

# Practical & Legal Aspects of Restructuring Strategies in a Financial Crisis

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# Cash Flow Issues

1. Calculate and project available cash
  - Assess undrawn lines of credit
  - Determine which customers are likely to pay
  - Identify opportunities for quick sales of non core assets
  - Incentivize customers to pay early
  
2. Calculate and project how to use available 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 landlords 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 Does Executive Order 2020-21 Require? (critical v non critical)
- How does Family First Coronavirus Response Act work?

# Vendors

## Practical

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

## Legal

- Does Covid-19 meet the legal requirements to avoid supplying?
- What does it mean if Vendor is allowed to avoid supplying product?
- What if customer is "Critical" under EO 2020-21?
- I have a product that is essential but my supplier is shut down.
  - What are your options to break a contract with a vendor who you determine can't perform because of lacking financial resources or has lost employment force?
  - What considerations do you have to document to support your action?

# 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

- Buyers want supply if able to sell product.
- Demand assurance – MCL 440.2609.
- Vendor obligated to allocate production under MCL 440.2615.
- Secure alternative source.
- You have a customer that wants delivery and you can't perform, what are your options to not incur contractual damages?
  - Force Majeure
  - Can't economically serve just one customer
  - Economic hardship is not enough
  - Impossibility
  - Frustration of Purpose

# 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.

## • What are legal options?

- Are Courts open?
- What does contract say?
- Force Majeure
- Impossibility/Impracticability
- Frustration of Purpose

# Force Majeure/Impossibility/Frustration of Purpose - Related Concepts

- Force Majeure
  - Term in contract often used to describe situations where performance is impossible, impracticable or prevented by a “superior force.”
  - Not just expensive to perform. Need more.
  - Legal analysis starts with the Contract and Terms and Conditions. Terms may be supplemented by the UCC 2-615 – performance “impracticable.”
  - Customer wants narrow application to receive products. Supplier wants broad application, to avoid breach and damages.
- Impossibility/Impracticability
  - Common law concepts
  - After a contract is made, a party's performance is made impracticable/impossible without his fault by the occurrence of an event the nonoccurrence of which was a basic assumption on which the contract was made.
- Frustration of Purpose
  - (1) the contract must be at least partially executory; (2) the frustrated party's purpose in making the contract must have been known to both parties when the contract was made; (3) this purpose must have been basically frustrated by an event not reasonably foreseeable at the time the contract was made, the occurrence of which has not been due to the fault of the frustrated party and the risk of which was not assumed by him.
  - Economic hardship insufficient.



# Banks

## 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/TDR

## 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?
- Bank's 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.
  - Collect on receivables.
  - 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.
  - Most Banks are taking a wait and see approach right now.
  - If already distressed – Covid-19 is likely not a “get out of jail free” card.

# 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

- SBA emergency loans?
- 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
  - If receiver – Bank can assume control quickly.
  - If simply a money judgment or claim and delivery - execution could be 70 – 90 days from date of commencement of suit.

# What are Borrower's Bankruptcy Options?

## Practical

- Small business
  - Less than \$7.5m 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

- Reasons 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 (with Court permission) 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 60<sup>th</sup> 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

- 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 \$7.5m), a Plan must be filed within 90 days (unless the court finds circumstances exist for which the debtor should not be held accountable). A Small Business case avoids the expenses of a Creditors Committee, and avoids the dangers to equity holders of the “Absolute Priority Rule.” A successful Small Business case would be resolved more quickly and at less expense than a typical Chapter 11 case.
- 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?

# Government Covid-19 Funding

- Business Interruption Loans - \$10MM
- Covid Econ Stabilization Act - \$500B
- Paycheck Protection Loans (limits)
- Delay Employer Payroll Taxes (ER Only)
- Employee Retention Tax Credit
- Ease use of NOL's/AMT Tax Credits
- Increase Business Int Ded – Temp Inc To 50% ATI
- Hospitality – Immediate write-off; not 39 years
- Furloughed EEs – 4 months of pay through Federal Government
- Unemployment – Extended to 39 weeks plus additional \$600/week for 4 months
- Banks
  - Ease of CECL Restrictions
  - Allows larger than authorized loans
  - More leeway on troubled consumer loans
- Auto Industry
  - Loans previously mentioned
  - NO CHANGE – USMCA footprint req's
- Airline Industry - \$28B
- Ag - \$14B Comm Credit Corp; \$9.5B specialty ag
- Health Industry - \$27B
- Hotels – Loans; each site a separate business
- Individual Benefits
  - \$1,200pp/\$2,400 per couple (limits)
  - \$500 per child
  - Penalty Free withdrawal from retirement accounts (still taxable over 3 years)
  - Reduced limit for charitable contributions

# 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.

# Questions?

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# Resources

- [Rhoades McKee Coronavirus Resources](#)
- [O'Keefe Crisis Management](#)
- [MEDC Resources for Michigan Businesses During COVID-19](#)
- [SBA Coronavirus \(COVID-19\): Small Business Guidance & Loan Resources](#)
- [List of COVID-19 Small Business Relief Programs](#)
- [SBA Disaster Loan Assistance](#)