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Bankruptcy's 'Deep Freeze' May Be Struggling Cos.' Best Hope

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Two years after the financial crisis began near the end of 2007, there were 104,383 business bankruptcy filings. The vast majority of these cases ended in liquidation. Today, the words used to describe the widely anticipated number of filings include a "tsunami," a "cascade," or even a "biblical wave of bankruptcies." Perhaps the number will be equal to or greater than the 163,681 business bankruptcy filings in 1986-1987.[1] This might not be a bad thing.

It took the economy two years for the recession caused by the financial crisis to end, but when it did, we were left with more or less the same economy: Some companies disappeared and business ownership changed in the normal musical chairs fashion, but the world looked more or less the same. Jobs may have been lost, but other jobs were created including, for better or worse, a new gig economy. In short, people continued to go to work.

Today, the number and scope of businesses affected is far greater and broader than any prior recessionary event, except for the Great Depression. The U.S. unemployment rate of 14.7%-23.6%, depending on whose calculations are used,[2] is at the same level it was during the Depression. No one really knows whether there will be a new normal or what that new normal will look like. The crisis we face today is not simply financial; it is existential. Temporarily or permanently, the COVID-19 pandemic will change where and how we work and how we eat, shop and play.

Since the middle of March, the Federal Reserve has pumped $6 trillion in loans and credit support into the economy. By doing this, the Fed has kept many businesses, such as the airlines, alive and out of bankruptcy. But not all businesses or business sectors are the recipients of the government's largess and many businesses will go into bankruptcy.

Prenegotiated Cases

Burdened already by outdated business models and excessive corporate debt that they gorged on while credit was cheap, many companies, now without liquidity or revenue, are totally at the mercy of their lenders and bondholders. The pandemic did not cause their problems, but it has tipped the scales and provided an opportunity for their debt holders to force them into bankruptcy to deleverage, to right size their operations by shedding leases and employees, and to effect a change in ownership by equitizing billions of dollars of debt.

In the Neiman Marcus Group bankruptcy, the current proposal is for $4 billion of debt to be restructured.[3] In the J. Crew Group Inc. bankruptcy, the plan calls for $2 billion in debt to be converted

to an 82% stake in the reorganized entity.[4] Of course, in the process, trade creditors will probably be paid pennies on the dollar. The more things change, the more they stay the same.

Prepackaged Bankruptcies

Other companies that are less exposed to the marketplace whose businesses are basically sound and need their existing vendor base may be able to do capital stack restructurings in true prepackaged bankruptcies. These restructurings often take less than a month to complete and basically leave the company's trade vendors unimpaired while rationalizing the debt and ownership structure based upon more realistic projections of the company's future business. The new owners will give existing owners a "hope note" or other nonliquid consideration for their cooperation in the process where their equity interests are extinguished.

Liquidations

Crushed by the weight of increasing insurmountable debts, little or no revenue, and dubious prospects for any meaningful revenue in the near future, many consumer-facing businesses such as those in the hospitality sector — where seismic changes are likely to occur — will go into Chapter 7 or simply go out of business. These filings will be on top of nonpandemic business failures.

For everyone else — that is, the vast bulk of the regular and small to midsized companies that are in trouble — the pandemic has already changed the ground rules for will happen before and in bankruptcy.

"Coronagenic" Stasis

In the last two months, every business that had the opportunity, drew down on their credit lines. They also pulled every lever to preserve cash by furloughing employees, deferring capex, skipping rent and debt payments, stretching payables, and cutting dividends. Many of these companies are not in crisis because they were poorly managed or because they are overleveraged. Instead, they just do not have enough money to operate because they are not permitted to do business and have no customers.

For now, many commercial lenders and landlords will either voluntarily forbear from enforcing their rights against these companies or be prevented from taking action because they have no access to the courts.

Banks also do not really want to own a portfolio of foreclosed or bankrupt companies, which, given the extremely depressed valuations of many businesses today, would be the likely outcome if they acted. That is not what banks are built to do and when they have taken ownership of foreclosed or bankrupt properties as they did en masse in the late 1980s during and after the savings and loan crisis, they were not particularly successful.

Lenders and landlords will also be mindful that the inventory of a retailer-borrower is not easily liquidated when customers cannot or will not go into a store. Virtual, as opposed to physical, liquidation sales will likely cause suboptimal liquidation values. Plus, retail stores of all types will be filled with last season's stale merchandise that may have to be quickly sold or removed to make room for the next season. If lenders and landlords push their debtors too hard, the result may be true fire sale prices, which is actually not what occurs in most carefully planned liquidation sales, and which benefits no one.

Some lenders will sell their loan paper at below par cost to hedge funds and private equity firms that are sitting on $1.5 trillion of deployable capital. These buyers may hold onto the paper or opportunistically seek to acquire companies at distressed prices.

Consequently, many troubled companies, especially midmarket companies, will just try to stay in a form of stasis. With empty streets evoking apocalyptic science fiction images, it seems apt to describe the situation in which businesses find themselves as "coronagenic" stasis. This state, much like cryogenic stasis

in science fiction, where a diseased body is maintained at a near freezing temperature until a cure can be found, will, for many companies, be a minimalist, deep hibernation mode where they await rescue.

Of course, when things begin to normalize and courts are open for business, we should expect that lenders will come storming out of the gate, threatening to enforce defaults and demanding a combination of higher interest rates, fees, additional collateral, equity options or outright control.

Normal 363 Sales Process Is Now Crippled

Often, companies voluntarily enter Chapter 11 — or lenders force their borrowers into Chapter 11 — to take advantage of the Section 363 sales process provided under the Bankruptcy Code. This transparent process creates a very efficient marketplace for the sale of businesses or assets where buyers get the opportunity to participate in an open auction. A Section 363 sale delivers the business or assets to the buyer free and clear of any liens, claims or encumbrances. This is not possible outside of bankruptcy. But, for now, this is unlikely to happen because the Section 363 process does not create an efficient marketplace today.

It is difficult to bid on assets or a business when there is no ability to kick the tires: physically do diligence, inspect companies and factories, and meet in person — not by Zoom — with management. Because companies have little or no revenue or liquidity and therefore barely any runway to get to a Section 363 sale, companies will not be as keen to file, and some lenders will see no benefit from pushing borrowers into bankruptcy.

When companies have filed, courts have created their own type of coronagenic stasis in bankruptcy cases, similar to the New York State on PAUSE program. They have done so to prevent liquidations and irreparable damage to debtors as well as to create an environment in the microcosm of a bankruptcy case that is safe from the exogenic attributes of the pandemic.

Modell's Sporting Goods Inc., a storied retailer of sporting goods and related footwear and apparel, filed for Chapter 11 relief in part to liquidate its assets, conduct store closing sales, and assume, assign or reject its leases. Then, the governors of the various states where Modell's stores were located all but closed their states.

Relying on Section 305 of the Bankruptcy Code, which empowers a bankruptcy judge to suspend all proceedings in a case if doing so is in best the interests of creditors and the debtor, and Section 105 of the Bankruptcy Code, which enables a bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]," Modell's sought a suspension of its Chapter 11 cases.

It argued that "[t]he cornerstone of these cases is the liquidation of the debtors' 134 stores and e-commerce site through store closing sales" and that no liquidation could happen under the present circumstances. U.S. Bankruptcy Judge Vincent Papalia of the District of New Jersey agreed and temporarily suspended aspects of the case.[5]

Pier 1 Imports Inc., a nationwide retailer of home furnishings and home accessories, filed for protection in mid-February with an agreed plan to either effectuate a sale or equitize its term loan indebtedness. Its goal was to get out of bankruptcy in 66 days from the day it filed. The pandemic made that plan moot.

After noting that "COVID-19 presents a temporary, unforeseen and unforeseeable glitch in the administration of the debtors' bankruptcy cases,"[6] U.S. Bankruptcy Judge Kevin Huennekens of the Eastern District of Virginia demonstrated why bankruptcy courts are uniquely capable of addressing the misalignment within the marketplace brought on by the current environment. Using the broad grant of powers contained in the Bankruptcy Code, Judge Huennekens suspended certain payments and

obligations of the debtors, allowing it to shelter-in-place protected by "court-imposed efficiencies and order" while Pier 1 determined how to maximize value for its creditors.[7]

Equally as important, the Bankruptcy Court made clear what it was not doing.

It did not abolish Pier 1's obligation to pay rent. Rent will accrue. It made no determination as to the amount of rent that may be due under any applicable lease. It made no determination as to whether the government-mandated closures constitute a taking under the Fifth Amendment sufficient to merit the nonpayment of rent. It did not decide whether Pier 1's performance under a lease was excused due to impossibility, impracticability or frustration of purpose. It simply stayed all parties' rights and defenses in connection with these issues.

Recognizing the new reality, the court said:

> There is no feasible alternative to the relief [requested by the debtors]. The debtors cannot operate as a going concern and produce the revenue necessary to pay rent because they have been ordered to close their business. The debtors cannot effectively liquidate the inventory while their stores remain closed. Unless and until the stay-at-home and shelter-in-place orders are relaxed, the debtors are unable to open their stores to conduct the sales and customers are unable to come to the stores to buy the inventory marketed for sale. Any liquidation efforts would be ineffective and potentially squander assets that could otherwise be administered for the benefit of all creditors in this case.[8]

Conclusion

Although it may seem counterintuitive, bankruptcy lawyers often try to persuade companies to restructure out of court and not to file for relief; bankruptcy cases are commercially disruptive, psychologically debilitating and expensive. But, in today's abnormal environment, refuge in bankruptcy to take advantage of the unique mechanisms and tools that exist only in bankruptcy cases may make the most sense.

Bankruptcy, as Judge Huennekens noted, creates a collectivized proceeding that bars individual creditor collection actions in the service of the greater creditor good.[9] It can also facilitate the crafting of a grand bargain that, while pleasing no one, achieves the fairest and most equitable outcome for all.

Bankruptcy judges and skilled debtor and creditor committee counsel facilitate this grand bargain with creativity and a holistic mindset that considers the multitude of constituents in a bankruptcy case. Their goal is to prevent parties from acting for their own pecuniary benefit or, as Judge Huennekens wrote, "potentially squander[ing] assets that could otherwise be administered for the benefit of all creditors in this case."

There may be many bankruptcies in our future, but this, surprisingly, may be not be a bad thing. Bankruptcy is the best medium for pandemic-challenged companies to restructure, become nimbler and more competitive, and stay alive. It is also the most capable forum where companies that cannot overcome their difficulties can go to liquidate and fairly distribute their assets.

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[1] Annual Business and Nonbusiness Filings by Year (1980-2019), Admin. Office of the U.S. Courts, https://abi-org.s3.amazonaws.com/Newsroom/Bankruptcy_Statistics/Total-Business-Consumer1980-Present.pdf.

[2] The Associated Press, US Unemployment Surges to a Depression-Era Level of 14.7%, N.Y. Times (May 8, 2020), https://www.nytimes.com/aponline/2020/05/08/business/ap-virus-outbreak.html.

[3] Declaration of Mark Weinsten, Chief Restructuring Officer, of Neiman Marcus Group Ltd LLC, in Support of the Debtors' Chapter 11 Petitions and First Day Motions ¶ 90, In re: Neiman Marcus Group Ltd LLC, No. 20-32519 (Bankr. S.D. Tex. May 7, 2020), ECF No. 86.

[4] Declaration of Michael J. Nicholson in Support of Debtors' Chapter 11 Petitions and First Day Relief ¶ 6, In re: Chinos Holdings, Inc., No. 20-32181 (Bankr. E.D. Va. May 4, 2020), ECF No. 6.

[5] Order Temporarily Suspending the Debtors' Chapter 11 Cases Pursuant to 11 U.S.C. §§ 105 And 305, In re: Modell's Sporting Goods, Inc., No. 20-14179-VFP (Bankr. D.N.J. March 27, 2020), ECF No. 166.

[6] In re: Pier 1 Imports, Inc., No. 20-30805-KRH, 2020 WL 2374539, at *6 (Bankr. E.D. Va. May 10, 2020).

[7] Id. at *2.

[8] Id. at *6. Unfortunately, on May 19, the debtors in the Pier 1 case, informed the court that because "the effects of the COVID-19 pandemic have proven insurmountable," it no longer saw any viable path to restructuring its business as a going concern and would liquidate all assets. The powers of the Bankruptcy Court are great but even those powers cannot fully protect debtors from the vicissitudes of the marketplace.

[9] Id. at *2, n.5.