estate deed of trust documentation with the applicable county record; (b) if personal property, filing financing statements (UCC1) in the applicable secretary of state and applicable county, and (c) if cash/accounts, by taking control of the Debtor's power to dispose of the cash through a deposit account control agreement (DACA) or other control/lockbox agreement.

Liens are often lost by (a) improper perfection through bad collateral descriptions, failed acknowledgements, overlooked UCCs, omitted attachments; (b) improper postclosing diligence (failing to renew UCCs), agreements and actions made by lender representatives allowing use of cash or inadvertently releasing control of bank accounts or the contents thereof

8. Secure Performance from Solvent Third Party entities with a letter of credit, which requires a mere statement, rather than a bond, which guarantees a fight

Securing the debtor's obligations with a third party letter of credit is often the best way to minimize risk. Drawing on a letter of credit is not subject to the automatic stay that is imposed in bankruptcy because the letter of credit is not "property of the bankruptcy estate" nor proceeds thereof. However, if a condition precedent to drawing on the letter of credit is presentment of an invoice or demand to the debtor and such notice has not been given prior to bankruptcy a problem may exist. Care must be taken to avoid requirements that a collection-type notice be sent to the debtor prior to the draw. Drawing on a letter of credit does not violate the automatic stay but a condition precedent to draw such as demand on the debtor may.

9. Get new financial statements regularly, especially if there is concern over a bankruptcy.

This will help you investigate the risk of bankruptcy and determine whether further payments are appropriate. If a debtor refuses to supply any financial information, this should only add to a creditor's concern.

10. Assume any payment made while the economic developer is in financial distress is subject to a potential preference claim.

Preference claims are a true “gotcha” of the bankruptcy world.

The Bankruptcy Code defines a preference as a transfer of an interest of the debtor in property:
--to or for the benefit of a creditor;
--for or on account of an antecedent (pre-existing) debt;
--made within 90 days of the bankruptcy filing (or within 1-year if the transfer was to an insider);
--made while the debtor was insolvent; and
--which allows the creditor to receive more than it would have received if the payment had not been made, and the claim was paid through the bankruptcy process

11. Beware the automatic stay

Immediately upon the filing of a Voluntary Petition in Bankruptcy, an "Order for Relief" is entered. In an Involuntary Petition, the court will enter an "Order for Relief" after the debtor is given an opportunity to oppose the petition. Once the order for relief is entered, the bankruptcy process begins and the "automatic stay" is in place. The automatic stay ends the "race to the courthouse."

During the automatic stay, all creditors are forbidden from taking aggressive action against the debtor or otherwise improving their position. General unsecured creditors will not be able to secure the amount owed to them, by judgment or otherwise. Simultaneously, the debtor is no longer permitted to simply pay any creditor they wish.

12. Understand foreign bankruptcy issues prior to entering a deal with a foreign company.

The Bankruptcy Code generally adopts the Model Law on Cross-Border Insolvency from the UN Commission on International Trade Law. The process starts with a foreign insolvency proceeding. A "foreign representative" may then request recognition of the foreign proceeding in a US Bankruptcy Court in a District where the debtor has its principal place of business or principal assets or where a judgment enforcement proceeding is pending.

Once the foreign bankruptcy is recognized, the foreign representative can act for the debtor in the US Bankruptcy Court. The foreign representative has the automatic right to operate the debtor's business as a "debtor in possession." Several U.S. Bankruptcy Code provisions will apply, including the automatic stay provisions which will now apply to assets of the debtor in the United States. Creditors must be careful about violating the automatic stay as to foreign owned property in the United States.

13. Utilize the services of specialists in drafting security documents

When economic development deals collapse, the total amount lost is usually irrelevant to the public and the press. The effects in the press are the same regardless of whether the deal is $100,000 or $100,000,000. The last thing you want is the security documents being attacked during the publicity process. If you do not regularly draft documents securing the interests of companies in bankruptcy, then an outside specialist should draft or at least review them.

14. Independently verify all feasibility studies and cost projections.

Developers and their consultants inflate the numbers and oftentimes use cost numbers rather than appraised value or other reliable indicators.



"Louie, you apply for a loan while Rocco heads in through this door and files for bankruptcy."

15. Always guard against sunk cost fallacy. Mention "bankruptcy" in every briefing of your client at the beginning to get them to realize that deals go bad and know their limits. Never double-down on a failing deal.

When a project starts failing, the first person the developer will call on is the entity that provided funding. The developer will assume that the city will pay off the developer to avoid the impending doom of bankruptcy. Often his ally will be the economic development official who originally carried the deal to the city. The City will be asked to subordinate its debt to a vulture financier or other lender in an effort to save the developer. If City officials are ready for this tactic, they can say "no" with confidence. To get them ready, set the limits early on with a communications that indicates that no future subordinations to third party debt will be considered.