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Restructuring Considerations in an Uncertain Economic Climate

By Lisa M. Schweitzer and Thomas Kessler*

In this article, the authors explain how companies can refresh their internal planning and proactively consider the risks and opportunities that are presented when suppliers, customers and competitors encounter financial distress.

Economic indicators remain mixed on whether there will be a recession or a soft landing over the moths. Either way, it is likely that a significant number of companies, across industries, will need to restructure their financial debt and operations. 2023 brought a significant increase in Chapter 11 filings, with a 61% percent increase compared to the same period in 2022,[1] and filings across industries, including such notable companies as Bed Bath & Beyond, Envision Healthcare, Rite Aid and WeWork. Other companies have avoided formal bankruptcy filings by undertaking liability management transactions that increase near-term liquidity through additional borrowings. However, as several high profile filings recently have shown, it is likely that many of these transactions may simply delay, rather than prevent, bankruptcy filings in the future.

The current climate presents an ideal time for all companies to refresh their internal planning and to proactively consider the risks and opportunities that are presented when suppliers, customers and competitors encounter financial distress.

EARLY PLANNING FOR POTENTIAL COUNTERPARTY DISTRESS

While free-fall bankruptcies make headline news, in most cases a company has experienced financial distress for a significant period of time before deciding to file for bankruptcy. Companies can and should monitor for early signs of distress in order to develop a comprehensive strategy to minimize the impact of the financial distress of a key supplier, customer or other industry participant on its business and operations.

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[1] Epiq Global, "Year-to-Date Commercial Chapter 11 Filings Increased 61 Percent Compared To Same Period Last Year" (October 3, 2023), available at https://www.epiqglobal.com/en-us/resource-center/news/year-to-date-commercial-chapter-11-filings-increased-61-percent-compared-to-same-period-last-year.

In particular, management should be monitoring for early signs of potential distress and planning accordingly, and boards should oversee this process, including the following types of actions:

- *Stretching of Trade Terms* – Recent financial failures have been largely driven by near-term liquidity shortages. Companies should consider whether any request to renegotiate payment terms or noticeable changes in payment patterns could be signals of potential financial stress, and whether the larger commercial relationship could be at risk in the near or medium-term.
- *Renegotiation of Material Commercial Contracts* – For many companies, their long term supply and customer contracts do not match their current business models, including as a result of external factors, such as the rising costs of materials and labor, shifting customer demand for their goods and services, regulatory developments or other changes in their business operations (such as the increasing move to remote work). Companies may be approached to renegotiate these contracts either consensually or against a backdrop threat that contract amendments are necessary to ward off a larger failure. In negotiating the amendments of contract terms, companies should account for the potential impact of a subsequent bankruptcy filing on such amendments, and whether they may be forced to make further concessions later or whether any such amendments could be challenged in a bankruptcy proceeding.
  - Companies also should review and consider the effectiveness of their own contractual default and termination rights under existing contracts with major counterparties that may be in distress. The right to enforce termination rights tied to bankruptcy filings and the financial condition of the counterparty, or that require notice and waiting periods, may not be fully enforceable in a bankruptcy scenario.
- *Readiness for an Actual Bankruptcy Filing* – If a supplier or customer files for bankruptcy, it is important to be ready to react and mobilize from the start of the case in order to be best positioned throughout the process.
  - Initial Bankruptcy Relief – Most debtors signal their restructuring strategy in their first day filings, including whether they intend to reorganize, pursue a sale or liquidate their business. They also may obtain court relief to pay select creditors that could affect other creditors. Companies should monitor the debtor's filings early on and engage of counsel to position

themselves to mitigate the impact of a filing.

- o Planning for a Sale – Bidders have the right to cherry-pick assets and contracts in a bankruptcy sale process. Contracts that are taken by a buyer also have to be "cured" or be made current. It is important for companies to be proactive in best positioning their contracts to be assigned, or to be ready to oppose such an assignment if that is their preferred strategy.
- o Assumption and Rejection of Contracts – A debtor in bankruptcy has the opportunity to reject its existing contracts and leases, which leaves the counterparty with unsecured claims for damages flowing from such rejection. This tool enables a debtor to both shed unfavorable contracts and attempt to extract consensual modifications of its agreements with others. Companies should not wait to consider the risk of the loss of their contracts in a bankruptcy and/or the concessions that may be requested, as well as the strategic leverage they may have in a case as a key supplier or customer whose contracts are essential for a successful reorganization.
- o The Official Creditors' Committee – A committee is appointed at the start of each case to advocate for the interests of unsecured creditors, which is comprised of a mix of the largest unsecured creditors willing to serve and where the fees of the committee's professionals are funded by the debtor. Companies should consider serving on the committee as a way to further advance the interests of unsecured creditors in the case, including with respect to the direction of the reorganization and the treatment of unsecured claims.

- *Avoiding Hindsight Challenges* – In bankruptcy proceedings, a debtor may seek to claw back payments made to counterparties prior to filing or to extract further value through the pursuit of claims for preference (tied to counterparties having received payments or additional security outside of the ordinary course in the months prior to the bankruptcy) and fraudulent conveyance (for transactions in the years prior to the bankruptcy filing where fair value or reasonably equivalent value was not received by the debtor company at a time it was insolvent).
  - o Extra Care – Companies should take extra care when transacting with a party potentially in financial distress to ensure that transactions – particularly extraordinary transactions such as sales or acquisitions and the settlement of claims – are conducted in

good-faith, at arms-length and for reasonably equivalent value.

SEIZE THE DAY: HOW A COUNTERPARTY'S FINANCIAL DISTRESS COULD CREATE OPPORTUNITIES

In many circumstances, a key supplier or customer's financial distress is a cause for concern and defensive planning. However, in times of economic turmoil, companies should also proactively consider opportunities that may be realized from other market participants' financial distress. In particular:

- *Acquisition Opportunities* – While a company experiencing financial distress may pursue refinancings and operational restructurings as a first line strategy, to the extent such strategies do not prove successful the company may need to initiate a sale process to avoid having to turn itself over to its lenders. Other strategic players may be best positioned to act quickly in purchasing assets due to their ability to do discrete diligence and to close a transaction quickly. Companies should proactively consider whether there are opportunities for acquisitions of other market participants, and whether they can potentially initiate the process through an unsolicited offer where there may be significant first mover advantages in a fluid situation. There are significant considerations surrounding the decision whether to engage in acquisition transactions with a distressed counterparty outside of bankruptcy, as well as the strategy for pursuing acquisitions in bankruptcy auctions, where outside counsel can help companies best position themselves to succeed in their acquisition strategy.
- *Other Opportunities* – To the extent companies are unable or uninterested in acquiring assets, other opportunities may exist including the chance to move customers from a competitor to their own business, to improve their position with common suppliers and to hire key employees who are laid off or otherwise looking to move away from a failing company. Given that these situations tend to unfold over time and are very fluid, a company may realize the most opportunities by developing a strategic plan early, monitoring the situation as it unfolds and remaining nimble and flexible in reshaping their acquisition strategy as the target's financial health may deteriorate and the situation may evolve either in or outside of a formal proceeding.

SELF-MONITORING: FINANCIALLY HEALTHY COMPANIES SHOULD REMAIN ALERT AS TO POTENTIAL RISKS TO THEIR OWN BUSINESS

Even healthy companies should do their own periodic check-ups to identify potential financial and operational risks to their business and to ensure reporting and planning accounts for potential risks including market and industry changes.

It is prudent for management, with the oversight of the board, to regularly:

- Review the company's liquidity horizon and debt maturities, including to consider the expected strategy for addressing future capital needs, potential market alternatives that may provide additional liquidity or lower cost capital (such as liability management transactions) and the potential market and corporate risks that could affect the availability or cost of future capital.
- Monitor any contingent liabilities, including unasserted claims and legacy liabilities, that may affect the company's performance or result in significant financial liabilities, and consider the availability of structuring transactions that could be implemented to manage and isolate such liabilities over time.
- Refresh disclosed risk factors to include potential risks associated with industry changes, material supplier and customer risks, the existence of legacy and contingent liabilities and potential changes in the availability and cost of capital and consumer demand, among other things, as part of the preparation of public reporting.

As companies wait to see how the financial markets and industry outlook will unfold in coming months, they can take the above proactive and defensive planning steps to best position themselves to address industry distress, both to minimize its impact on their own financial health and to realize strategic opportunities as they may arise.