



The Coronavirus and Its Likely Impact on the Bankruptcy World: Eight Predictions from Two Restructuring Professionals

Written by:

Thomas J. Salerno
Stinson, LLP; Phoenix

G. Neil Elsey
Avion Holdings, LLC; Scottsdale, Ariz.

*"I got the rockin' pneumonia and the boogie woogie flu."
Johnny Rivers, 1972*

The coronavirus known as COVID-19 was unheard of in the U.S. a scant six or seven weeks ago. Originating in Wuhan, China, it is a SARS-like virus that quickly spread first to neighboring Asian countries and, in the age of advanced mass transit, throughout a large part of the world. Today, it dominates the world press, politics and polite (and less-than-polite) conversation, and is rapidly altering the way we work, play and interact — even the way we greet one another (with “elbow bumps” being an oddly acceptable way to greet a counterpart in a business setting). It is also apparently a partisan disease in Washington, D.C., with both sides of the aisle blaming the other for its existence, a conversation that neither the virus nor the rest of the world cares about.

Our personal and professional routines are now materially impacted. Just this week, the American College of Bankruptcy announced the cancellation of its induction ceremonies in Washington, D.C., with scores of similar events being postponed or cancelled outright. Entire offices and schools are being closed. An entire country has imposed movement restrictions over its citizens (Italy's 60 million inhabitants), with large numbers of other countries implementing wide-ranging gathering-place, travel and work restrictions. Indeed, perhaps the only silver lining amid these gathering storm clouds is that some lawmakers are imposing self-quarantines, actually leading by example!

Any attempt at this stage to put a number on confirmed coronavirus cases worldwide is spurious, particularly so in the U.S., where *de minimus* distributions of testing kits have been limiting any accurate ability to properly assess the extent of the virus's spread. As a practical matter, in the time it takes between someone writing a number of confirmed cases and the electronic signal going to a printer, the tally is already out of date and inaccurate. “See you at the conference!” “Have a safe flight!” and “Going on a cruise!” have become warped punch lines.

The authors have between them nearly 60 years of restructuring experience and have weathered no less than four serious economic downturns (exclusive of the gathering economic storm). Although accompanied by the customary rumbling of thunder, this coming storm looks and feels different — more like 40 days of hard rain. Although COVID-19 is not yet a full-blown health pandemic, the resulting economic pandemic and its impact on the bankruptcy and restructuring world is, and will continue to be, very real. The authors hereby proffer the following observations and make eight predictions as to how COVID-19 will alter the restructuring landscape in both the near term (and possibly longer).

Economic Context: “The Storm Is a’Brewin’!”

The coronavirus’s impact on capital markets, supply-chain disruption, hospitality and transportation is already seismic and being compared with the “*economic shockwave*” akin to the 9/11 economic ramifications. With events being cancelled nationwide and corporations and consumers cancelling nonessential travel, the impact on hotels, air travel, ground transportation and restaurants and other service providers that serve business travelers is becoming severe. Room rates and occupancy are down across the board, and the cruise industry is taking on water at a rapid and dangerous rate, particularly after the State Department issued a travel advisory warning U.S. citizens not to travel on cruise ships. Combined with the unsettling press evoking images of floating quarantine ships and empty streets in Europe, it is hard to imagine a more dismal outlook in that space.

Disruption in manufacturing, imports, exports and capital markets had already occurred due to the virus necessitating the closure of manufacturing plants and the trade wars having previously interrupted the flow of goods and services. For all of you anxiously awaiting the latest release of the new (and improved!) iPhones, that has now been delayed for several months. Larger companies and their downstream suppliers and manufacturers are all experiencing material drops in cash flow. The U.S. has propelled its growth on the backs of tax cuts, deficit and cheap money. Not surprisingly, many businesses are highly leveraged, and with cash flows shrinking, this debt will materially hinder their ability to reposition and restructure. This is being reacted to in the capital markets, which loathe uncertainty, and this pandemic dishes up uncertainty in super-sized portions. In truth, we don’t even know what we don’t know yet. *Credit has already started to tighten, and credit will continue to tighten for all the reasons discussed below.*

Add to the all-too-close thunder the lightning of the oil production supply and price war going on between Russia, Saudi Arabia and the rest of the world. This has now resulted in *oil prices dropping 30% overnight* to \$31 a barrel as of the date of this writing. On top of an existing surplus of 3.5 million barrels a day, in one chaotic day Saudi Arabia lowered its price of oil by \$10/barrel *and* announced an increase in production of 2 million barrels a day! While this is perhaps good news for the consumer looking to fill their Ford F-150 without taking out a second mortgage, this gambit is about destroying U.S. dominance in the oil-export industry. This is not about a squabble between two countries; it is squarely aimed at crippling U.S. shale producers who have propelled the U.S. to record exports, earning the country the title of largest oil producer in the world. Indeed, many smaller oil companies have busted their oil price loan covenants and are now in default. Even if there ultimately is a truce among producers and prices rise, credit will move away from the risk and depress the market for a long time.

The virus might not peak until summer, blanketing sentiment for the rest of the year. Except for cash, there really is no place to hide.

PREDICTION NUMBER ONE: This will come as a shock to absolutely no one who has a pulse: The authors see *a new wave of restructurings* in the energy, hospitality, transportation, manufacturing and retail industry spaces. About the only upside will be the pharmaceutical companies and health care industries as they kick into overdrive to deal with the pandemic, certainly in the short term. The bankruptcy filings and issues will hit all sides of any business relationship: companies, their customers, banks/secured lenders, vendors, landlords, insurance companies and employees (not to mention the impact on the equity value of these newly distressed enterprises).

PREDICTION NUMBER TWO: In a reflexive reaction, *credit will tighten*, thereby further impacting already-tenuous cash flows and the ability to access financing. The Sovereign Central Banks (such as the Federal Reserve, the European Central Bank and others) will attempt to stem the flow of red ink and systemic credit defaults, and will try to respond to both the virus (and its costs) and the economic stress it is creating. There will be recessions in several countries, and these countries will be in need of credit help.

Downstream vendors, manufacturers and suppliers will be especially strained by reduced cash flow and the credit vacuum, making reductions in the workforce inevitable. Accordingly, transferred pressure on the consumer will lower consumption and spending. The flight of capital to safe harbors like U.S. Treasuries has brought the yield curve on 3-month, 10-year and 30-year T-bills to under 1% on all three for the first time in history. The big banks have risk, but not as much as private-equity firms, which have done most of the major highly leveraged transactions in the last 10 years. Banks will tighten credit, and private equity, in an effort to unload, will have many discounted asset sales and bankruptcies. Pension plans that are already underfunded and under pressure will find their assets (and returns on those assets) increasingly inadequate to fund their obligations.

The Federal Reserve will not have much room to help until the virus situation subsides, because it might be tantamount to pouring stimulus down the drain. The only effective thing the Fed can do is load up on assets in an effort to help, but rate cuts, while politically expedient, will not be an effective long-term solution. The FDIC may react by giving banks more room to work out longer-term solutions to loan problems. Real estate CMBS loans have a mountain of maturities coming due this year and in 2021 and 2022 because of originations made in the past seven years. They will tighten and restrict the flow of upstreaming debt, thereby affecting originations.

PREDICTION NUMBER THREE: Dust off your *Black's Law Dictionary*! Distressed companies can be expected to invoke *force majeure clauses* to argue that they are not really in “default” as they defend collection actions and ultimately access bankruptcy proceedings. While this is a nice parlor game for lawyers, this sideshow will do little to address the larger economic issues of declining cash flows and asset valuations (discussed in Prediction Number Seven, below), which will persist and put pressure on continued operations and reorganizations (in or out of bankruptcy).

PREDICTION NUMBER FOUR: *Bankruptcy courts will be more lenient with debtors* due to this unforeseen worldwide phenomena (again, like the 9/11 response), which will translate into more delays in the bankruptcy process for creditors, landlords and others. Courts are likely to give debtors the benefit of the doubt, given the economic forces out of their control, for a little longer than in traditional cases. That said, this will only last so long and will do little to address the overall economic issues. In fact, it will continue to highlight an additional hurdle to the free flow of commerce, inject added costs, and promise a long slog out of the quagmire. It will also increase the professional and related fee burdens on bankruptcy estates.

PREDICTION NUMBER FIVE: On a purely administrative front, court administration will likely change as well. *Bankruptcy courts will allow for more telephonic appearances in matters* in order to attempt to minimize community coronavirus transmission, which will have the double-edged potential impact of further distressing the airline/hotel/restaurant sectors while at the same time cutting some costs for clients in the bankruptcy process. Nothing like the specter of 50 masked creditors and lawyers in a courtroom; Zorro would find comfort in it! This will also make access to perceived debtor-friendly havens such as the Southern District of New York and District of Delaware even more attractive. “Phoning it in” will take on a whole new meaning!

PREDICTION NUMBER SIX: In adversity, there is opportunity — hence, as in the 9/11 and 2008 financial market meltdowns, *there will be more opportunistic acquirers of assets/companies* circling (sometimes called “vulture investors”). Bankruptcy creates a unique vehicle to acquire assets free and clear of liens and adverse interests as well. Unlike the 2008 meltdown of capital markets, however, it is likely that some cash-heavy funds, preying on the discounted asset values, will put their cash into distressed assets. The foregoing notwithstanding, many of those funds will spend considerable resources and time on rearranging their current assets and may be slow to invest until their own houses are in order, resulting in a limbo, “zombie”-like period. These delays may prove helpful to distressed companies as they wait patiently for the cavalry to arrive with their money and solutions.

PREDICTION NUMBER SEVEN: Given further restrictions on cash flows and liquidity, there will be (certainly in the near term) a *depressing of values* (based on discounted cash flow valuations). This will impact LTV and trigger other covenant defaults, certainly for the short term. This also will have an additional overlay issue for lenders that need to “mark to market” on collateral valuations, which may have ripple effects (such as regulatory issues). In addition, this will impact sales of assets in bankruptcy cases (as the vulture investors continue to circle), as well as cramdown dynamics.

PREDICTION NUMBER EIGHT: Watch for law firms, financial advisors, accounting firms and other restructuring professionals to establish *multi-disciplinary “task forces”* in order to have coordinated and rapid responses to clients and potential clients in a proactive move to deal with the myriad legal and economic issues attendant to the pandemic. Once again, in adversity there is opportunity.

As we all undeniably live in ‘interesting’ times on many fronts, it remains to be seen whether these predictions are a mirage on the edge of a storm or are accurate. Even if a vaccine appears within the next quarter, the 40 days of rain are already upon us, and the resulting consequences will not be magically cured.

Let the soothsaying begin!