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Coronavirus: Its Impact on Chapter 11 Cases

This question – how the Coronavirus will impact Chapter 11 cases going forward – is still to be determined, but this author believes it may turn the Chapter 11 process into what it was originally intended to be, a reorganization.

Today, and for the past decade and longer, most Chapter 11 cases (other than prepackaged plan cases) have resulted in Section 363 sales of all the assets of the debtor to the highest bidder (the term Section 363 sale means a sale pursuant to Section 363 of the Bankruptcy Code), and sometimes that 363 sale comes within months of the filing of the case. Chapter 11 sales of all assets bring more value to the creditors than foreclosure sales, and of course "more value to the creditors" almost always means more value for the first priority secured lender of the debtor. After the 363 sale the Chapter 11 case is typically over for all practical purposes, and what happens is one of two things: Either (a) the Chapter 11 case is converted to a Chapter 7 case, which is a liquidation of any remaining assets by a trustee who is appointed by the U.S. Trustee; or (b) a plan is confirmed in the Chapter 11 case pursuant to which all remaining assets are transferred to a Liquidating Trust and its Liquidating Trustee who then proceeds to liquidate all of the remaining assets. Same difference almost, albeit with some technical differences and advantages to each. In either situation, the "remaining assets" are typically lawsuits which the trustee is empowered to pursue, including for example claims for preferential transfers to creditors, claims for fraudulent conveyances against others, claims for breach of fiduciary duty against officers and directors, and anything else like antitrust or securities fraud claims. It takes years of litigation usually before the unsecured creditors can receive anything from the process, which is usually just pennies on the dollar or less. It is the rare case where any meaningful distribution is made to the unsecured creditors.

This Chapter 11 process, described above in very general terms, has been condoned by most bankruptcy judges and the attorneys involved in the process, because it is the best thing for our economy in that it preserves operating companies intact, which benefits its employees who need the jobs (and buyers typically want to continue to operate the business), its customers which rely on its product or services, and it brings the most value to the creditors, including a continuing market for the trade creditors who supply goods or services to the debtor (and who may lose some amounts due to them by the debtor but who preserve their past profits as well as future ones). It is difficult to argue against this rationale for the process. Of course, the attorneys who represent each of the different constituencies (the debtor, the lender, the creditors committee, and the creditors) all get paid for their time and effort too, as well they should of course.

This author believes the Coronavirus may change the process going forward, and it certainly has the potential to do so if it spreads as widely as some predict it will and if it disrupts the normal machinery of our world and domestic economies as some predict too. How will judges, secured lenders, unsecured creditors, and others evaluate a situation if major disruption of everything becomes the new normal? Who will consider buying a bankrupt company through a Chapter 11 363 sale if there is so much disruption and uncertainty? Would the value of the bankrupt entity, assuming it has some, be preserved in a "fire sale" price to a third party? Would the secured lender and the debtor even be interested in trying to find out for themselves? The answers – while unknown so far – would seem to be that perhaps there is a better alternative in Chapter 11 for both a debtor and its secured and unsecured creditors, and for the judges who must face this potential new normal caused by the Coronavirus.

The better alternative may well be a true corporate reorganization through the more traditional Chapter 11 plan process – that is, instead of selling the debtor's assets pursuant to a 363 sale as has been the norm for a decade and longer, the debtor may want to file and seek to confirm a true Chapter 11 plan which truly reorganizes the debtor for the mutual benefit of all the constituencies.

The secured lender (or lenders) are usually the most important and controlling constituency in this process (let's start calling the different constituencies "players" in the process). For the secured lender, it may make more business sense for it to do two things – namely, reduce its interest rate being charged the debtor and convert some portion of it debt to equity (an ownership interest) in the debtor – rather than trying to cash out its unpaid loan through a 363 sale. The rationale for the sale and "cash out" of its loan has been it can quickly make a new loan with that cash and earn interest on it at least. That rationale may not be so easily or readily attainable in a "new normal." It may make more business sense for the lender to stick with its current debtor by reducing its interest charges and even by converting some of its debt to equity in the expectation that equity will have value in the future. These are the difficult business decisions that secured lenders may face if there is a new normal which persists for months or years.

The unsecured creditors will also have to face the "new normal" reality and take a reduction of the amounts owed them for past due product or services. Persuading them or forcing them to take less is much easier in Chapter 11 than it is to force the secured lender to take less. Basically, a vote of a majority in number of unsecured creditors and of two-thirds of the amounts owed them is enough to force them to take less or a "haircut" as it is often called. Usually that vote is not difficult to obtain, especially if an official Creditors Committee has been formed and has negotiated the deal with the debtor and recommends it to the unsecured creditors. Typically, if the secured lender is asked and has agreed to take its own haircut in some form, then it will insist that the unsecured creditors do the same for two reasons – namely, it is the fair thing overall and a reduction of the unsecured debt increases the value of the

equity interests being obtained by the secured lender. Indeed, as part of any deal with the unsecured creditors, they may be given as a group some amount of the existing equity ownership of the debtor.

Lastly, the existing equity ownership in the debtor will also have to make major concessions. First, as the last to be paid anything in terms of priority of rights to receive anything at all, it is the fair thing to do if the secured lender and unsecured creditors will be taking haircuts of their own. Secondly, the existing equity interests may have no real value without the reorganization of the debtor, and the argument is why should the existing equity retain anything. The answer has a practical side to it of course: If management owns equity and if they remain in operating the debtor, they probably deserve some equity, however small. They may also be asked to take reductions in their compensation.

In short, all of the different players in the process will be required to take haircuts of some sort in order to save the debtor from destruction for the mutual benefit of all of them. While the American way is generally to look out for number 1 almost exclusively, this dire situation (if it occurs) will necessitate a balance between the different players which is mutually beneficial overall for them. The players will each have their own attorneys representing them, and bankruptcy attorneys usually are familiar with the necessities of the situation. The Bankruptcy Code itself also has mechanisms built into the system to allow for each player to exert pressure on the other players to cooperate, and the bankruptcy judge sometimes is called on to intervene to help the players or their attorneys to be "more reasonable" in their positions. For example, the debtor can threaten a cramdown plan of reorganization on the secured lender (that is, a plan without its consent); the secured lender can threaten the unsecured creditors with a 363 sale or a liquidation otherwise whereby the unsecured creditors and the equity interests will recoup nothing at all; and the existing equity can tell them all to "go fly a kite" or worse and say here are the keys (and good luck) or threaten them all with endless litigation. Everyone knows how the "game" can be played as required and also knows that trying to reach a consensual deal is preferable.

We live in interesting times indeed, if not somewhat scary ones even for we Americans. We all hope for the best of course, but for those of us who experienced the worst of Hurricane Katrina we have learned to try to be prepared to the extent possible.

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