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Restructuring in the New 'Abnormal'

by James J. Mazza, Jr. and Justin M. Winerman

Restructuring professionals routinely spend time identifying troubled companies and industry sectors, pontificating about when the next restructuring wave will occur. As the 2020s ushered in, the talk among restructuring professionals was that corporate leverage was approaching unsustainable levels, and there were growing signs of an overdue recession, including the rare sighting of an inverse yield curve. Closing out 2019, U.S. companies owed approximately $10 trillion in debt, or 47% of the country's gross domestic product (GDP). Then the COVID-19 pandemic hit —a "black swan" event that nobody predicted (not counting generic pandemic risk factors in public company disclosures that have now become all too real and tailored to COVID-19). Rather than discussing when the new wave will arrive, restructuring professionals can now turn to addressing the one they face. Fortunately, the bankruptcy process offers a variety of tools to do just that: remote hearings; mediation of major disputes; creation of litigation trusts to pursue litigation after a company exits from Chapter 11; 363 sales; the automatic stay; releases; rejection of unfavorable agreements; and the ability to bind holdouts and cram down dissenting creditor classes.

This Time is Different

The "Great Recession," which was largely attributable to turmoil in the financial markets precipitated by the subprime mortgage crisis and overexposure to credit default swaps, had unmistakably severe consequences. The U.S.'s real GDP fell 4.3% from its peak in Q4 2007 to its trough in Q2 2009, the largest decline since World War II. The U.S. unemployment rate rose from 5% in December 2007 to 9.5% in June 2009, and peaked at 10% in October 2009 (with more than 37 million Americans filing unemployment claims). The world economy contracted by 1.7%.

In hindsight, the phrase "Great Recession" now sounds somewhat hyperbolic, as COVID-19's disruption is set to dramatically outpace the Great Recession's statistics. The Congressional Budget Office forecasts a $3.7 trillion federal deficit (its largest size as a share of the economy since World War II), a 5.6% economic contraction in U.S. GDP, and an unemployment rate in the U.S. of nearly 12% by year's end. As of the third week of April 2020, American workers alone had filed 26.5 million initial unemployment claims since March 14, 2020. Many forecasters, including former federal reserve chair Janet Yellen, have predicted a 30% annualized decline in U.S. GDP for the second quarter, much more than the reported 8% maximum decline during the global financial crises. As if this unprecedented health and economic crises were not enough, the disruption caused by never-before-seen negative oil prices only exacerbates the situation.

Liability Management: Crossing the Street in a Crowd

Previously healthy companies are now suddenly facing existential crises: their liquidity is at risk, business plan projections now must account for precipitous revenue drops, and entire business models stare at potential obsolescence. Companies in industries that were already in distress pre-pandemic (*e.g.*, retail and oil and gas) have been hit even harder and already have been succumbing to the pressure, leading to an unsurprising initial wave of bankruptcy filings.

In this initial reactionary phase, lenders, landlords, and other creditors have been relatively accommodating, perhaps the only rational choice rather than pushing companies into bankruptcy. Since mid-February 2020, companies have engaged in liability management exercises and scrambled to shore up their liquidity through whatever means available: drawing down remaining availability on revolvers; procuring loans on unencumbered collateral; accessing, if qualified, the unprecedented trillions of dollars of government relief; turning to the public bond market or to private capital that has been waiting on the sidelines and accumulated to levels of $1.5 trillion in cash at the end of 2019. At the same time, companies have cut costs through, *e.g.*, capex reductions; hiring freezes, furloughs, and salary reductions; and elimination of dividends and stock buybacks. Clearly the "cash is king" mantra practiced by the restructuring community got through to corporate America.

Public companies' first quarter results were decidedly low (with some rare exceptions). As those numbers sink in, the pandemic economy has entered into a new phase. To the extent they haven't already, companies will be seeking additional covenant holidays, waivers, and forbearances; considering deferral of interest payments and utilizing cure periods, if available; scouring credit document definitions to eke out covenant compliance; and finding shelter in our nation's bankruptcy courts. Practitioners will be watching closely as first movers (many not by choice) will set the market expectations for those who had the luxury to wait and cross the street in a crowd. While kicking the can makes eminent sense as the crisis' trajectory continues to evolve, the table is being set for massive deleveraging of the U.S. corporate debt.

Flattening the Bankruptcy Filing Curve

As millions of Americans, including the authors of this article, continue to shelter in place, questions abound as to how to repair economic damage that has yet to run its course. The good news is that while many hunker down, the epidemiological curve appears to be flattening here in the U.S. and in many of the hardest hit countries. There will, however, be a new normal — a new abnormal, if you will — and things may not return to the way they were for a prolonged period.

To quote the great baseball philosopher, Yogi Berra: "It's hard to make predictions, especially about the future." We are not so inclined to prognosticate on questions such as when the country will re-open and if the recovery will take the shape of a v-curve, "u", an "l", or a "w". We will leave that to the pundits. What we can say is that the bankruptcy process will be instrumental in any recovery. In the bull market leading into 2020, companies were understandably keen on avoiding bankruptcy. Chapter 11 can be an expensive and litigious process, unless there is a clear, quick path to exit —e.g., a prepackaged plan— and parties will continue to attempt to find out of court solutions. Now, however, many companies will not have such luxuries and may have to file so-called "free-fall" cases to survive.

Chapter 11's Tools of Revitalization

In this new abnormal, we would venture that cases regarded as successful —*i.e.*, saving companies, jobs, and ultimately paving the way to a collective economic recovery — will be the ones where consensus and compromise take priority above all else. To be sure, litigation will play a strategic role in building consensus and achieving commercial solutions and in some instances will be absolutely necessary to maximize value. But parties should carefully choose their litigation battles, lest they lose credibility with deluged courts or their victories will prove Pyrrhic.

Restructuring professionals know all too well that bankruptcy courts offer a natural litigation forum with each phase of a case (particularly a free-fall case) presenting opportunities for jousting, particularly when a litigants' fees are covered by the debtors' estate. At the outset of cases, junior creditors' objections to DIP financing terms and secured creditors' protests to adequate protection packages are *de riguer*; parties may contest the bankruptcy filing itself as an ultra vires act or may even engage in venue transfer litigation; Rule 2004 fishing expeditions and investigatory processes can take on a life of their own midway through a case; and battles over the Bankruptcy Code's confirmation requirements frequently mark the climactic battle in many cases. In this environment, there will no doubt be objections lodged regarding plan feasibility and valuation issues given COVID-19's economic upheaval.

These skirmishes should not derail successful reorganizations, and creditor constituents should be motivated to resolve them expediently. First-mover companies that are able to solve their leverage problems quickly may be beneficiaries of consolidation opportunities unavailable to those who wait. On the flip side, companies that file too quickly and without a clear exit strategy will be at risk of lingering in Chapter 11 and potentially liquidating. Thus, even with an increase in free-fall filings, exit planning in terms of requisite creditor support and exit financing options will continue to be crucial. And even though banks and CLOs have restrictions on their own lending practices as a result of the Great Recession, private capital has no such limitations with an abundance of dry powder in reserve and, as last month's *Turnaround and Workouts* noted, many investment shops are ramping up to take advantage of these opportunities. These investors will have the opportunity to make attractive returns and buttress the economy, playing the role of white knights.

Mediation can also help facilitate the recovery process. Pre-pandemic, the prevalence of mediation to resolve major disputes in bankruptcy cases worked well when judges or other eminent practitioners brokered solutions in seemingly intractable situations. Candid communication from mediators regarding which side will likely win or lose and the collateral consequences of any result, without incurring the time and expense of full blown litigation can be invaluable to achieving solutions. In the new abnormal, saving a month or two from litigation could mean all the difference in a company's survival. Bankruptcy offers other tools of expediency, including 363 sales that companies can use to sell their assets free and clear of liens giving the purchaser a chance to operate the company as a going concern and litigation trusts permitting a company to operate freely outside of Chapter 11, while the trustee pursues litigation claims left to the trust.

Bankruptcy judges, who have rightfully earned their reputation as the consummate commercial problem solvers, will be functioning as the intensive care physicians overseeing the recovery. In the early stages, they have been incredibly accommodating and flexible (as shown already in the contested hearings with cross examinations occurring by video, and "mothball procedures" that have become the flavor of the day in retail cases), but will rely on professionals to prioritize the need for actual court time thoughtfully.

While those who have lived and worked through prior downturns will be able to draw from their experience to tackle the challenges presented by COVID-19, the unprecedented, distinct features of this economic and health crisis will require flexibility and some improvisation. This new abnormal will be a true test of Chapter 11 as the commercial safety net as never seen before. Creative, sophisticated advisors and judges working collaboratively with the bankruptcy bench should be up for the challenge. ¤

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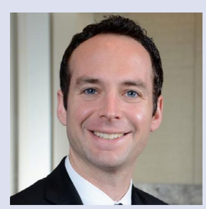

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