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

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Curriculum Vitae

Miles Risley is the City Attorney of Corpus Christi, Texas. He received his law degree from the University of Texas in 1992. He graduated summa cum laude from West Texas State University in 1989.

Mr. Risley has practiced municipal law since 1994. He became City Attorney of Corpus Christi in 2014. He was City Attorney of Wichita Falls between 2009 and 2014. Prior to his service in Wichita Falls, he was the City Attorney of Victoria, Texas. Before coming to Victoria, he practiced with the law firm of Byington, Easton, and Risley, PC in Austin, Texas. He has also been an adjunct instructor at Victoria College and has served as a U.S. Army Military Intelligence Officer.

Mr. Risley has been a municipal attorney and member of the Texas City Attorneys Association (TCAA) for the past 23 years. Mr. Risley is also a Local Government Fellow of the Texas International Municipal Lawyer's Association (IMLA). In addition, Mr. Risley is a member of the Texas State Bar College and has made presentations to IMLA, the TCAA, and the National Contract Management Association. His presentations and papers have discussed land use law, municipal court, the Texas Open Meetings Act, the Texas Public Information Act, government contracting, gang injunctions, the Fair Labor Standards Act, and tow truck regulation. In addition, he is currently the President of the Texas Coalition for Affordable Power, which advocates for the interests of electricity consumers and purchases electricity for more than 160 cities and other political subdivisions.

Mr. Risley has extensive experience dealing with economic development matters. He has drafted, reviewed, and/or litigated dozens of economic development agreements. He has drafted and reviewed Type A and B corporation economic development agreements, agreements pursuant to Texas Local Government Code chapters 43, 212 and 380, nonannexation agreements, disannexation agreements, tax abatement agreements, hotel occupancy tax agreements, bankruptcy claims, financing statements, security agreements, deeds of trust, loan agreements, developer participation agreements, and other development-related agreements involving cities, Type A and B corporations, and other City-related entities.

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Introduction:

Companies turn to government for assistance for many reasons. Sometimes they turn to government merely because it is a source of low cost financing. Often, companies turn to government because their business models are not attracting much capital due to the questionability of their plans or the unlikelihood of profit. More nefariously, some companies turn to government financing because they have a future plan to extract value from government and extract themselves from future obligations.[1] These latter two categories of businesses pose a significant threat of bankruptcy. There are many best practices to reduce the chance of embarrassment or avoidable loss when these questionable businesses persuade your cities they are an attractive place for public investment.

Best Practices:

1. Use a 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. A written application pins the proposal down early to thwart this tactic.

c. A written application allows the entity and its principals to be vetted. Until names are written down with employee identification numbers, states of incorporation, social security numbers, and dates of birth, careful vetting will be inaccurate and explained away.

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

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

b. A 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

[1] See George Kerlof & Paul Romer, *Looting: The Economic Underworld of Bankruptcy for Profit*, Brookings Paper-s on Economic Activity, 2:1993.

3. Use deed restrictions, reversionary clauses, and covenants 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[2]

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

c. 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

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 prior to bankruptcy

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;
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> (c) insulate the entity from liabilities of affiliates and third parties; or
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> (d) be subject to contractual limits on dissolution.

It is not unusual for the initial application for economic development assistance to be filed by the parent-company, which touts its own experience, assets, and team, then that parent-company to attempt to execute

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2 See Roger Bartlett, *Article 9 Foreclosures, State Bar of Texas Collections and Creditor's Rights Cours*e, May 7-8, 2009 San Antonio.

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 continually perfect your liens and security interests in the applicable collateral.[3] 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.

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[3] See Richard Grant, *Bankruptcy Proofing Your Contracts: A Summary of Bankruptcy Protection Devices*, June 16, 2015.

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.[4]

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 United Nations 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.

Foreign creditors are now also entitled to non-discriminatory treatment in any US Bankruptcy with "the same rights regarding the commencement of, and participation in, a case under this title as domestic creditors." They are entitled to the same notices given to creditors generally.

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4 See http://www.fullertonlaw.com/bankruptcy-primer-for-creditors

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.[5]

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.[6] 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.

If development assistance is provided to businesses with a repeated statement that many will not survive, then communities will be able to deal with bankruptcies in a healthy manner that avoids much of the hysterical statements that often accompany business failure after public assistance. When businesses fail, communities can be reminded that bankruptcy reorganization serves an economic development function.[7] It is costly to aggregate capital and develop a business organization.[8] The task of economic development policy is to facilitate that process. Bankruptcy reorganization can be viewed as partly serving a

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[5]See Peter G. Smith, *The Municipal/Governmental Perspective of Economic Development Incentive Agreement Provisions University of Texas School of Law 11th Annual Land Use Planning Law Conference.*

[6]See David Ehrhardt and Timothy Irwin, *Avoiding Customer and Taxpayer Bailouts in Private Infrastructure Projects: Policy toward Leverage, Risk Allocation, and Bankruptcy,* 2017 International Bank for Reconstruction and Development, https://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-3274

[7]Jean Brauchera, *Bankruptcy Reorganization And Economic Development* 23 Cap. U. L. Rev. 499 (1994)

[8]See Charles W. Adams, *An Economic Justification for Corporate Reorganization*, 20 HOFSTRA L. REV. 117, 117 (1991) (discussing the costs of raising capital for a reorganization). ("Even though the company is insolvent, there may be a substantial demand for the goods and services that it produces, and it may have a successful business operation and an efficient organization.

preservation function for aggregations of capital. This preservation includes human capital invested in developing expertise in managing and working for a particular business.[9] Chapter 11 is a means to stop the dismantling of businesses and provides an opportunity to look for ways to keep them intact. Particularly in view of our lack of success in devising effective programs to help start businesses, it makes sense to save existing ones when possible.[10] Preserving businesses has important benefits by assisting other existing, connected businesses.[11]

[9] See Brauchera at 9.

[10] See Nicholas Leman, *The Myth of Community Development*, N.Y. TIMES, Jan. 9, 1994 (Magazine), at 27 (discussing lack of success in community economic development efforts and contrasting with the success in community development efforts to provide affordable housing and day care).

[11] Albert O. Hirschman, *The Strategy Of Economic Development* (1958)