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PERSPECTIVE

Navigating the fiscal impacts of the COVID-19 pandemic

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It is important that businesses enduring significant financial distress, even if the problems only arose as a result of fallout from the pandemic, act proactively to sustain viability and chart a viable path forward. Although management may be in a mood to retreat from the outside world and avoid coming to grips with the changed and uncertain new reality, it is essential that companies consult with and seek guidance from professionals with experience and expertise in helping businesses address financial challenges. Where feasible, the goal should be to resolve financial issues outside of court and facilitate the company moving forward on a restructured and sound basis. When necessary, business reorganization or transition through a more formal process should be considered and evaluated. Management needs to avoid delaying action until is too late to rehabilitate or even salvage the business and must ensure that adequate funds are maintained and/or financing lined up to facilitate business reorganization or transfer.

In the current unprecedented times and uncertain business climate, preservation of cash is paramount. Preserve liquidity and cash reserves. Many businesses have drawn down their credit lines in order to have cash available because they became concerned about their future accessibility to credit. Companies need to prepare cash budgets based on alternative assumptions about the length and severity of the shutdown/ slowdown caused by the pandemic. An anticipated potential liquidity crunch constitutes a key "trigger" signal for management that prompt action needs to be taken and outside guidance should be accessed.

In the present climate, it is likely that many businesses need to extend payment on payables, more carefully manage collection of receivables, and, to the extent eligible, seek funding through government programs. In ordinary times, it is not unusual for principals (and others) to provide funding for and invest in businesses without seeking concessions and support from other stakeholders. Of course, these are not ordinary times. The infusion of funds to bridge operations should be part of a collaborative process involving existing lenders, landlords, key suppliers and possibly other stakeholders depending on the business. The parties need to see a business plan that shows a sustainable path forward for the company subject to their support involving necessary concessions that will allow them to have a viable borrower, tenant or customer into the future. Considering obtaining the investment of additional funds into the business is another sign for management and ownership that consultation with outside professionals is needed.

In addition to considering additional funding and preparing a budget based on alternative assumptions regarding the ongoing pandemic on the business, the company should seek assistance for review of lease, credit agreement and other contract provisions that may mitigate liability for non-performance (e.g., force majeure clauses) and for evaluating credit relief alternatives that may be necessary or optimal for maintaining viability, including payment and other contract term forbearance, deferral, abatement, moratoriums, modifications, extensions, supply and purchase commitments, and/ or restructuring. On the other side of the equation, appropriate advice and professional assistance is needed when responding to requests from lenders, creditors, suppliers and others who work with the business. The likelihood that some of these parties are having their own financial challenges is high and companies need to make sure that that they are properly protected and mitigate risk going forward.

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Communication is a key for businesses managing their relationships with stakeholders in challenging times. It is important for the company to get out and stay in front the problems. This is done through frequent communication with capital structure and operational stakeholders, including secured lenders, landlords, other debt holders, suppliers, customers, employees, various other counterparties and equity holders. For each stakeholder, management should evaluate motivations, rights and obligations, assess negotiating leverage and review corresponding supply contracts, leases, credit agreements, and various other contracts to identify necessary modifications.

In developing an overall plan for moving forward, management should evaluate and determine, with appropriate input from outside experts, whether the business needs a balance sheet restructuring (deleveraging debt), an operational reorganization (eliminating certain locations and/or reducing or terminating parts of the business), and/ or the use of sale or merger process to clean the slate. Can the business be returned to profitability if the debt burden is reduced? Is a more streamlined operation, eliminating non-performing and subpar locations and/or divisions or other parts the business necessary to build sustainability? Is the business no longer viable standing on its own, but still attractive (at least in part) to a potential acquirer or joint venture partner?

The goal should be to address and resolve financial issues out of court, if feasible. Out-of-court arrangements are consensual. While negotiated in the shadow of a potential bankruptcy case, they require consensus and, unlike in Chapter 11 bankruptcy, cannot force concessions and contractual modifications on creditors and other counterparties. When good communication is maintained, accurate information is provided, and trust is built with creditors, the opportunity for an out-of-court restructuring is maximized. Restructuring arrangements may provide, among other things, for adjustment of payment terms (abatements, moratoriums, deferrals, extensions, reductions and others), forbearance agreements, and/or loan, lease and other contract modifications. In some cases, there will be insufficient time, lack of cooperation, and/or just too may complexities to accomplish a necessary restructuring out of court.

When adequate consensus is not achievable to facilitate an out-of-court solution, Chapter 11 of the U.S. Bankruptcy Code provides a means for businesses to reorganize or implement a sale transaction where all company debt is not being satisfied. Upon commencement of a Chapter 11 case, an automatic stay goes into effect, putting all litigation and collection efforts against the debtor on hold and providing some breathing space. The debtor generally has the power to reject, assume, or assume and assign leases and other executory contracts, even if prohibited under the contract. Landlord claims arising from rejection of leases are capped.

The goal of Chapter 11, in most cases, is confirmation of a plan of reorganization. Upon bankruptcy court approval, the plan is binding on creditors and equity holders of the debtor, provides for the treatment of claims against the debtor, and the obligations under the plan replace pre-bankruptcy obligations of the debtor. Accordingly, a confirmed Chapter 11 plan can impose (cramdown) on creditors, equity holders, and other counterparties non-consensual modification of contract rights and restructuring of debt. A company can deleverage its debt and reset its balance sheet under a Chapter 11 plan. It can also streamline its operations by reducing or eliminating locations, divisions, and other parts of its business and addressing related claims (which may be minimized and/or, depending on the circumstances, receive no payment). Upon confirmation of a reorganization plan, the company receives a discharge from its pre-confirmation debt. Further, while a business can be sold under a plan, even outside of a plan, Section 363 of the Bankruptcy Code can be used to implement a going concern sale of the debtor's business or to sell specific assets. This can frequently be done on an expedited basis when circumstances warrant quick action.

In order to minimize expense, delay and uncertainty in the Chapter 11 process, it is desirable, when feasible, to streamline the process. This can be done through a "prepackaged" plan. In such cases, the plan has been developed, negotiated, and prepared prior to the commencement of the case. Frequently, a plan support agreement is entered with key stakeholders to memorialize their support for the plan and the Chapter 11 process. Upon commencement of the case, the support agreement and the plan are filed and the process can move forward on an expedited basis. To the extent prepackaged and, in particular, when the plan is supported by significant creditor constituencies, the reorganization process can be significantly shortened and less costly.

Another route to a streamlined reorganization process is also available to small businesses (companies with less than $7.5 million of non-contingent, liquidated debt). This debt limitation was increased from to $2,725,625 as part of the Coronavirus Aid, Relief, and Economic Security (CARES) Act in March. The small business "Subchapter V" had only taken effect on February, and then the impact of the pandemic hit. At this point, Congress has increased the debt limitation for one year. Subchapter V is designed to make Chapter 11 reorganizations for small businesses more efficient, streamlined and less expensive than traditional Chapter 11 reorganizations. It eliminates some of the required steps to plan confirmation and also some of the creditor protections that otherwise come into play in the confirmation process.

Chapter 7 of the Bankruptcy Code provides for liquidation. For practical purposes, it can be viewed as a formal burial process. A bankruptcy trustee (the identity of whom is unknown prior to commencement of the bankruptcy case) is appointed, acts as a fiduciary for creditors, and is responsible for marshalling and liquidating assets of the debtor and distributing available proceeds, if any, to creditors.

An alternative to Chapter 11 to be considered in some situations is an assignment for the benefit of creditors (ABC). An ABC is a business liquidation device available to an insolvent debtor instead of a formal federal bankruptcy case. In some instances, an ABC can be the most advantageous and graceful exit strategy. This is especially true where the goals are (1) to transfer the assets of the troubled business to an acquiring entity free of the unsecured debt, and (2) wind down the company in a manner designed to minimize negative publicity and potential liability for directors and management. The option of implementing an ABC is available on a state-by-state basis. In California, the ABC process is non-judicial.

Compared to a federal bankruptcy case, an ABC may involve less administrative expense and can be a substantially faster and more flexible liquidation process. In addition, unlike a Chapter 7 liquidation, where generally an unknown trustee will be appointed to administer the liquidation process, in an ABC, the assignor can select an assignee (who acts in the same capacity as a bankruptcy trustee) with appropriate experience and expertise to conduct the wind down of its business and liquidation of its assets. In prepackaged ABCs, where an immediate going concern sale will be implemented, the assignee will be involved prior to the ABC going effective and can frequently effectuate a turnkey transaction upon commencement of the ABC.

In order to maximize the opportunity to sustain and rehabilitate a business negatively impacted by the pandemic, prompt evaluation and action to preserve liquidity and protect the viability of the business must be taken. Early action can increase the opportunity for a collaborative approach enlisting support of and concessions from key stakeholders with an interest in seeing the company survive. Further, when an out-of-court restructuring is not feasible, early action by management, including obtaining appropriate outside guidance, can help place the company in a position where it will be prepared to maximize the opportunity for successful business reorganization under Chapter 11, which ideally should be pursued on a streamlined basis. ■

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