Workouts and Restructurings in the COVID Era

by Neal L. Wolf

Introduction

I have not taken the time to research and, hence, cannot speak knowledgeably about the economic impact of government measures taken to defeat the Spanish Flu epidemic of 1918, and the legal consequences thereof. I can report, however, that in the lifetime of this Baby Boomer, from both a legal and an economic perspective, the recession that has quickly resulted from public health directives and initiatives that have been invoked to combat the global COVID-19 pandemic is, in many respects, unique.

To be sure, hurricanes, tornadoes, and floods have occurred with great frequency in the past. These disasters have, on a localized basis, interrupted if not completely shut down businesses, caused widespread unemployment, strained health care providers as well as providers of other essential goods and services, and spawned many contract defaults. In the case of COVID-19, however, the recession has been directly brought on by governmental public health initiatives, however necessary and appropriate they may be. Moreover, no one, not even the “experts," can knowledgeably predict when the pandemic will subside and how quickly the economy will recover from it.

For many businesses, there is only one present certainty – they will not be able to meet their obligations to employees, creditors, and contract counterparties (including landlords) unless they significantly restructure those obligations, either through an out-of-court workout or restructuring or in a bankruptcy case.

Some Legal “Tools” for the Business Owner to Know of and, if Possible, Maintain in Her or His “Hip Pocket” during Negotiations

The uniqueness of this crisis may provide little solace to the owner of an affected, indeed afflicted, business. If there is a silver lining in this woefully dark cloud, however it is that these unusual circumstances may provide the business owner with some special legal tools and arguments that he or she might employ in seeking temporary or permanent relief from, or a restructuring of, contractual obligations.

It is essential that the business owner know what these tools are,

and how they may be employed for the benefit of his or her business, ***before*** initiating restructuring negotiations. *Effective negotiation* ***begins and ends*** *with a good recognition of [i] what would, or is likely to, occur in any ensuing litigation or bankruptcy, [ii] the degree of uncertainty of achieving the projected result, and [iii] the cost of the process in professional fees, time expended, distraction, etc.* To establish reasonable goals and generate a reasonable restructuring plan, one must know the answer to these questions.

Some state law tools

Some state law tools that may be available to the business owner in the COVID era include, without limitation, force majeure, commercial frustration, impossibility, mutual mistake of fact and/or law, failure of consideration, and statutes like California Civil Code § 1511.

The above-cited statute provides, in relevant part, that "[t]he want of performance of an obligation…or any delay therein, is ***excused*** by the following causes, to the extent to which they operate: 1. ***When such performance… is prevented or delayed… by the operation of law***, even though there may have been a stipulation that this shall not be an excuse… 2. ***When it is prevented or delayed by an irresistible, superhuman cause, or by the act of … the United States***…"(Emphasis and italics added.)

It is too early in the COVID crisis to determine whether, and how, courts will apply these legal defenses and statutes like California Civil Code § 1511 to COVID-induced defaults. They do, however, provide the company with colorable legal arguments.

The United States Bankruptcy Code

Because of the costs and uncertainties associated with the bankruptcy process, the bankruptcy court should, in virtually every instance, be a court of last, not first, resort. The COVID-beleaguered debtor should make every reasonable effort to restructure its balance sheet and alter its debt obligations on an out-of-court, consensual basis before commencing a bankruptcy case. There are circumstances, however, when it is highly necessary and/or desirable to file a bankruptcy case.

Small Businesses - The provisions of the newly-enacted CARES ACT that have been receiving the most attention from owners of small businesses that have been devastated by the COVID-19 pandemic are those relating to the business-sustaining forgivable loans and tax benefits that will potentially be available to those companies. One feature of the statute that has received far less attention, however, but can be quite important to owners of small businesses, is the extension of the right to seek relief under the debtor-friendly provisions of subchapter V of chapter 11 of the Bankruptcy Code, The Small Business Reorganization Act of 2019 ("subchapter V" or the "SBRA"), to a much larger class of small businesses. For more information, please see our previous alert.

Larger Businesses - Some businesses will not be able to avail themselves of the benefits of SBRA because (a) their debts exceed the $7,500,000 debt limit, (b) they are publicly traded, or (c) they are a single-asset real estate company. These companies may nonetheless seek relief under the older, "main," provisions of chapter 11 of the Bankruptcy Code. In chapter 11, the debtor has the benefit of, among many other debtor-friendly provisions: [i] a provision allowing the debtor to remain in possession and control of its business, [ii] an automatic stay that enjoins all collection and foreclosure actions, [iii] provisions allowing the debtor to reject uneconomic contracts and leases, [iv] provisions allowing the debtor to assign favorable contracts and leases notwithstanding the presence of non-assignment clauses in those agreements, [v] a provision giving the debtor the exclusive right, for a specified time period, to promulgate a plan of

reorganization, and [vi] provisions allowing the debtor to "bind" objecting and recalcitrant creditors to the debtor's plan of reorganization.

The Importance of Liquidity – "Cash is King"

During periods of recession, it is absolutely essential that affected businesses take steps to preserve and, if possible, enhance their liquidity. Their customers may have stopped or delayed paying bills. Their revolving credit facilities may have been exhausted, pared down, or frozen. The business will need that cash for a wide variety of purposes including not only normal operating expenses but the additional costs associated with the potential need to purchase goods and services on a cash on delivery or even cash in advance basis. They may also need the cash for professional fees and expenses associated with the filing and prosecution of a chapter 11 case.

The Commencement of Restructuring Negotiations

While shelter-at-home directives, enforced business closures, and volitional cancellation of conferences, concerts, and sports events for public health reasons are all very recent, and it is far too early to gauge the general impact of such developments on creditor, landlord, and judicial attitudes toward defaults and restructuring initiatives (much less, chapter 11 plans of reorganization), one must assume that this is a favorable, or sympathetic, environment in which to seek such concessions. Some early (and, admittedly, limited and preliminary) direct feedback that I have obtained from clients who have already approached their lenders and/or landlords for concessions would support this assumption.

Start Early, with No Threats of Litigation or Bankruptcy

In the ideal circumstance, restructure negotiations should be initiated by the company as *early as possible* before a default occurs or is likely to occur. In the typical circumstance, the business owner should not commence restructuring negotiations with the threat that he or she will file a bankruptcy case or invoke one or all of the above-referenced defenses if the creditor/landlord commences litigation. To the contrary, talk of litigation and/or bankruptcy should remain in the background, if possible. Each party's perception regarding the likely result, and costs and uncertainties of, litigation and/or bankruptcy should be that party's litmus test for the reasonableness of any restructuring proposal. Although, during the course of negotiations, one party may find that the other is ill-advised regarding the likely results of bankruptcy and/or litigation, one must begin restructuring negotiations with the assumption that the other party is both sophisticated and well-advised. If circumstances prove otherwise, it may become necessary to "educate" the other party.

Begin with a Concrete Proposal and the Data to Support it

The Restructuring Proposal - At the start of, or very early in, negotiations, the company should present its creditor or landlord with a restructuring proposal. The company should not expect its creditor to present a proposal. The creditor simply does not have all the financial and other facts necessary to fashion a realistic proposal. Moreover, creditor confidence will quickly be eroded if it appears that the company is unable to fashion an achievable restructuring plan of its own. In some instances, for reasons related to past interactions and events, the creditor has previously lost confidence in the competence and/or credibility of management. In such instances, it may be desirable to engage a financial consultant that is known to, and respected by, the secured creditor to either develop or review and endorse the financial plan, if the company can afford to do so.

The restructuring proposal should be both conservative and achievable. It is ALWAYS BETTER to meet

and exceed expectations than to aim too high, fail to achieve one's projections, lose credibility, and later seek to amend the financial plan after the creditor has already lost confidence in management's ability to operate the business competently and/or project the results of its own business operations.

Financial Projections - If the company is seeking a major "overhaul" of the subject obligation, as distinguished from a minor adjustment such as a relatively short payment moratorium, it should be prepared to furnish its creditor with historical financial statements, financial projections, appraisals (where appropriate) and other information that will enable the creditor to make a fair evaluation of the proposal. The financial projections that the company provides to its creditor(s) must be conservative, realistic, and achievable. They should reflect the company's most realistic forecast of what will occur if the proffered financial plan is implemented. They should include cash flow projections that, hopefully, will indicate that the company can, from a liquidity standpoint, perform its restructured obligations.

Conclusion

These unique circumstances beg for the implementation of realistic, creative and flexible restructuring approaches. If all parties are well-advised regarding the likely results, costs, and hazards of litigation and bankruptcy, it should be possible to fashion workable restructuring solutions without absorbing those costs and hazards. It is, however, not always possible to do so.

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