

RESTRUCTURING DEBT AND THE IMPACTS OF THE CURRENT HIGH INTEREST RATES – Strategies for Financial Stability Amid Economic Volatility.

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Current Trends





The Problem: *A Hypothetical Scenario of a Company's Distressed Financial Cycle in Current Economic Conditions*



The Facts:

- High Quality Manufacturing, LLC (the “Company” or “Borrower”) is a public company that manufactures office furniture and experienced double-digit growth during the pandemic by re-engineering its product for home office use, which required it to almost completely drawn-down its line of credit. Its shareholders were happy with increased distributions.
- The Company has a plant in Nashville, Tennessee and owns the real estate and improvements, which have increased in value given the growth in Nashville.
- The Company has a 15 year real estate loan with Music City Bank (the “Bank” or “Lender”) in the amount of \$15 million that was entered into in January 2020 with an interest rate of 3.24% and a balance of \$11,756,002.88, and a \$5 million line of credit with an interest rate of 2.49% that is 95% drawn (collectively, the “Loan”). The Loan is secured by all of the Company’s assets, including the real estate, improvements, FFE, inventory, and receivables.
- The double-digit growth the Company experienced during the pandemic has stopped and current sales are less than pre-pandemic sales.



Common Loan Financial Covenants:

- **Debt Service Coverage Ratio (“DSCR”):** Net operating income divided by total debt service.
- **Fixed Charge Coverage Ratio (“FCCR”):** EBITDA minus cash taxes, dividends and distributions, unfinanced capital expenditures divided by fixed charges (i.e., scheduled principal payments on Indebtedness plus interest expense).
- **Senior Funded Debt to EBITDA Ratio (“Senior Debt Ratio”):** Senior funded indebtedness divided by EBITDA.
- **Net Worth:** Assets minus liabilities, measured at a point in time. Guarantors are often subject to Minimum Net Worth requirements that are measured as provided in the loan documents, oftentimes on a monthly or quarterly basis.
- **Liquidity:** Liquid assets such as cash, marketable securities, receivables, and inventory, are measured at a given point in time. Guarantors may be subject to minimum liquidity requirements that are measured as provided, most frequently monthly or quarterly.
- **Reporting:** The Borrower and guarantors required to submit financial statements and tax returns on an annual or quarterly basis.



Company's Loan Financial Covenants

- **DSCR:** The Borrower shall maintain a DSCR of at least 1.20 to 1.00 as of the last day of each fiscal quarter measured on a trailing four quarter basis.
- **FCCR:** The Borrower shall not permit the Fixed Charge Coverage Ratio to be less than 1.20 to 1.00 as of the last day of each fiscal quarter measured on a trailing four quarter basis.
- **Senior Debt Ratio:** The Borrower shall not permit the Senior Funded Debt to EBITDA Ratio to be greater than 3.00 to 1.00 as of the last day of each fiscal quarter.
- **Net Worth:** Borrower and any Guarantor party, in the aggregate, shall maintain a Net Worth equal to or in excess of \$10,000,000 at all times during term of agreement.
- **Liquidity:** Guarantor shall maintain liquid assets having a value of not less than \$1,500,000 at all times during the term of the agreement.



Company's Financial Reporting Covenants

- **Reporting:** Borrower shall furnish to the Lender the following reporting
 - Within 120 days after the end of the fiscal year of the Borrower, audit financial statements
 - Within 45 days after the end of each fiscal quarter of the Borrower, company prepared and certified financial statements
 - With financial statements, financial covenant compliance certificates
 - Tax returns
 - Within 30 days after the end of each fiscal year of the Borrower, projections for current fiscal year
 - Within five days after knowledge thereof, written notice to Lender of, among other things, the occurrence of any default or event of default under the loan documents



The Perfect Storm (Part 1):

- Global Office Furniture (“GOF”) is the Company’s largest customer that accounts for 75% of its business and is a global online seller of office furniture, for both home and office. The re-engineering of the Company’s product for home use was driven by this customer.
- The Company and GOF have a long-term contract that has two (2) years remaining with thirty (30) day payment terms. GOF also provided the Company with a \$500,000 deposit.
- GOF always paid on time, but recently has been late in its payments and receivables associated with GOF have increased significantly and are currently at \$5,000,000.



The Perfect Storm (Part 1) *Continued* :

- The Company has continuously followed-up with GOF for payment and GOF has consistently said “the check is in the mail”. The Company recently threatened to stop manufacturing product for GOF and ten (10) days ago, GOF paid \$1,000,000 and placed a large order.
- This \$1,000,000 payment allowed the Company to make its Loan payment and the Company just avoided default.
- As a result of this payment, the Company shipped \$1,500,000 in goods to GOF to satisfy the large order, which were delivered two (2) days ago.
- Yesterday, the Company received a notice from the United States Bankruptcy Court for the District of Delaware that GOF filed for protection under the United States Bankruptcy Code (the “Bankruptcy Code”).
- The Company’s Board of Directors asked its General Counsel to provide options with respect to the bankruptcy, especially since GOF accounts for 75% of the Company’s sales and the Company cannot make its Loan payments without payment from GOF.



Automatic Stay (11 U.S.C. § 362):

- An injunction that automatically stops lawsuits, foreclosure, garnishments, and all collection activity against the debtor the moment a bankruptcy petition is filed.
- It applies to all secured and unsecured creditors and allows the trustee or debtor-in-possession to equitably proceed with reorganization or liquidation. In essence, it provides the debtor with “breathing room.”
- A creditor can gain knowledge of a stay by public record or notice of bankruptcy.
- The stay is automatically terminated when the property is no longer property of the estate.
- There are 28 policy-based exceptions to the automatic stay under 11 U.S.C. § 362(b), including criminal proceedings, regulatory cases, and acts by the government to protect public health and safety.



Automatic Stay (11 U.S.C. § 362):

- A secured creditor may file a motion to modify the stay (i.e. “lift the stay”) to get its property back where (1) there is no equity in the property and the property is not required for an effective reorganization, or (2) if there is “cause.”
- Any violation results in actual damages, including punitive damages if appropriate, plus attorney’s fees.
- It is advisable to have protocols in place in the event of a bankruptcy so that the automatic stay is not knowingly or unknowingly violated.
- Some Bankruptcy Courts will enforce a pre-bankruptcy waiver of the automatic stay, such as in a Forbearance Agreement.



Executory Contracts:

- While not defined by the Bankruptcy Code, courts have interpreted an executory contract to be a contract where there remains unperformed material obligations by both parties at the time the bankruptcy is filed.
- Executory contracts must be entered into before bankruptcy is filed.
- Bankruptcy courts apply the “Countryman” test to determine if a contract is executory. The test requires:
 - a) that performance remains due on both sides, and;
 - b) at the time of the bankruptcy filing, the failure of either party to complete performance would have constituted a material breach.
- Creditors must continue to perform under the contract regardless of prior default but the debtor must provide “adequate assurances of future performance.”
- A debtor can assume, assign, or reject executory contracts, but subject to a possible “cure” with assumption and other requirements with the assignment.
- An executory contract may not be terminated based upon a bankruptcy.



Goods Delivered Twenty Days Prior:

- Section 503(b)(9) provides administrative expense status for goods delivered twenty days prior to the filing of bankruptcy, defined as: "the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of business."
- Claims for the value of these goods are entitled to priority and are to be paid out of a bankruptcy estate in advance of general unsecured creditors – giving a "golden ticket" to the qualifying portion of the creditor's claim.
- To receive an administrative expense claim under § 503(b)(9), a supplier must demonstrate that:
 - a) the goods in question were received by the debtor within 20 days before the filing of the bankruptcy,
 - b) the goods were sold to the debtor, and
 - c) the goods were sold in the ordinary course of business.



Critical Vendor:

- A critical vendor is a vendor deemed so critical to the debtor's business operations that a failure of the vendor to provide goods or services would have a material adverse effect on the debtor's business and its ability to reorganize in bankruptcy.
- The term "critical vendor" is not defined within the Bankruptcy Code.
- A debtor is required to pay its vendors in the ordinary course of business for goods and services provided post-filing but generally is required to obtain authorization from the bankruptcy court to pay vendors for goods and services provided before the filing of the bankruptcy.
- Debtors file critical vendor motions at the beginning of the case to allow for a certain amount of funds to be used to pay the claims of critical vendors; the debtor is the party who determines which creditors are to be deemed critical.
- By signing on as a critical vendor, that vendor will get paid all or some of the outstanding pre-petition balance owed to it.
- Critical vendors are required to execute contracts with the debtor, the terms of which are oftentimes favorable to the debtor, and may be required to waive certain rights.
- Critical vendors are generally not shielded from a claim by the debtor to claw back funds paid in the period immediately preceding the filing of the bankruptcy case.



Claims:

Unsecured Claims

- An unsecured claim is a payment request to the bankruptcy estate by a creditor whose claim is not secured by a lien, mortgage or other security instrument.
- Whether the claim is secured or unsecured depends on the debt contract entered into between the debtor and the creditor.
- An unsecured claim may be a priority unsecured claim, which entitles the creditor to be paid ahead of other claimants.

Administrative Claims

- An example of priority unsecured claims; must be paid in full before general unsecured claims are paid, unless the creditors agree otherwise.
- Claims must be for goods or services that benefitted the administration of the debtor's estate to qualify for priority.
- Section 503(b) of the Bankruptcy Code enumerates three categories of administrative claims: (a) professional expenses of running the bankruptcy case, (b) business expenses for debtors operating during the bankruptcy case, and (c) additional administrative expenses including claims associated with certain taxes or certain costs incurred in the filing of an involuntary bankruptcy.



Setoff/Recoupment:

Setoff and recoupment are two distinct legal remedies can be of critical consequence in the settling of accounts between a creditor and the bankrupt debtor as they allow creditors to collect when there is a mutual debt.

Setoff

- Recognized in § 553(a) Bankruptcy Code, an equitable right of a creditor to deduct a debt it owed to the debtor from a claim it has against the debtor arising out of a separate transaction.
- To effect setoff, a creditor must file a motion seeking to lift the automatic stay; a creditor bears the burden of proving its right of setoff.

Recoupment

- A common law doctrine that is similar to setoff but requires that opposing claims arise from the same transaction; most likely to arise where the parties each owed amounts from the same transaction.
- Recoupment is merely a means used to determine the proper liability on the amounts owed and is defensive in nature.
- Not subject to the automatic stay, a creditor may pursue recoupment without filing a motion to lift the stay.



Avoidable Transfers:

- Preferential payments, or preferences, are payments made by the debtor to creditors before a bankruptcy case is filed that allows the creditor to receive more than they would have been able to recover in the bankruptcy case.
- Section 547 of the Bankruptcy Code allows a trustee or debtor-in-possession the ability to avoid, or recover, certain preferential payments or interest transfers made by the debtor in the 90 days prior to the filing of the bankruptcy petition.
- Affirmative defenses available to a creditor to reduce or eliminate preference exposure are provided in § 547(c) and include:
 - a) the subsequent new value defense;
 - b) the ordinary course of business defense; and
 - c) the contemporaneous exchange of new value defense.
- The public policy objective underlying avoidable transfers is that, in bankruptcy, similarly situated creditors should be treated equally; one creditor should not be given a preference over the others in the same class.



The Breach:

As a result of GOF's bankruptcy, the current real estate office market, and the reduction of consumers building home offices, the Company breached the following loan covenants:

- Debt Service Coverage Ratio
- Fixed Charge Coverage Ratio
- Senior Funded Debt to EBITDA Ratio
- Net Worth
- Liquidity



Summary for the Board:

After reviewing the Company's bankruptcy options with respect to GOF with the Company's General Counsel, the Board was briefed as follows:

- The Automatic Stay prohibits the Company from suing GOF to collect.
- The \$1,500,000 in goods delivered to GOF in the twenty (20) days prior to GOF's bankruptcy qualifies as administrative claims under Section 503(b)(9) of the Bankruptcy Code and will be paid during the bankruptcy plan process so long as the estate is administratively solvent.
- The Company is permitted to recoup the \$500,000 deposit without relief from the automatic stay to reduce the remaining general unsecured claim to \$3,500,000.
- The Company was denied critical vendor status because GOF has other options to purchase the furniture it needs, but at a higher cost.
- The \$1,000,000 payment may be an avoidable preference.
- GOF has not yet decided to assume or reject the contract with the Company at this time.
- The Company will need to disclose certain loan covenant violations to its lender as a result of this information.



Governance and Disclosure Reminders for Directors

The business judgment rule is the applicable standard of judicial inquiry with respect to directors' decisions, however, this standard of review is heightened in circumstances including defense against a change of control or engaging in a sale of control. In these circumstances, the "Unocal Standard" or "Revlon Test" will be applied. Where there is a conflict of interest, the "entire fairness" standard is applied.

- The business judgment rule grants deference to board decisions: directors' decisions are presumed to have been made on an informed basis, in good faith, and in the honest belief that the taken action was in the best interests of the company.
- The rule protects directors' decisions unless a plaintiff is able to carry its burden of proof in showing that a board has not met its duty of care or loyalty.
- Note that there are no "new" fiduciary duties for directors when a corporation is insolvent; directors of a company in the vicinity of insolvency should view their duties through the lens of the different beneficiaries of those fiduciary duties which, when a company is indeed insolvent, includes creditors.



Governance and Disclosure Reminders for Directors

In terms of securities law disclosure duties, every effort should be made to ensure that information required to be disclosed in reports mandated under the Securities Exchange Act of 1934 is disclosed in a timely manner.

- All material information must be disclosed, which includes all aspects of risk and risk management as well as financial reporting consequences.
- There is no bright line test for materiality: materiality depends on what a “reasonable investor” would consider the information important in making an investment decision.
- Liability can also arise if information is omitted and the omission makes a disclosure misleading. Items which are likely to be material: liquidity or solvency concerns, difficulty accessing credit, money markets, or commercial paper markets, significant counterparty risk, credit risk or concentration of risk, significant changes in assets and impairment in the value of assets, and efforts to raise capital and other related matters.



The Perfect Storm (Part 2):

- A few months after GOF filed for bankruptcy protection, the Company was notified that XYZ, Ltd. (“XYZ”), its main raw material supplier, also filed for protection under the Bankruptcy Code in Delaware and is seeking the sale of its assets to a stalking horse bidder.
- Under § 365 of the Bankruptcy Code, the Company’s main supplier is required to perform under the contract.
 - Creditors who are parties to executory contracts must continue to perform under the contract regardless of a prior default of the debtor so long as the debtor provided “adequate assurances of future performance.”



A Breath of Fresh Air:

- The Company was recently informed that GOF filed pleadings to sell substantially all of its assets to a stalking horse bidder that is seeking to assume the Company's contract, cure all defaults, and increase the amount of products it buys from the Company. The buyer is a Private Equity firm with significant assets.
- After announcing the purchase of GOF's assets, the Private Equity firm that is building an office furniture investment portfolio approached the Company about an investment.
- The Company and the Private Equity firm discussed the Private Equity firm purchasing 51% of the Company and bidding on the assets of the Company's main supplier XYZ; however, the Company needs to obtain financing for this purchase which is estimated at \$7-10 million.



“Free and Clear” Bankruptcy Sale:

- Section 363 of the Bankruptcy Code provides a procedure for the debtor-in-possession to obtain court approval to sell its assets outside of the ordinary course of business.
- The bankruptcy court has the power to approve a sale of all or a portion of its assets “free and clear” of liens, claims, interests, and encumbrances if one of the following five conditions of § 363(f) is satisfied:
 - a) The sale is permitted by non-bankruptcy law;
 - b) The party holding the interest in the property being sold consents;
 - c) If the interest is a lien, the purchase price for the property is greater than the aggregate value of all liens on the property (meaning the debtor has equity in the property);
 - d) The validity of the interest is in bona fide dispute (there must be an objective basis for dispute, not merely an allegation that a dispute exists); or
 - e) The interest can be reduced to a claim for money.
- A typical § 363 sale can occur quickly, taking as little as 60-90 days to complete.



The Plan:

In consultation with legal counsel, the Company wants to approach the Bank to disclose the covenant breaches, request a forbearance agreement, and present a plan.

The Plan:

- The Company will disclose the covenant defaults.
- The Company will request a twelve (12) month forbearance period in which it will only make interest payments on the Loan.
- During this forbearance period, the Company expects to collect all amounts from the GOF bankruptcy.
- During this forbearance period, the Company expects to sell 51% of its interest to the Private Equity for \$5 million.
- However, the Company needs \$7-\$10 million to bid on XYZ's assets in the bankruptcy sale and is asking the Bank up to \$10 million to purchase the assets with a blanket security interest in the assets.
- The Company is also asking the Bank to permit the sale of 51% of its ownership to the Private Equity firm.



Forbearance Agreement with Lender:

- Music City Bank agrees to enter into a forbearance agreement for twelve (12) months, but under the following terms:
 - Existing defaults are not waived, but lender agrees to forbear from exercising any rights against borrower or collateral during forbearance period; Lender may exercise rights following a termination event
 - Borrower pays a significant forbearance fee to the lender and interest accrues during the forbearance period at a rate of 18.00% per annum
 - Borrower ratifies and confirms the terms of the existing loan documents, and the liens and security interests previously granted to the Lender, acknowledges validity of indebtedness owing to lender, and waives and releases claims against Lender
 - The Collateral secures the repayment of the entire Indebtedness
 - Availability on the line of credit is terminated other than discretionary advances permitted by Lender and financial covenants reset for the forbearance period
 - Borrower required to hire financial consultant at borrower's expense
 - Borrower required to submit weekly 13-week cash flow statements to lender; borrower's senior executives required to attend regular lender meetings to discuss status of the business



Music City Bank:

Music City Bank proposes a \$10 million loan to purchase XYZ's assets at current rates and requires a guarantee from the Private Equity company.

- Commercial loans typically feature a repayment term between 3 and 5 years, and interest rates as low as 6.5% or as high as 18.99% (or higher) depending on the lender, loan type, relationship, and assessed risk of lending.
- Loan-to-value ratios typically fall into the 65% to 80% range.
- The corporate banking sector in general, and commercial lending specifically, faces major hurdles including regulatory scrutiny and capital demands, changing competitive landscape and consolidation, relatively high interest environment, developments in technology, geopolitical unpredictability, heightened focus on risk assessment, and threats like cybercrime and increasing customer demands, among other challenges, all leading to higher costs and operational risk.



Take Aways

- Early and transparent communication with a lender can build trust and potentially avoid transition to lender workout group
- Develop a clear understanding of operational issues and a plan to address operational issues and projections in advance of lender discussions
- Engage counsel and possibly other professionals in advance of lender discussions
- Develop a process to monitor bankruptcy cases
- Develop a process to watch potentially troubled vendors and customers



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As chair of the firm's Finance, Restructuring and Bankruptcy department, Mark Owens' practice includes business, commercial, finance, litigation, bankruptcy and creditors' rights matters valued from millions to billions of dollars. Responsive, grounded and calm under pressure, clients trust and rely upon Mark to protect their assets and interests when safeguarding their position at every turn.

Mark advises on complex workouts and loan restructurings, representing secured and unsecured creditors, creditors' committees, preference and fraudulent transfer defendants, lessors and landlords in bankruptcy cases. Mark provides legal counsel on repossessions, general collections and Uniform Commercial Code issues. He is also involved in commercial litigation in numerous courts throughout the country.





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David Hall focuses his practice in the areas of corporate finance, and business reorganization and restructuring. Having worked on numerous large and complex debt financing and restructuring transactions over the course of his career, David understands the challenges that businesses, financial institutions and their leaders encounter in virtually all matters of commercial lending, restructuring, workout and turnaround.

David's financing experience includes commercial financing, real estate and construction financing, acquisition and mezzanine financing, and state and municipal finance, including tax-exempt bond issuances. His restructuring experience includes receiverships, out-of-court restructuring transactions, turnarounds, and complex workouts across a wide variety of sectors, having represented debtors, secured creditors, asset purchasers and other parties in interest in some of the largest Chapter 11 bankruptcies in the country and the City of Detroit's historic Chapter 9 proceedings.

