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COVID-19 and Quick 363 Bankruptcy Sales

By Kenneth A. Rosen

The Federal bank regulators which supervise banks have made a statement encouraging workouts necessitated by the coronavirus. Loans which would otherwise be classified as TDRs (Troubled Loan Restructurings) will not have to be classified as such under certain conditions. For example, if the workout was necessitated by the pandemic and if the loan was otherwise in good standing as of December 31, 2019. The government's intent is clear: Everyone gains more by a workout or restructuring than by liquidation or litigation. Value is often severely diminished in bankruptcy or in a liquidation.

Here is the problem: In recent years, Chapter 11 has increasingly become the *sale* chapter of the bankruptcy code rather than the *reorganization* chapter. This could have sweeping effects given the bankruptcy wave expected as a result of COVID-19's shocks to the economy.

In fact, this trend likely means that, contrary to the statements of the Federal government that restructurings (a principal goal of Chapter 11) are good for the national economy, unsecured trade creditors—such as the vendors who supply shirts for department stores, food service products to restaurants or raw materials to manufacturers that have been shut down and which themselves are having difficulty getting paid—will get a lot less than expected out of their customers' Chapter 11 cases.

The problem starts with section 363 of the bankruptcy code, intended as a way for debtors to sell assets outside the ordinary course of business if the assets could become worthless without quick action. Think a supermarket where the fruit and vegetables would go bad if not sold immediately.

But well before our current economic problems, debtors have been pressured by their lenders to put forward justifications under section 363. Lenders (banks), figured that it makes more sense to (a) promptly swap debt for equity, or to credit bid for the assets and thereafter restore value that need not be shared with the debtor's other creditors or (b) promptly convert their collateral to cash, take the loss, and relend the money. And courts, heavily pressured by talk of the need for quick action, were approving accelerated 363 sales—even if some important questions were going unanswered.

For these reasons, creditors struggling to cover their own costs and pay their employees during the pandemic shutdown (and afterwards) should be very worried.

How Section 363 Went Wrong

In traditional reorganizations, creditors could get a dividend out of a case as a result of debtor reorganization, e.g., downsizing, reducing debt, eliminating unprofitable products lines, or getting out of certain geographic markets. But with the influx of accelerated 363 sales processes to accommodate lenders, that is no longer the case. On day one (or close to it) a debtor presents the court with a tale of woe. Herculean efforts were made to turn things around prior to bankruptcy and a lot of money was lost. Now, the iceberg is melting.

General Motors was not a real reorganization case. But, it did teach us that 363 sales of substantially all going concern assets was permissible even in a "mega" case. GM's assets were sold to "newco." Thereafter a liquidating plan of reorganization was filed with the bankruptcy court. GM set a pattern for future Chapter 11s.

The judge rarely is offered much more information—such as why the debtor cannot be downsized in Chapter 11, why expenses cannot be cut further, or why the tools provided by Chapter 11 cannot facilitate reorganization. The judge, unfortunately, is asked to believe that all hope of a reorganization is lost based on the debtor's *summary* presentation and prepetition track record. And, understandably, bankruptcy judges are reluctant to call a lender's or debtor's bluff when they hear that the sale is essential to preserving jobs.

Now, with the anticipated wave of Chapter 11s due to the coronavirus, more proof should be required. Will a representative from the debtor say something like this under oath? "I cannot figure out a feasible solution even though I was paid very well to do so and I do not think it is worth the effort to try now even with the many protections of the bankruptcy code. The debtor's problems cannot be fixed within a reasonable time period. I, therefore, support a fast sale."

If you hadn't guessed, that sort of proclamation hasn't been happening. But the 363 sales go forward anyway.

Forgetting Chapter 11's Intent

It's important to remember that Chapter 11 is an alternative to a secured creditor's exercise of state law remedies and that it facilitates greater value to be obtained for collateral than what the lender would otherwise achieve in a foreclosure. Some observers have said that if the lender seeks to block a true reorganization—one that might yield a recovery for unsecured creditors—the lender ought to pay a price (carve out a recovery for unsecured creditors) for depriving unsecured creditors of the opportunity.

That's unlikely to happen, especially in an economic downturn. But there are ways the parties involved could improve this situation.

Judges are well qualified to prevent the debtor from exploiting the reprieve in Chapter 11. Attentive creditors' committees also are watchdogs and could help assure against incurring unpayable liabilities after the date of bankruptcy. And, smart lenders could incorporate the risks in Chapter 11, being compelled to tolerate a debtor's final efforts to reorganize with the benefits of Chapter 11 protection, into the pricing of their loans or by requiring the commencement of Chapter 11 cases sooner.

Bankruptcy judges should place greater weight on the statutory goals of Chapter 11 and also recognize the federal government's stated desire for restructurings. They should probe deeper as to the extent to whether the debtor was in good standing with its lenders and vendors prior to the pandemic, the extent to which the debtor commenced its case due to the pandemic and why the debtor is unable to do a traditional restructuring given the tools of Chapter 11. It is not just the bank and the creditors of the debtor with interests in the debtor's Chapter 11 case. There are creditors of the debtor's creditors who have an interest in the debtor's case. Liquidations and bulk sales that strip away going concern value has a ripple effect. Until some of this happens, unsecured creditors should be on alert: They won't get much of anything when companies they've served end up in Chapter 11.

Note: The views expressed herein are those of the author only and are not necessarily shared by others at Lowenstein Sandler. Each case is unique. The law is subject to interpretation.

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Contact

KENNETH A. ROSEN
Partner
Chair, Bankruptcy, Financial Reorganization & Creditors' Rights
T: **973.597.2548**
krosen@lowenstein.com