March 17, 2020

Coronavirus Pandemic Portends Heightened Risk of Financial Distress, Potential Changes in Restructuring Market

As the coronavirus (COVID-19) pandemic continues to shake global markets, it is likely that more companies will need to restructure to address liquidity constraints, to right-size their balance sheets, or to implement operational restructurings. In addition to a potential surge in restructurings, the spread of COVID-19 is already having pronounced impacts on companies planning or pursuing restructurings, and further market turmoil may cause even broader changes to the restructuring marketplace.

Potential Increase in Restructuring Activity

COVID-19, and the broader effects it is having on the global economy, increase the likelihood that many companies will need to restructure, whether in- or out-of-court. In light of far-reaching containment efforts adopted by governments and widespread fear of the pandemic, the travel and hospitality sectors face obvious headwinds as a result of COVID-19. Government- and employer-imposed travel restrictions, cancellation of conferences and other large events, and a lack of customer demand are likely to have significant effects on revenues, while businesses operating in these spaces—including airlines, cruise ship operators, and hotels—often have high fixed operating costs. While many of these companies may be able to weather a short slump in activity, the extent and duration of COVID-19's dampening effect on global travel, and the lingering effects, if any, on consumer confidence, are unknown. If the situation worsens or persists, businesses in the travel and hospitality sectors may need to resort to relief under chapter 11.

The effects of COVID-19 have roiled other industries, especially oil and gas, demonstrating a ripple effect that extends far beyond the travel and hospitality sector. Oil prices have dropped at least 40% this year alone, initially as a result of decreased demand, particularly in China, caused by COVID-19, but more recently compounded by disputes between Saudi Arabia and Russia over price and production cuts. The International Energy Agency's prediction that global oil-demand in 2020 will decrease for the first time since 2009 underscores the risks to an industry that was already facing widespread financial distress and has been one of the primary distressed sectors seeking relief in chapter 11 over the past several years.

While the travel, hospitality, and energy sectors each face heightened concerns, the spread of COVID-19 is likely to affect all sectors of the economy. Disruptions to global supply chains, particularly those originating in China, combined with overall market volatility and declines in consumer confidence, threaten companies across all industries. Certain sectors that have seen frequent restructurings over the past several years, including retail, health care, and pharmaceuticals may be particularly sensitive to the effects of COVID-19.

Since the conclusion of the 2008 financial crisis, the rate of corporate bankruptcy filings has remained relatively stable and low. Restructuring activity in 2019 increased modestly over 2018, which uptick, some suggested, signaled further distress in 2020 and the beginning of a new cycle of distress. The COVID-19 pandemic amplifies existing economic uncertainty, elevating the probability that restructurings will spike even more in 2020 and beyond.

Impact on Companies Pursuing Restructurings

The economic effects of COVID-19 are adding to the challenges faced by companies already undergoing restructuring. Most successful restructurings involve one or more infusions of capital, whether at the outset of the case, in the form of debtor-in-possession financing, or in connection with a company's exit from bankruptcy, often in the form of a rights offering or exit loan facility. Given the turmoil in financial markets, companies are already finding it difficult, and more expensive, to raise sufficient financing to fund or consummate a restructuring, which narrows the restructuring options available to distressed companies. Further, for companies that recently obtained funding commitments, lenders, investors, and backstop parties are considering whether recent events may provide grounds for modifying or terminating these commitments.[1] Similarly, creditors are scrutinizing restructuring support agreements, commonly used to "lock in" creditors to a particular plan of restructuring before a company files for bankruptcy, to assess whether the effects of COVID-19 provide a basis for termination or modification. For parties currently negotiating restructuring support agreements or funding commitments, material adverse effect clauses and other termination provisions can be expected to be highly negotiated, with companies seeking to exclude the effects of COVID-19 and creditors seeking the opposite.

The economic uncertainty caused by COVID-19 has also caused bankruptcy courts to struggle in making necessary factual findings regarding the feasibility of plans of reorganization. Section 1129(a)(11) of the Bankruptcy Code requires, as a condition to confirming any plan, that confirmation of the plan is not likely to be followed by a need for further financial reorganization or liquidation. In making that assessment, courts consider, among other things, the company's post-reorganization capital structure, economic conditions, and the earning power of the debtor's business as demonstrated by its business plan. The effects of COVID-19, however, may call into question the funding commitments that the debtor has secured, as well as the debtor's ability to execute its business plan, making such a determination challenging.

To establish that its business plan is achievable, and that its plan is therefore feasible under the Bankruptcy Code, debtors and their advisors would be well advised to account for the potential effects of COVID-19 on their business, including stress testing financial projections and being prepared to justify those projections

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1 Our client alert on COVID-19 and material-adverse-effect clauses can be found here, and our alert regarding force majeure clauses can be found here.

in light of recent events. Similarly, debtors and their advisors should evaluate whether to discuss COVID-19 among the risk factors set forth in their disclosure statements.[2]

Potential Changes in the Restructuring Market

Over the past decade, companies from all industries have increasingly utilized "prepackaged" and "prearranged" bankruptcies, whereby companies agree on a proposed plan with a sufficient number of creditors before filing for bankruptcy, and then file for chapter 11 relief to quickly implement such deal. For debtors seeking to implement balance-sheet restructurings, prepackaged and prearranged plans afford them the benefit of expedited chapter 11 cases and attendant cost savings. The spread of COVID-19 may slow this trend in two key respects. First, if capital markets tighten and economic uncertainty escalates, distressed borrowers may find it more difficult to obtain the funding commitments necessary to broker consensual and expedited restructurings among their stakeholders, leaving companies with little choice but to seek bankruptcy protection before a consensual deal is reached. Second, extreme market volatility, together with potentially sudden disruptions in supply lines and the disproportionate effects that certain containment measures may have on individual businesses, increases the chances that certain companies will need to resort to chapter 11 relief with little or no advanced planning. Such "free-fall" bankruptcies tend to take longer and be more adversarial.

Significant market disruptions may also lead to an uptick in section 363 sales of substantially all of a debtor's assets at the very beginning of a bankruptcy case. As demonstrated in the 2008 financial crisis by mega-cases such as *Lehman*, *General Motors*, and *Chrysler*, the inability to obtain adequate debtor-in-possession financing to operate a large business in chapter 11 may increase the need for quick section 363 sales shortly after the bankruptcy filing. Although some courts have recently questioned the propriety of early-stage sales, a potential financial crisis brought on by COVID-19 may give rise to a return of such strategies.

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[2] Our client alert regarding the impact of COVID-19 on public disclosure obligations for SEC reporting companies can be found here.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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