COVID-19: The benefits of US chapter 11 relief in a time of economic crisis

Restructuring Alert
COVID-19 Alert
19 March 2020
By: Tom Califano | Daniel M. Simon

While the impact of the coronavirus disease (COVID-19) is as of yet uncertain, one thing is clear: the global outbreak of COVID-19 has caused – and will likely continue to cause – a precipitous decrease in demand and supply as a result of quarantine orders, business closures, and social distancing, all aimed at flattening the curve of the pandemic. As a result, a dramatic and pronounced economic downturn is predicted as the pandemic’s impact touches virtually all businesses, regardless of geography or industry. Indeed, preliminary estimates
suggest that COVID-19 could cost the global economy upwards of $2.7 trillion.[1]

What’s more, as the US economy continued to grow in unprecedented fashion over the last several years, many companies industrywide increasingly took on significant and historically high levels of debt.[2] The pandemic therefore may serve as an economic tipping point for what may have otherwise been an inevitable crisis for these particular companies. Accordingly, this article is intended to help fiduciaries and executives better understand how valuable a tool chapter 11 can be during a time of crisis by availing themselves of the protections afforded in a chapter 11 reorganization under the United States Bankruptcy Code.

Chapter 11 of the Bankruptcy Code, at its very core, allows a company facing a crisis to maximize value, preserve jobs and operations and weather a crisis. The Bankruptcy Code enables a company to operate as a “debtor in possession” and maintain its board of directors as well as management throughout the case thereby preserving a continuity of operations. Additionally, chapter 11 affords companies a breathing spell from creditor demands and market forces, which permits management to focus on formulating a plan to resolve and/or restructure their debts while seeking to preserve value and jobs and abating the distractions and stress of the threat of piecemeal dismemberment by competing creditors. While this article does not serve as a comprehensive overview of the wide-ranging options for relief available to companies who may need to file, it is intended to highlight some of the most significant benefits to companies facing severe challenges under the current circumstances.

**Benefits of chapter 11**

**A. The automatic stay**

A primary benefit of bankruptcy is the “automatic stay.” Under section 362 of the Bankruptcy Code, simply filing a bankruptcy petition—with no further action—stays all creditor actions, including lawsuits, foreclosures, repossessions, bank levies, wage garnishments, and other collection activities (subject to certain exceptions). This stay is effective, and actions taken in violation thereof are void, regardless of where the creditor action is taken, including outside the United States.

The stay thus provides the aforementioned breathing spell, which allows its management to focus on minimizing the impact of the filing on operations and to examine the company’s options and negotiate with creditors. In addition to the automatic stay, section 1121(b) of the Bankruptcy Code provides a chapter 11 debtor the exclusive right to propose a reorganization plan within 120 days of filing. This exclusive right, combined with the automatic stay, enables management to maintain control and guide the reorganization with less constant and immediate pressure from creditors.

**B. Emergency operational relief**

After a chapter 11 filing, the bankruptcy court schedules an expedited hearing—usually within forty-eight (48) hours of the filing — to hear first day emergency motions. The relief sought typically includes the authority to pay employee wages and benefits, insurance obligations and taxes, as well as other matters to ensure a smooth landing into chapter 11 and the continued operations of the business, giving much-needed comfort to employees, vendors, and customers. This hearing also gives the company the opportunity to introduce itself to the bankruptcy court, describe the circumstances that forced it into the chapter 11 proceeding, and, at a high level, map out the course of the company’s strategy for a successful exit. Note that in this particular COVID-19 crisis, most bankruptcy courts have made accommodations to allow chapter 11 debtors to appear telephonically so that companies may still benefit from the chapter 11 process notwithstanding travel, lodging, and other related restrictions and limitations.

**C. Debtor-in-possession (DIP) financing**

A powerful tool for companies facing a liquidity crisis is the potential to obtain DIP financing. As part of the “first day” relief, a bankruptcy court may approve emergency financing to provide necessary funding for the debtor to operate while in chapter 11. While in the current climate, traditional financing may be extremely difficult to procure
—particularly for a distressed entity—DIP financing provides a unique opportunity for lenders. In chapter 11, DIP lenders are typically afforded extraordinary protections and incentives for providing financing, including attractive interest rates, super-priority liens and claims (paid before virtually all other claims in the bankruptcy, including other secured claims), and even the ability to “prime” other senior secured lenders under certain circumstances. A DIP lender also typically receives releases and other protections that mitigate other considered risks for a lender. Thus, despite the present economic crisis, a company facing significant liquidity issues may be able to obtain, in a chapter 11 setting, emergency funding on an expedited basis that would not otherwise be available. This fact alone may serve as sufficient justification for a distressed company to seriously consider the benefits of chapter 11.

D. Treatment of executory contracts and unexpired leases

In times of crisis, companies often find themselves overwhelmed by obligations created by “executory” contracts, i.e., contracts under which all parties have ongoing obligations, as well as unexpired leases. But section 365 of the Bankruptcy Code permits chapter 11 debtors to reject agreements, leaving the counterparty only as an unsecured creditor. In addition to the option to reject, chapter 11 debtors may assume and/or assign contracts they favor subject to a cure of any outstanding defaults on said contracts. It is important to note that, subject to certain time limitations set forth in the Bankruptcy Code, the non-debtor counterparty is obligated to perform its obligations under the contract until such time as the chapter 11 debtor elects to assume, assign, or reject the respective executory contract. Thus, the Bankruptcy Code allows debtors to receive the benefits of their existing executory contracts while determining which contracts will survive the bankruptcy and, upon rejecting burdensome contracts, become free from continued performance obligations which may no longer be commercially attractive.

E. “Free and clear” sales

Section 363 of the Bankruptcy Code provides a chapter 11 debtor the opportunity to sell its assets free and clear of claims, liens, encumbrances, competing ownership interests, and other liabilities which may prevent a sale outside of chapter 11. As a result, buyers are incentivized by the unique opportunity to purchase distressed assets inside of bankruptcy (as opposed to out-of-court), especially because the bankruptcy court order approving the sale often expressly forecloses “successor liability” claims against the purchaser.

F. Collective remedy

Chapter 11 is a collective remedy, meaning it brings all stakeholders of a company to the same forum – the bankruptcy court – and encourages a global resolution of claims and liabilities at all levels. Indeed, chapter 11 enables companies to conduct collective negotiations with its creditors, customers and other counterparties in a streamlined process, which injects efficiency, fairness, and certainty into the reorganization process. Additionally, while a chapter 11 debtor solicits support from all of its constituents, its plan – the governing document that effectuates its reorganization subject to court approval – need not be accepted by all creditors in order to be binding upon them.[3] In other words, a company may typically confirm a chapter 11 plan that is acceptable to the majority of its creditors without fear of recalcitrant holdouts. Conversely, the threshold to effectuate significant changes to a debt instrument outside of bankruptcy can be significantly higher, often, for example, requiring the unanimous consent of lenders.

Conclusion

In sum, the COVID-19 – or any other existential – crisis will most likely have significant negative impacts on many industries. But that does not mean that companies should be forced out of business. Indeed, filing under chapter 11 does not mark the end of a company’s operations, but should instead be viewed as a second chance opportunity for profitable reemergence into the market. The provisions highlighted above are just some of the ways that filing for chapter 11 protection under the Bankruptcy Code can serve to benefit companies impacted by the crisis.

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[3] The threshold provided by the Bankruptcy Code requires acceptance by more than one-half in number and two-thirds in amount of creditors in each class of creditors.

**AUTHORS**

**Tom Califano**
Partner
New York | T: +1 212 335 4500
thomas.califano@dlapiper.com

**Daniel M. Simon**
Partner
Atlanta | T: +1 404 736 7800
Chicago | T: +1 312 368 4000
daniel.simon@dlapiper.com