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Professional Perspective

CEO Considerations Before Filing Chapter 11

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With each passing day of coronavirus-related shutdown and reopening, corporate leaders are increasingly uncertain about the impact the virus will continue to have on their businesses. Amid the fragile economic environment of a global pandemic, the most informed C-suite executives are strategizing and considering all of their options—including reorganization.

Filing under chapter 11 of the bankruptcy code in the wake of Covid-19 could present an opportunity for a company to emerge from an unprecedented pandemic with a business plan that is in step with the world's “new normal.” From the outset, a CEO's understanding of the most critical pieces of the bankruptcy process can place a company on a successful trajectory. Some will use this time as an opportunity to drive consolidation through bankruptcy sales. Others will use chapter 11 as a buttress against aggressive lenders while the world returns to normal. No matter how familiar a CEO may be with the bankruptcy process, consideration of the five following areas will better prepare the company for an effective reorganization.

Taking Care of Your People

Employee Wages

In the context of a chapter 11 bankruptcy case, keeping the business running is the first area of focus. Retention of the labor force is the foundation for continuing operations. Aside from the ordinary pressures of keeping employees happy and productive, major concerns in any chapter 11 case include ensuring the payroll is paid on time and employee benefits are maintained.

When employees learn their employer filed for bankruptcy, they are frequently concerned about job security. The best way to retain employees after filing a chapter 11 is to pay them what they are owed and to continue to pay them on time and on stated terms. Maintaining steady payroll ensures that employees continue to work diligently and the company is able to preserve the significant value of the work force. Since labor is almost always the foundation of a company's operations, paying out employee wages should not only be a priority under the Bankruptcy Code, but also in the mind of the CEO leading a company through a restructuring.

To preserve the value of its people, a debtor corporation should ensure that employees are paid their pre-petition wages and benefits—that is, the payroll that accrues between the previous pay day and the bankruptcy filing. Normally, a debtor cannot pay pre-petition debt, but the Bankruptcy Code excepts payment of employee wages. The debtor company will need to seek relief to pay these pre-petition employee wages by filing a motion to pay these claims via §105(a) of the Bankruptcy Code. Section 105(a) states that the bankruptcy court “may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions” of the Bankruptcy Code.

To the extent that all employee payments are not made before a filing, certain employee claims are entitled to priority under the bankruptcy code, and must be paid before any other debts. One type of debt that is given priority includes “wages, salaries, or commissions, including vacation, severance, and sick leave pay earned by an individual” earned within 180 days before the chapter 11 filing.

Most chapter 11 cases can and should include a motion to pay pre-petition claims of employees including benefits, as part of the “first day” motions that need court approval as soon as possible after filing. A corporation should discuss employee wages and benefits with restructuring professionals before any filing.

Internal Communications

Communication is key, more so when people are confronted with high-stress situations. The human brain processes information differently when in crisis, reducing comprehension up to 80% in some cases. Covid-19 has presented the world with economic, health, and social stressors all at once. Accordingly, internal messaging will be even more essential for a company going through a restructuring.

Corporate leadership should communicate early and often, and communications should be “simple, credible, and consistent.” This requires keeping internal messaging brief and ensuring that the same information is repeatedly conveyed from multiple credible sources. Such credible sources include C-level executives, but also operational leaders and managers in the field. However, the message should be consistent amongst the various messengers, as any variance could cause confusion and result in decreased credibility of the leadership. Internal messaging provides an opportunity for corporate leadership to keep employees working toward the same goal during a chapter 11 restructuring, and can result in smoother operations and a more seamless restructuring process.

Sources of Financing

There are two routes a company can take in a chapter 11 case when it comes to financing: operate using cash collateral alone, or use a combination of cash collateral in addition to what is called a "DIP loan."

Cash Collateral

Section 363 of the Bankruptcy Code defines cash collateral as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest," and this can include proceeds, rents, profits, and other types of revenue generated by the cash collateral. Stated more simply, cash collateral consists of the cash and the cash equivalents of the company that were subject to a lien on the petition date and now belong to the bankruptcy estate.

If a creditor has a lien on an asset of the company, any cash that is made from the sale of the asset or is generated by the asset is considered cash collateral. For example, when money from the company's accounts receivable starts coming in, that money would be placed in an account for cash collateral. Since cash is easily moved and hard to monitor, cash collateral can only be used by the debtor company with either consent of the creditor, or upon order of the court after notice and a hearing.

Adequate Protection

The debtor company must provide "adequate protection" of secured parties' interests in collateral throughout the bankruptcy while the automatic stay is in effect. Adequate protection can take a number of forms under the Bankruptcy Code. For instance, the court can require the debtor to make periodic payments or pay interest, or to provide additional or replacement liens. If the debtor company is still making money, then it should pay the periodic payments or interest as long as the business can support such payments. To the extent that pre-petition collateral is converted to cash and spent, the debtor company can provide "replacement liens" to adequately protect secured creditors.

Debtor-in-Possession Financing

In addition to cash collateral, the debtor company can obtain what is commonly referred to as a "DIP Loan." Unlike chapter 7 cases where the bankruptcy estate is controlled by a trustee, in a chapter 11 restructuring the debtor is allowed to continue operating the company in the ordinary course of business. Such a debtor-operated entity is called a "Debtor in Possession."

A DIP loan funds operations throughout the course of the chapter 11 case, but in order for a debtor company to get a DIP loan, it must first find a lender. The DIP may use debtor's pre-petition lenders, or a new lender who first lends money to the debtor company "post-petition," or after the chapter 11 case has been filed. When considering DIP lenders, the leadership of the debtor company should be cautious. Often, distressed funds lenders can buy this debt cheaply and effectuate a strategy to take control of the company post-plan confirmation. Such lenders are essentially investing equity into a company under the guise of debt, using the loan as a tool to do so. That being said, DIP loans are an important and frequently critical source of financing for a debtor company.

Recognizing the potential risk of lending to a company going through a restructuring, the Bankruptcy Code provides multiple avenues of collateralization for a DIP lender. For example, § 364(c) allows the bankruptcy court, after notice and a hearing, to grant one of the following three forms of security: a super-priority administrative claim, which has priority over other administrative expenses; a lien on property of the estate that is not subject to any prior liens; or a junior lien on property of the estate that is subject to an existing lien.

If the DIP is not able to obtain a DIP loan under 364(c), then 364(d) can be used to grant a DIP lender a "priming lien," that is, a lien even higher in priority than preexisting liens. However, there must also be notice and a hearing and preexisting lienholders must be provided with "adequate protection" of their interest in the property. Adequate protection for the preexisting lienholders means that the preexisting lienholders must be protected against diminution in value of the property upon which they have a lien. More often than not, this means that there must be an "equity cushion," meaning that the value of the collateral is higher than the value of the lienholder's claim.

Critical Vendors

Another significant consideration for corporate leadership is who are the company's "critical vendors"? The term "critical vendor" does not appear in the Bankruptcy Code. The concept behind "critical vendors" is that there are some types of vendors that are absolutely necessary for the debtor company to pay in order for the company to effectively reorganize. The debtor company can seek authority from the bankruptcy court to pay the entire amount of the creditor's pre-bankruptcy claim. Therefore, even before filing a chapter 11 petition, it is important for corporate leadership to begin asking themselves, "Who must the company pay?" and "Who shouldn't the company pay?"

These decisions can vary widely depending on the debtor's business. For instance, if a poultry company filed for chapter 11, the company's sole chicken feed supplier would likely be deemed a "critical vendor," and would be paid the amounts they earned prior to the debtor company's bankruptcy petition. By contrast, one of multiple companies that has provided the debtor company with chicken wire in the past may not be considered critical. It all depends on what is necessary for the business to reorganize.

In some circumstances, the debtor company may even be able to keep confidential those vendors whose pre-petition claims are being paid. For example, in a recent chapter 11 case in Delaware, the court issued an order that "authorized" but did not "direct" the debtor company to "pay Production Expenses as it deems appropriate in the ordinary course of business, without further application to this Court, including making all payments, and honoring and satisfying all obligations, whether relating to the period prior or subsequent to the Petition Date" up to the amount of $23 million.

The same logic applied to retaining a labor force applies to retaining critical vendors: Who will want to continue working through the bankruptcy unless they are paid for the work they performed before bankruptcy? In the absence of an existing enforceable contract, a debtor cannot otherwise force a critical vendor to continue working for them. As a result, this area of bankruptcy often involves a fair amount of negotiation. Many if not all of the debtor company's creditors would like to be on the "critical vendor" list, but since there is no statutory provision dictating who gets what, the debtor company's leadership needs to strategize and negotiate to find what is best for the sake of the company's reorganization.

Venue

Corporate leadership should also be aware that the location of filing could make it more difficult for the company to restructure. For example, the 2004 Seventh Circuit *Kmart* decision significantly limited a debtor company's ability to pay the pre-petition debts of its critical vendors. The U.S. Court of Appeals for the Seventh Circuit held that "preferential payments to a class of creditors are proper only if the record shows the prospect of benefit to the other creditors" and that "disfavored creditors [must be] at least as well off as they would have been had [a] critical-vendors order not been entered." Accordingly, to make a payment to a critical vendor in the Seventh Circuit, the debtor company must overcome two difficult hurdles that are not present in other jurisdictions.

Meanwhile, the U.S. Court of Appeals for the Fifth Circuit has not yet ruled on critical vendor payments, though the bankruptcy courts of the Northern District of Texas have put forth a three-prong test that requires proof of the critical nature of the vendor. Since "critical vendors" can be significant in a restructuring, it is an imperative consideration for a CEO when talking through potential venues with the debtor company's restructuring professionals.

Utilities

Some pre-petition vendors, such as utility companies, are prohibited from denying services to chapter 11 debtors on statutory conditions of adequate assurance. Section 366 of the Bankruptcy Code relates to how the debtor company interacts with utility companies, and provides that while a utility company cannot "alter, refuse, or discontinue service to, or discriminate against" the debtor due to the bankruptcy filing or debt owed, the debtor must provide "adequate assurance of payment" to the utility within a certain timeframe.

If the debtor does not timely provide adequate assurance of payment, then the utility can alter, refuse, or discontinue service. Some forms of "adequate assurance" include a cash deposit, a letter of credit, a certificate of deposit, a surety bond, a prepayment of utility consumption, or another form of security that is mutually agreed on between the utility and the debtor or the trustee."

Purpose

It is imperative that the corporate leadership of a debtor company realize and understand its purpose moving forward in the bankruptcy case. While bankruptcy can provide a temporary reprieve, the goal is not to file bankruptcy and see what happens. A CEO must have a thorough understanding of exactly what changes should be made throughout the bankruptcy case, and how those changes will ultimately help the business achieve its newfound purpose.

Especially in light of the Covid-19 pandemic, the C-Suite should take time to discuss with restructuring professionals what needs to change in the business itself to make it successful upon a restructuring. For example:

- Are there contracts that are more burdensome than beneficial and should be rejected?
- How can debt repayments plans be restructured?
- Can the company bring on new investors?
- Are there any new potential business lines the company could use the reprieve to start?
- Should part of the business be sold?

All of these are questions that CEOs and other corporate executives should ask their restructuring advisers upon the commencement of a bankruptcy case—preferably earlier.

Public Relations

Public relations is a crucial component of a restructuring, and one that should not be taken lightly. Effective communication with customers through the pendency of a bankruptcy case can be the difference between a successful and a failed restructuring, as the value of a brand and the company's customer bases are key components. The CEO should commit to open and honest communication, including statements which convey the company's ability to continue satisfying customer demand at the same level of quality throughout the restructuring.

The company should draft and finalize a press release addressing the chapter 11 restructuring, with the help of restructuring professionals, before any chapter 11 documents are ever filed. That press release should be filed as soon as the company's attorney confirms the filing. The press release is the company's opportunity to explain what chapter 11 is in its own words, why the company thinks a restructuring will set it up for success going forward, and how the filing will impact its customers directly.

Accordingly, this initial communication is important enough that corporate leadership should ensure that the media and analyst contacts are personally sent a press release by the public relations team. Ideally, the public relations team should also "deliver statements targeted to the concerns of company constituents, including employees (the top priority), vendors, creditors, suppliers, customers, shareholders, the sales force, and other important groups." In the face of a chapter 11 filing, make public relations a priority and an opportunity to frame the story of the debtor company's revival.

Right People, Right Places

Right People

As a CEO, it is likely that a chapter 11 will be your first foray into restructuring. Surrounding yourself with the right advisers who can navigate you through new waters will ensure that you can put your new purpose into effect. Attorneys, financial advisers, and investment bankers with restructuring experience are often critical players in a company's restructuring. It is important that not only do you learn from these advisers, but that they are able to learn from you about your business.

It may also be worth talking to your counterparts at peer firms that have gone through a successful restructuring. However, this should only happen if it can be done without jeopardizing the current business and confidentiality. For example, consider reaching out to someone at a company that is in the same industry, but not a direct competitor.

Regular and frequent meetings with the internal executive team and the board of directors are another way to surround yourself with the right people. As the CEO, you will likely be the conduit between the restructuring advisers and the other corporate leadership, and regular meetings with both provide an opportunity for information sharing.

Right Places

Under the Bankruptcy Code, corporations can file chapter 11 petitions in the bankruptcy court based in the place of incorporation, the location of the company's principal assets, or the company's principal place of business. For smaller corporations, this may be a single place, but for larger corporations this can provide a list of potential venue choices. If there is more than one venue choice, then comparative law issues arise, and you should seek your restructuring attorney's opinion on where it makes the most sense to file your case. For instance, as mentioned above, the way different venues handle critical vendors may vary from one venue to the next. Likewise, the law differs between venues on other issues like insider releases, financing, and timing.

Conclusion

Extraordinary times often demand courses of action that a CEO has not previously contemplated. Although bankruptcy can sound ominous, a chapter 11 restructuring can provide an opportunity for a company to correct internal issues and to set the company on a better course. A restructuring can also provide a company with the tools to reconfigure a company in a new world. Understanding the key components early on will enable a CEO to chart the company's course.