BANKRUPTCY & RESTRUCTURING

A Roundtable Discussion

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Due in large part to the challenges brought on by the pandemic, Chapter 11 bankruptcy filings last year hit the highest level since 2010—a trend expected to continue throughout this year.

Bankruptcy and restructuring is complex, full of twists and turns. Yet for all the expense, blame, negotiation, compromise and introspection involved, the process does provide an opportunity for distressed companies to get their businesses and finances back on track.

For those companies that meet the challenges of bankruptcy and restructuring, there could well be a brighter future in store; for those that do not, a different outcome lies in wait.

The Los Angeles Business Journal posed a series of questions on the topic to some local trusted advisors who work with struggling businesses to share their insights.

BANKRUPTCY & RESTRUCTURING ROUNDTABLE

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Now that we are on the road to recovery from the pandemic, what trends are you seeing around restructuring and bankruptcy filings?

RALLIS: With the end of lockdowns and the reopening of the economy, state and local governments will soon end, or have already ended, their eviction and foreclosure moratoriums, which will allow evictions and foreclosures to restart after being on pause for more than a year. It is expected that landlords and lenders will already be ready to move on day one after the expiration of the moratoriums, potentially causing bankruptcy filings to spike as distressed companies threatened by an eviction or foreclosure can procure a temporary reprieve by filing bankruptcy and obtaining the benefits of the automatic stay.

RAANAN AND TEDFORD: A major trend in bankruptcy filings is that…there have not really been that many bankruptcy filings (at least not yet). Some high-profile cases have been filed, but many companies have opted to just shut down instead of trying to reorganize through bankruptcy. Even when they have filed for bankruptcy, some well-known businesses have opted for chapter 7 liquidation instead of chapter 11 (such as Souplantation and Pacific Theaters).

What effect did the challenges of the past 15 months have on the bankruptcy and restructuring landscape?

BANNER: Remarkably, the past 15 months did not result in the wave of bankruptcy filings that many bankruptcy professionals expected. Other than the notable large retail filings, mid-market bankruptcy filings have been few and far between. Many factors have likely influenced this unexpected outcome of the COVID-19 pandemic, including PPP and EIDL loans, the historically low interest rates and the various eviction moratoriums. Many businesses that would normally resort to a bankruptcy restructure in a poor economic environment were able to take advantage of these policies and programs to essentially weather the storm. Unfortunately, the low number of bankruptcy filings does not necessarily mean that less businesses were closing. What we have seen is that numerous retailers, restaurants and other businesses that would normally be able to reorganize in a bankruptcy cases in a more favorable economic environment were simply forced to permanently close their doors and/or liquidate in recent months due to the pandemic.

RAANAN AND TEDFORD: The CARES Act, other stimulus packages, unemployment benefits, and hope that things would reopen soon buoyed many businesses during the pandemic. Landlords also were flexible, though moratoria on evictions left some with little choice. Oddly enough, in the Central District of California, we did not see an upswing in bankruptcy filings. We are on pace to have fewer bankruptcies filed this year than in any year in recent memory. And we are on pace to have about the same number of Chapter 11 business cases filed this year as in each of the last 6 years. To give you an idea as to how few cases are being filed: As of July 14, 2021, 149 Chapter 11 business cases had been filed in our district this year; in 2010-2011 there were more than 720 such cases each year.

What are some signs that a business is struggling and that restructuring or bankruptcy might be a necessary path?

BANNER: Just like for personal finances, once a business begins to struggle to pay debts as they come due, it is time to take a step back and evaluate your options. This rule of thumb is not always so obvious when operating a business, as prioritizing payment of debts is an often-organic process based on available capital. Nevertheless, if a company finds itself putting off payments to trade creditors in order to make payroll, or a company elects to extend repayment terms outside the ordinary course – for instance paying debts normally paid in 30 days to 60 or 90 days – these can all be signs of financial distress. Consulting with a bankruptcy professional once the early cracks begin to show is the best way to avoid a complete meltdown of a going concern.

RAANAN AND TEDFORD: Financially distressed businesses typically cannot pay their debts on time, or at all, struggle to raise capital and are forced to borrow at sub-optimal terms, including high interest rates. Many are forced to direct receivable collections to lock boxes, which limits the funds available for their operations. Other signs include sudden and dramatic turnover of high-level employees and the loss of a key client(s). Often struggling businesses are involved in expensive litigation and/or large judgments, which distract leadership and syphon company resources.

At what point should a business consider hiring a bankruptcy or restructuring professional and what should they look for?

BANNER: The earlier, the better. One common misconception is that a bankruptcy or restructuring professional need only be consulted as a "last resort" when a bankruptcy filing is imminent. To the contrary, when brought in at the early signs of financial distress, a bankruptcy or restructuring professional could be the key to avoiding a bankruptcy altogether. There are many options at a company's disposal to address the source of financial distress, and sometimes a resolution is achieved through negotiating an out-of-court restructure with one, or a handful of a company's creditors. Unfortunately, companies often seek help when many of the out-of-court options are no longer viable, or when crucial bridges with stakeholders have been burned.

RAANAN AND TEDFORD: Chapter 7 (liquidation by a trustee) usually is worth doing only if the business already is closed, and if (1) there are assets that can be sold, or (2) a strong signal needs to be conveyed that the business really is defunct. For operating businesses that have some going concern value, an orderly liquidation through Chapter 11 is a better option. For companies that want to reorganize, Chapter 11 is good for real estate companies with property that has significant equity or can generate enough cash to make monthly interest payments. For operating companies, Chapter 11 is a good idea if the business is (or can be) profitable, but needs to shed some bad leases, restructure secured loans, and/or stretch out payments to creditors. Bankruptcy protects the debtor's assets and gives it some time to negotiate terms with creditors.

What is the first thing a company should do if it plans to file for bankruptcy?

BANNER: Immediately consult with a bankruptcy professional – but not just for advisement on the bankruptcy process, but to discuss the various options at the company's disposal. To file, or not to file a bankruptcy is often just a small part of the equation. The company may want to consider out-of-court options, ranging from individualized negotiations with creditors to an assignment for the benefit of creditors (a process similar to bankruptcy done outside of a formal court proceeding). If a bankruptcy filing is more appropriate for the company, the form of that bankruptcy can be tailored to the needs of the company, whether it be a sale of the company or its assets, a reorganization, or a complete liquidation. The best route varies based on a company's individual circumstances.

RAANAN AND TEDFORD: Especially if the company is operating, get its records (and record-keeping) in order. From the first day to the last, the debtor's success depends on its ability to properly identify and disclose its assets, liabilities, and financial history, generate reliable financial statements during the case, and prepare realistic financial projections. No matter how profitable a company may be, cases can go south quickly if the debtor's financial reporting is inadequate or untrustworthy.

RALLIS: A distressed company anticipating the need to seek bankruptcy relief must continuously be thinking and planning ahead, including consulting with restructuring professionals (e.g., bankruptcy attorneys and turnaround specialists) as early as possible about its strategic options and developing a game plan that identifies the goals the company wishes to accomplish through a restructuring or reorganization and outlines how it intends to accomplish those goals. Once a case has been filed, the bankruptcy process will be time- and resource-consuming on the company itself (at the time when the company's principals should be focused on stabilizing or improving the business), and a company that enters bankruptcy without already having a clearly defined strategy on how to exit bankruptcy is likely to face greater odds of successfully reorganizing.

What are some bankruptcy pitfalls that businesses should avoid?

RAANAN AND TEDFORD: It is a long list. Mostly, don't do things that may turn the judge against you. Don't transfer away assets before filing. Don't provide false or misleading information in court filings. Choose your battles (if you litigate about everything, the judge may see you as the problem, not the solution). Also, don't make everyone your enemy. Litigating against creditors – especially secured creditors who can add their legal fees to the loan balance – drives up costs. Often, by the time you finish fighting with a hostile creditor you spend more on legal fees than you would spend if you had just agreed to pay more under a chapter 11 plan.

BANNER: The moment a company begins to experience financial distress, close attention must be paid to the flow of cash. For instance, payments to equity holders or other "insiders" of the company made within a year of filing bankruptcy could be later clawed back through the bankruptcy process. Similarly, payments to any creditors within the 90 days before a bankruptcy could be clawed back as "preferential" payments to those creditors (to dissuade companies from paying off the creditor they like prior to bankruptcy). Those are only two examples of common pitfalls a company faces after a bankruptcy filing. Consulting with a bankruptcy professional early in the process can help mitigate the risks associated with the company's financial dealings leading up to a bankruptcy filing by advising against problematic cash flow decisions before they are made.

What are some alternatives for a distressed business to explore other than bankruptcy?

RAANAN AND TEDFORD: Financially distressed businesses have many options in addition to bankruptcy, including:
Debt renegotiation: Getting creditors to reduce their claims is the least expensive option, though it comes with a caveat. Approaching creditors could signal financial difficulty which could hurt a business' ability to raise funds.
Dissolution: A business can liquidate its assets, pay creditors based on legal priorities, and cease operating.
Assignment for the benefit of creditors (ABC): An owner may transfer business assets to an assignee/fiduciary who assumes responsibility for liquidating the assets and paying creditors.
Asset sale: By selling some corporate assets an owner can pay critical business debts, avoid personal liability, and even preserve a part of the business.
Sale of business: An owner can sell the business to a competitor or a better capitalized entrepreneur.

RALLIS: As an alternative to bankruptcy, a distressed company can explore an out-of-court workout, which, when compared to chapter 11, is a more informal, faster, and less costly process by which the company and its creditors attempt to work out a debt-restructuring plan without court oversight. The downsides in pursuing a workout are that it sometimes only takes one holdout creditor to make a potential workout fall apart and that the company does not have the benefit of the automatic stay while negotiating a workout. That means that, in the absence of an agreed-upon forbearance, a creditor can still proceed with any collections action against the company during those workout negotiations. A company seeking to sell its assets, including a going-concern business, to a buyer may also consider exploring an assignment for the benefit of creditors (or ABC), which would allow the buyer to acquire the company's assets free and clear of the company's unsecured debts.

What's the best way for a distressed company to find a qualified buyer or financing in today's market?

BANNER: Companies are often surprised to learn that there is an entire field of professionals dedicated to the sale of distressed assets – whether it is the sale of restaurant equipment or the sale of a going concern with millions in annual revenue. In short, if there is a buyer out there, such professionals will find them. We have had great success over the years connecting clients with appropriate professionals in order to maximize the value of a distressed asset sale.

What should a small business expect during the first few months after filing for bankruptcy?

RAANAN AND TEDFORD: Petitions often are filed on the eve of a foreclosure, judgment, or other adverse event the debtor wants to delay. But there is no rest for the weary. Existing bank accounts must be closed and new ones opened right away. A "7-day package" must be submitted within a week. Detailed schedules of assets and liabilities must be filed within a few weeks. Soon after the case is filed, someone will need to attend an "initial debtor interview" and later a "meeting of creditors." In a Subchapter V case, the debtor must file financial statements and tax return with its petition, detailed operating reports must be filed each month, and a plan must be filed within 90 days. While doing all of this (and more), the debtor must keep its business going. For a truly small businesses, this is a monumental task.

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Are there any new laws and regulations to be aware of that affect the bankruptcy and restructuring landscape in 2021?

RALLIS: Certain temporary statutory provisions benefiting small businesses in bankruptcy, which were originally enacted in 2020 by the CARES Act and then extended in 2021 by the COVID-19 Bankruptcy Relief Extension Act, are currently set to expire in March 2022, unless a further legislative extension is passed. These provisions allow a larger pool of small businesses to seek bankruptcy relief under subchapter V within chapter 11 by raising a small business's debt limit for subchapter V eligibility from $2.7 million to $7.5 million. For most small businesses, a subchapter V case would likely be more advantageous than a traditional chapter 11 case as proceeding under subchapter V involves a more streamlined and less expensive process to reorganize and offers certain benefits not otherwise available to a chapter 11 debtor, such as the elimination of the "absolute priority rule" (which means that the owners of a company in a subchapter V case can retain their equity without the company having to pay its creditors in full).

RAANAN AND TEDFORD: The Small Business Reorganization Act, which went into effect in early 2020, continues to provide opportunities for small businesses to reorganize faster and more efficiently, and for business owners to retain their ownership interests without having to contribute new funds. In 2021, Congress extended a temporary increase in the debt ceiling for small businesses seeking relief under the new Subchapter V of Chapter 11, to $7.5 million. That could go back down to about $2.7 million in March 2022. For individuals seeking bankruptcy relief, 2021 brought a substantial increase in the California "homestead exemption," which allows individual debtors to retain equity in their homes. This year, the exemption increased from as little as $75,000 to as much as $600,000.

How does filing for bankruptcy impact the sale process?

RALLIS: The commencement of the bankruptcy case will add some delay to the sale process. Any proposed asset sale will typically need to be subject to some form of an overbid process or auction, which is intended to maximize the value of the assets to be sold. Though the debtor-seller will get to formulate the terms and conditions of the bidding and sale procedures, it must nevertheless establish to the bankruptcy court that such procedures will not chill bidding and will foster a competitive sale. For a prospective buyer who has already conducted due diligence, the debtor-seller may elect such prospective buyer to be the stalking-horse bidder in connection with any overbid process, with the prospective buyer afforded certain incentives, such as expense reimbursement and a breakup fee, in the event that it is not the successful bidder. Also, a sale process and sale approved by the bankruptcy court can afford certain protections to the successful buyer (e.g., acquiring the target assets free and clear of claims, liens, and successor liabilities).

BANNER: Often, a sale through a bankruptcy is actually preferable to an out-of-court sale. The reason for this is that, under the Bankruptcy Code, a buyer is able to purchase assets "free and clear" of liens and claims encumbering the assets through a bankruptcy sale. This offers a buyer a tremendous amount of comfort and security, which typically cannot not be achieved outside of a bankruptcy setting. One of the challenges we face when representing a buyer outside of bankruptcy, whether by foreclosure or otherwise, is that creditors and other parties continue to go after a buyer for the liabilities of the seller. A "free and clear" bankruptcy court sale order, on the other hand, provides a near iron-clad defense to any such claims.

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Do guarantors of the debts of a bankruptcy debtor have defenses that can excuse them from liability under the personal guarantees?

RAANAN AND TEDFORD: The short answer is "perhaps." California Civil Code sections 2787 through 2855, as well as common law, provide guarantors multiple defenses. These include exoneration, when terms of the original obligation were altered without the guarantor's permission (Civ. Code 2819), lack of consideration/value received by the guarantor (Civ. Code 2792), guarantor's obligations cannot exceed or be more burdensome than those of the principal borrower (Civ. Code 2809), and a right to demand that the creditor first seek payment from the principal obligor and foreclose on property securing the debts (Civ. Code 2845, 2849), among others. Unfortunately, California guarantors often waive most of their defenses (Civ. Code 2856), with exception of those based on public policy considerations such as crimes committed by a creditor. Business owners who sign personal guarantees need to carefully read loan documents to understand whether they are waiving valuable rights. Important: A person who signs a continuing guaranty can revoke it as to future transactions with a written notice to the lender. (Civ. Code 2815).

If a business is privately held, will a business bankruptcy hurt the owner's credit score?

BANNER: The effect of a company's bankruptcy on its principal is a common concern we hear from client. The short answer is "No" a company's bankruptcy filing should not affect a principal's credit. However, if the principal's personal financial affairs become intertwined with the company's, there is a possibility of an adverse credit event. For instance, company credit cards are a common way that company debts make its way to an individual's credit report. If a company credit card has your name on it, you should be concerned about personal liability. Also, principal's often guarantee the

debts of a company, which could lead to collection and lawsuits after the underlying company files bankruptcy. Any time you take on a debt for the company, you should consider what will happen if the company later files for bankruptcy.

What legal ramifications should a business consider when filing for bankruptcy?

RALLIS: A distressed company should understand that following a bankruptcy filing, the company will be subject to court supervision and oversight, as well as various disclosure requirements. For example, if the company wishes to secure financing, sell its assets, or otherwise enter into a transaction considered to be outside of the ordinary course of its business, then it will first need to obtain approval from the bankruptcy court. Additionally, by filing bankruptcy, the company is required to effectively open itself up to the public by disclosing all of its assets and liabilities, as well as other aspects of its financial affairs, and, at the same time, creditors and other parties have the right to scrutinize the company's finances.

RAANAN AND TEDFORD: Bankruptcy laws are designed to give debtors a "fresh start," and serve an important role in our economy. However, bankruptcy is also risky. It can result in the loss of control over business operations and the unplanned liquidation of the business through forced sale of its assets. Bankruptcies often result in higher scrutiny of pre-bankruptcy financial decisions, including payments or transfers to insiders who could be sued by trustees or creditors' committees in an effort to avoid the prepetition transfers. Bankruptcy exposes the debtor's finances and other secrets to its competitors, which could hurt the debtor's ability to compete.
On the positive side, bankruptcies give debtors the breathing space they may need to renegotiate agreements with creditors, vendors, and even employees. It also allows debtors to reject key agreements and shed debt.

What is the best advice you can give when it comes to restructuring or bankruptcy?

RALLIS: Do not bury your head in the sand. The bankruptcy or restructuring process can be complex and overwhelming and requires a significant amount of planning in order to improve a distressed company's chances of a successful reorganization. Yet, a substantial majority of business leaders have unlikely gone through such a process in their careers. As a result, it is better for their companies' survival that those leaders, early on, acknowledge that they do not have all of the knowledge or understanding necessary to navigate the restructuring process on their own and seek out the counsel of capable restructuring professionals.

RAANAN AND TEDFORD: Every case has its unique set of facts and legal challenges. However, as a general rule debtors should maintain open lines of communication with creditors, trustees, courts, and other stakeholders. A debtor who manages creditor expectations and communicates honestly and timely about its challenges will likely reduce creditor resistance to reorganization efforts. Also, a debtor who recognizes financial difficulties early and retains relevant professionals to advise on solutions will often have greater success in reorganization and bankruptcy proceedings. Finally, creditors and debtors in distressed business situations should be realistic, flexible, and open to compromise. Protracted, expensive litigation rarely benefits the parties.