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Practical & Legal Aspects of Restructuring Strategies in a Financial Crisis

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Cash Flow Issues

Practical

1. Calculate and project how much cash to work with
 - By assessing undrawn lines of credit
 - Determining what customers are likely to pay
 - Identify opportunities for quick sales of non core assets
 - Incentivize customers to pay

Cash Flow Issues

2. Calculate and project how to use the cash
 - Identify critical vendors
 - Determine a communication strategy
 - Determine and rationalize labor force required to meet demands

Who do we have to pay?

Practical

- Employees
- Health Insurance
- Critical vendors
- Who can we stretch?
 - Landlords
 - Utilities
 - Taxes (property)
 - Bank
 - Equipment leases
 - Change payment terms for non-critical

Legal

- What legal recourse do people have that don't get paid?
- What is the process if vendors/creditors are not paid and how likely to be implemented?
- Review strategy with different types of creditors
 - Banks
 - Vendors
 - Landlords

Employees

Practical

- Layoff non essential employees
- Furlough employees
- Part time option
- Reduce wages and benefits

Legal

- What is the legal risk to not paying payroll?
- What is the difference between furlough and a layoff?
- Does FMLA Act require certain employees be allowed to stay home at 75% pay?

Legal Issues re Payroll

- Under the Federal Labor Standards Act (“FLSA”), an employer must pay non-exempt employees (not employees employed in an executive, administrative or professional capacity who are considered exempt) the full minimum wage and any statutory overtime on the regularly scheduled pay day for the workweek in question.
- See <https://www.dol.gov/agencies/whd/fact-sheets/70-flsa-furloughs>
- Failure to pay payroll can result in steep penalties including, in addition to payment of the wages, liquidated damages, interest, attorney fees and court costs. The Michigan Wage and Hour Division may order the company to pay a penalty at the rate of 10% per annum and double the wages owed if the violation is flagrant or repeated. Also, under wage and hour laws there is potential individual liability for an individual who makes wage decisions that impact compliance with the laws.

Payroll (con't)

- To avoid fines, penalties, potential personal liability, most prudent practice is for distressed companies to put into effect furloughs, layoffs and/or payroll reductions. The FLSA, generally, does not preclude an employer from prospectively lowering a non-exempt employee's hourly rate or an exempt employee's salary so long as the rate paid is least equal to the minimum wage or applicable salary basis or from reducing the number of hours of scheduled work of an employee.
- Difference between furlough and layoff:
- **Furlough** - A furlough, usually mandatory, requires an employee to work fewer hours or take a certain amount of unpaid time off.
- **Layoff** – a layoff is a temporary separation from payroll because, for example, there is not enough work for him or her to perform, but with the intention that once conditions change and work becomes available, the employee can be recalled. Conversely, if conditions don't change or the employer decides not to recall the employee, the layoff can become permanent. During period of unpaid layoff, employees are generally able to collect unemployment benefits and maintain other benefits coverage.

Family Medical Leave Act

- 2020 Changes effective on April 2.
- Requires paid leave for caregivers of children with closed schools.
- Only applies to employers with fewer than 500 employees.
- First 10 days of leave do not require pay (but employees can use leave under other law, or employment agreement)
- Up to \$10,000 (total) for each employee, \$200 per day.
- 2/3 of regular pay, up to the caps above.
- Employer gets a tax credit for the required amounts (no credit for exceeding the required amounts)

Vendors

Practical

- What are essential services?
- Do we have resource options if we can't make a deal or vendor can't perform

Legal

- What are our legal options if vendors can't perform?

Customers

Practical

- What are our production requirements?
 - Can we meet them?
 - Critical vendor shipments
 - Required manpower
- What happens if we can't meet production requirements?
 - How to incentivize customers to work with us?
 - What can we do to get paid?

Legal

- What happens if we can't meet customers requirements?
- What options to change payment terms of purchase order
 - Can we withhold shipments?
 - Request deposits, COD or progress payments
- Force Majeure – do Terms and Conditions require a contingency plan?

Customer/Vendor Legal Issues

Distressed supplier termination hurdles:

- Lack of qualified replacement suppliers.
- Tooling, PPAP requirements, access to IP restrict quick exit.
- Customer funding of supplier in short term to avoid disruption of production.
- Bankruptcy could be substantially more costly for the customer.
- State court litigation – uncertain timing/outcome.
- Demands from secured lender.
- Best practice – negotiate out of court agreement with customer, supplier and lender.

- Generally, if the customer or vendor fails to perform, rights include:
 - Sending a written demand for adequate assurance of due performance and until such assurance is received, suspend performance (stop buying, stop ship), unilaterally modify payment or delivery terms under the contract. UCC 2-609;
 - Subject to in any notice or cure period, terminate the contract.
 - Sue to enforce contract.
 - Sue for recovery of tooling.
 - Sue for unpaid balance.
 - Under force majeure event, be excused of performance.
- Contract may obligate to take and pay for goods absent a FM excuse.
- If a contract is a requirements contract, no obligation of buyer to keep requesting parts.

Force Majeure

- Term in contract often used to describe situations where performance is impossible, impracticable or prevented by a “superior force.”
 - Definition of these terms may be harsh – heavy cost to perform may not be sufficient to trigger force majeure
- Legal analysis starts with the Contract and Terms and Conditions. Terms may be supplemented by the UCC (UCC 2-615 – performance “impracticable”). Non-US law may apply.
- If a force majeure event makes delivery impracticable, delivery is excused so long as (i) seller gives timely notice; (ii) if partial delivery is possible, seller allocates among its customers in a fair and reasonable manner; (iii) if delivery is possible by changing the contractual transportation or delivery methods, the parties must accept “commercially reasonable” alternative; and (iv) alternative practical methods of performance are employed. required.
- Generally, sellers should act as though there has been a FM event and give notice, accepting the risk the buyer may terminate for a declaration of a FM event of unknown length.
- Customers may require contingency plans.
- Both sides required to act in good faith.
- OEMs have not invoked Force Majeure and may treat situation as mere expression of their right to issue 0 releases.

Banks/Lender

Practical

- Defaults
- “Material Adverse Change in Business”
- Borrowing base erosion
 - Eligible receivables past 90 days
- Banks deem themselves insecure
 - Banks can pick winners and losers
- Regulatory issues in workout strategy for Banks

Legal

- What are the options if a Bank won't fund under a LOC agreement?
- What is likelihood Bank will enforce generic (those that don't require a math problem) covenants
- What are the Banks' remedies in a default?

Bank/Borrower Legal Issues

Secured Lender

In the event of an occurrence of a default by the borrower under a secured loan agreement with the Bank (for example, failure to timely pay interest or principal, borrower is out of formula on the borrowing base, a material adverse change in Borrower's financial condition, or loan deemed insecure based on deterioration of Borrower's financial condition), Bank would have the right, in its sole discretion, to:

- Prohibit further draws on any line of credit.
 - Sweep cash in borrower's accounts maintained at bank and apply to loan balance.
 - Foreclose on collateral, including notice to account obligors of borrower to remit payables directly to the bank.
 - Enforce personal guarantees.
 - Commence claim and delivery action to take possession of collateral, collect loan balance from borrower and any guarantors.
 - Seek appointment of a receiver if real estate is involved
- If a notice of default will deem the borrower to hold all collateral of the bank in trust for the bank, this will impose fiduciary responsibility on the borrower and its owner to the bank. After receiving a default notice, if the borrower diverts bank collateral (sells equipment without the consent of the bank, fails to turn over customer checks or deposits them in a new bank account with a different bank), owner, officers, directors involved in the diversion risk personal liability for conversion of collateral and owner also will be personally liable for breach of fiduciary duty. State conversion statute provides for treble damages.
 - Practically, while the Bank may refrain from taking action to foreclose on machinery, equipment and inventory, it will act to preserve value of liquid collateral by taking possession of as much cash (bank deposits, proceeds of accounts receivable) as possible. To be sure, the bank is not obligated to keep loaning money to a borrower in default.

Bank/Borrower Legal Issues (con't)

Unsecured Lender

- In the event of an event of default for failure to timely pay interest and principal, the bank would have the right to:
- Terminate line of credit.
- Freeze any accounts maintained by the borrower with the bank and offset deposits against loans.
- Commence suit to collect loan balance.
- Enforce personal guarantees, if any.
- Since the loan is not secured, no borrower issues with conversion or breach of fiduciary duty.

Options to Borrower

- No real opportunity to borrow from a bank or asset-based lender.
- Any opportunity to obtain temporary funding from customers unlikely if customers are shut down.
- Only viable option for financing, especially for small businesses, will be to apply for disaster loans from federal or state governments.
- If lender bank is secured, negotiate a forbearance agreement to allow time to obtain the loan with the understanding that the borrower will have 100% use of the loan proceeds to meet critical expenses.
- Absent ability to negotiate a favorable forbearance agreement, seek bankruptcy protection to preserve assets pending approval and funding of government loan.
- If a collection suit is commenced by the bank, understand for planning purposes that the earliest a bank could obtain summary judgment and be in a position to execute could be 70 – 90 days from date of commencement of suit.

What are Borrower's Bankruptcy Options? The Good, The Bad & The Ugly

Practical

- Small business
 - Less than \$2.7m debt
 - 60 days to file a plan
- Other business
 - 120 days to file a plan
- Stays adverse action
 - Judgements
 - Receiverships
- Use of cash collateral is an issue

Legal

- Is bankruptcy a real option?
- What are the pros/cons?

Bankruptcy Considerations

Traditional Concepts

- Reason for filing:
 - a. Preserve assets - automatic stay against bank foreclosures, landlord evictions, lawsuits, judgment executions, termination of key contracts.
 - b. Controlled environment to restructure balance sheet and negotiate compromises with creditor constituents in orderly manner.
 - c. Opportunity to reject and be excused of future performance of burdensome contracts.
 - d. Controlled environment to effect a going concern sale of the company free and clear of liens, security interests, claims and interests of creditors.

Financial Considerations

- Key Operational Requirements
 - Need cash to pay operating expenses (payroll, goods and services, rent, utilities, insurance, taxes), professional fees and other costs of bankruptcy arising from and after bankruptcy.
 - What are the “mothball” costs of maintaining PPE in restart-ready mode?
 - traditional sources of financing are debtor in possession loans from a conventional (bank) or non-conventional lender (asset based lender or equity fund); or
 - Cash collateral - proceeds of collection of prepetition accounts receivable or postpetition sale of prepetition inventory subject to security interest of lender
- **Up to 60 day delay on rent:** Under sec. 365(d)(3) and (d)(5) of the Bankruptcy Code, current rent on business real estate or personal property leases must be paid commencing on the date of the filing of the bankruptcy petition but in no event later than 60 days after bankruptcy filing. Unpaid rent is due on the 60th day.
- Utilities have the right to alter, refuse or discontinue service if the debtor fails to make a deposit or other assurance of payment within 20 days. Debtor is expected to negotiate the amount of the deposit with the utility, but Court will determine the amount of the deposit if parties do not agree. Payments must remain current.
- **Professional Fees:** Amount may depend on the size of the company and complexity of issues. However, significant up-front fees should be expected.
- **Suppliers:** Most suppliers will demand cash-in-advance or similar terms post-bankruptcy. Terms may be altered through a critical vendor program, however, that may involve even more up-front cash.

Key Deadlines

Key Deadlines

- Chapter 11 Plan should be filed by the debtor within 120 days unless extended for cause by the court not to exceed 18 months.
- For a small business debtor who elects to proceed under the Small Business Reorganization Act of 2019 (defined as a person or entity, other than the owner of a single asset real estate, that is engaged in commercial or business activities that has aggregate noncontingent liquidated secured and unsecured debt of not more than \$2,725,625), a Plan must be filed within 90 days (unless the court finds circumstances exist for which the debtor should not be held accountable).
- Under section 365(d)(4) of the Bankruptcy Code, a non-residential real estate lease under which the debtor is the lessee must be assumed within 120 unless extended for cause by the bankruptcy court for additional 90 days.
 - Assumption requires “prompt cure” of pre-bankruptcy arrearages.
 - Contracts must be assumed “as is” – any alterations in a lease must be negotiated with the landlord.

Covid-19 and Chapter 11 specific issues

- If a filing is due to a temporary shutdown of debtor's customers or the debtor itself, where will the debtor obtain the necessary cash to cover holding expenses pending a solution in bankruptcy?
 - Traditional debtor in possession financing from a conventional or nonconventional lender unlikely if the debtor has no working capital (accounts receivable and inventory) to pledge as collateral; especially if customers or the debtor or both are temporarily shut down.
 - Cash collateral may be unavailable or nonexistent. Even if there is some cash collateral going into a chapter 11, no bankruptcy court will allow a debtor's use of a secured creditor's cash collateral without the consent of the secured creditor or a showing that the debtor can adequately protect the secured creditor against loss of collateral value existing as of the date of the bankruptcy filing (for example, replacing every prepetition dollar with a postpetition dollar).

Covid-19 and Chapter 11 specific issues 2

- Owner financing, direct or indirect via guaranty and pledge of personal assets, may be an option but unlikely.
- Disaster relief loans from the federal or state government will be the more likely source under these circumstances. Michigan is now eligible for emergency SBA loans.
- Questions will be:
 - How long it would take to obtain the government loan?
 - How long will a bankruptcy court allow a debtor with no ongoing operations and little cash to remain in chapter 11?

What Happens When It Is Over?

- What are the restart costs?
 - Does financing for these costs exist?
 - Can it be obtained in Chapter 11?
 - Who has Capital?
 - ❑ Government funding
 - ❑ OEMs, Tier 1s, industry sources
 - ❑ Non-traditional lenders
 - ❑ Sharks, hedge funds and acquirers.
- How long will restart take?
 - Are overseas supplies available?
 - How long is the lag?
 - Does capital equipment require maintenance before restart?
- Normally, Chapter 11 cases cannot simply be dismissed. The Court may permit dismissal for cause.
- Chapter 11 Plan may be necessary. Confirmation of Plan generally requires significant negotiations with creditors, may permit modification of claims, extension of due dates, renegotiation of terms. May also require sale of company.

Online Information for Federal and State Disaster Relief Loan Assistance

- <https://www.michiganbusiness.org/about-medc/covid19/>
- <https://www.sba.gov/page/coronavirus-covid-19-small-business-guidance-loan-resources>
- <https://www.forbes.com/sites/advisor/2020/03/20/list-of-coronavirus-covid-19-small-business-relief-programs/#6c7e7e90e89d>
- <https://disasterloan.sba.gov/ela>

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QUESTIONS?

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